

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:

**WORLDCOM, INC., et al.,
Debtors.**

§ Chapter 11
§
§ Case No. 02-13533 (AJG)
§
§ Jointly Administered
§
§

**THIRD AND FINAL REPORT OF DICK THORNBURGH,
BANKRUPTCY COURT EXAMINER**

January 26, 2004

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I. INTRODUCTION

On July 21, 2002, roughly five weeks after WorldCom, Inc. (“WorldCom” or the “Company”) publicly announced significant accounting irregularities that would require initial adjustments to its financial statements totaling approximately \$3.8 billion, the Company filed petitions for protection under Chapter 11 of the United States Bankruptcy Code. It was the largest bankruptcy proceeding in U.S. history.

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 Court prescribed a broad mandate for the Examiner’s investigation, directing that the Examiner “shall investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the arrangement of the affairs of [WorldCom] by current or former management, including but not limited to issues of accounting irregularities.” The Court directed the Examiner to file a report of examination within 90 days of his appointment.

In the weeks immediately following the Company’s bankruptcy filings, additional improprieties were revealed at WorldCom. This resulted in an additional proposed restatement of the Company’s financial statements totaling approximately \$3.3 billion in August 2002. Moreover, felony charges were filed against certain of the Company’s former senior accounting and finance personnel and four such persons pled guilty to these charges. After only a preliminary investigation, it became clear that the WorldCom story involved much more than the facts and circumstances directly tied to the Company’s accounting irregularities. Given this situation, it was not possible for the Examiner to conduct a

thorough investigation regarding the matters specified in the July 22 and August 6, 2002 Orders of the Bankruptcy Court within the time period initially set by the Court.

Accordingly, on November 4, 2002, the Examiner filed a First Interim Report in accordance with the 90-day time period established by the Court. The First Interim Report included preliminary observations about the conduct of WorldCom's former Management, its former Board of Directors and service providers to the Company, and identified numerous areas where additional investigation needed to be pursued. In deference to various governmental investigations and pending prosecutions related to WorldCom's accounting irregularities, the Examiner addressed such irregularities only summarily in the First Interim Report.

Following the issuance of the First Interim Report, the Examiner continued his investigation. Additional issues that were within the mandate of the Court's July 22 and August 6 Orders were identified and the Examiner determined that it was appropriate to file another interim report. Thus, on June 9, 2003, the Examiner filed his Second Interim Report. The principal focus of the Second Interim Report was on WorldCom's system of corporate governance, which the Examiner defined as "the system by which WorldCom was managed and controlled, the means by which WorldCom determined its objectives and performance, and the methods by which it promoted its transparency and accountability." Second Interim Report at 3. The Examiner observed that WorldCom suffered a virtually complete breakdown of proper corporate governance and that nearly every level of "gatekeeper" at the Company was derelict to some degree. Id.

Subsequent to June 9, 2003, the Examiner continued and completed his investigation. In this Third and Final Report, the Examiner reports on numerous matters, including some

that were not finalized in previous Reports.¹ These matters include: (i) WorldCom's dealings with investment bankers, particularly Salomon Brothers, Inc. ("Salomon") and its successor, Salomon Smith Barney ("SSB");² (ii) the Company's loans to its former Chief Executive Officer ("CEO"), Bernard Ebbers; (iii) the responsibility for the Company's fraudulent accounting, focused primarily on the work performed by the Company's former outside auditor, Arthur Andersen LLP ("Arthur Andersen"); (iv) the acquisition of Intermedia Communications, Inc. ("Intermedia"); and (v) the Tracker stocks.

The Examiner also reports on an issue that was not addressed in his earlier reports, namely WorldCom's state tax minimization program. This program, which began in 1998, is yet another example of the Company converting what could be legitimate into something that appears improper as a result of its aggressive design and implementation. With respect to the state tax minimization program, WorldCom likely avoided paying hundreds of millions of dollars in state taxes in 1998-2001 based upon the accrual of over \$20 billion in questionable royalty charges. The cornerstone of this program, which was designed by KPMG Peat Marwick LLP ("KPMG"), was the classification of the "foresight of top management" ("management foresight") as an intangible asset, which the parent company could license to the subsidiaries in return for massive royalty charges. As discussed below and in Chapter IV, the Examiner believes that "management foresight" is not an intangible asset that could support the royalty charges and that there are other flaws as well in the WorldCom state tax

¹ It should be noted that the Examiner's Reports are the work product of the Examiner and are intended to fulfill his responsibilities under the Court's Orders of July 22 and August 6, 2002. Accordingly, the Examiner's Reports should not be used in any other proceeding and the statements and information contained in the Reports should not be viewed as an admission by any person or findings by any other person or entity.

² SSB now has been succeeded by Citigroup Global Markets Inc. ("CGM"). Nonetheless, for most purposes in this Third and Final Report, the Examiner refers to the two predecessor entities, Salomon and SSB.

minimization program. As a result, the accrued royalties, and the substantial state tax savings created thereby, are vulnerable to attack by state taxing authorities.

The Examiner believes that WorldCom has causes of action against a number of persons and entities that bear responsibility for WorldCom's injuries. The potential claims identified by the Examiner are briefly summarized as follows:

- Claims for malpractice and negligence against KPMG to recover any interest and/or penalties paid by the Company to any state taxing authorities based upon the flawed advice KPMG provided to WorldCom in connection with the state tax minimization program. The Company may also have claims to require KPMG to return the millions of dollars in fees paid to KPMG for its flawed advice.
- Claims for breaches of the fiduciary duties of loyalty and good faith against Mr. Ebbers for awarding investment banking business to Salomon and SSB in return for lucrative financial favors, including extraordinary allocations of shares in initial public offerings ("IPO's") from 1996 until August 2000 and extraordinary loan assistance in 2000-2002. The Examiner also believes that the Company has claims against Salomon and SSB for aiding and abetting Mr. Ebbers' breaches of his fiduciary duties.
- Claims for breaches of the fiduciary duties of loyalty and good faith against Mr. Ebbers for accepting more than \$400 million in loans from WorldCom at non-commercial interest rates and for accepting loans without disclosing his inability to repay them. The Examiner also believes that WorldCom has claims against the remaining former Directors for their breaches of their duties of care and loyalty in connection with such loans.³ WorldCom also has a claim against Mr. Ebbers for breach of his April 30, 2002 Severance Agreement.
- Claims for fraud and breaches of the fiduciary duties of loyalty and good faith against former Chief Financial Officer ("CFO") Scott Sullivan and those other former WorldCom employees who have pled guilty to crimes related to the Company's accounting irregularities.⁴ In addition, claims related to the accounting irregularities may exist against other former WorldCom personnel, including Mr. Ebbers.

³ The former Directors are Clifford L. Alexander, Jr., James C. Allen, Judith Areen, Carl J. Agcock, Max E. Bobbitt, Francesco Galesi, Stiles A. Kellett, Jr., Gordon S. Macklin, Bert C. Roberts, Jr., the late John W. Sidgmore, and Scott D. Sullivan.

⁴ The former WorldCom employees who pled guilty are Controller David Myers, Director of General Accounting Buford Yates, and Betty Vinson and Troy Normand, direct reports to Mr. Yates in the General Accounting group.

- Claims for accounting malpractice or negligence and breach of contract against Arthur Andersen and certain of its former personnel based upon their failure to satisfy professional standards in their audits of WorldCom's financial statements for audit years 1999 through 2001.
- Claims for breaches of the fiduciary duties of loyalty and good faith against Messrs. Ebbers and Sullivan for causing WorldCom to proceed with the Intermedia merger amendment in February 2001 without proper authorization by the Company's Board of Directors. The Examiner also believes that WorldCom has claims against all other former Directors⁵ who later voted in favor of the Intermedia transaction for breaches of their fiduciary duty of care, based upon their failure to investigate whether to proceed with the Intermedia merger amendment and their failure to confront Messrs. Ebbers and Sullivan for authorizing the Intermedia merger amendment without Board approval.

The Examiner recognizes that the WorldCom plan of reorganization assigns any such claims to WorldCom and that the Company may have valid reasons, in exercising its business judgment, not to pursue particular potential claims, such as the inability to pay by certain defendants, the costs of litigation weighed against potential recovery, the presence of shareholder suits, or the strength of a particular claim.⁶ The Examiner expresses no opinion whether any of the claims actually should be pursued. Rather, the Examiner views it as his responsibility to identify potential claims and to leave it to the Company to decide which, if any, of the claims to pursue.⁷ To assist this evaluation process, the Examiner also is providing additional analysis regarding the legal standards applicable to certain of such potential claims, possible defenses and related considerations. See Appendix A ("Legal

⁵ The former Directors are the same as listed in footnote 3, less Mr. Sullivan.

⁶ Conversely, the Company may decide that it wishes to pursue claims not recommended by the Examiner.

⁷ The Examiner does not believe that every instance of wrongdoing identified in his Reports gives rise to a potential cause of action on behalf of WorldCom. Instead, the Examiner has identified the potential causes of action that the Examiner, after reviewing the applicable facts and law, believes would most likely survive motions to dismiss or for summary judgment and reach a fact-finder if presented in a lawsuit. The Examiner has sought to avoid discussing potential causes of action that the Examiner believes bear a significant risk of being dismissed as a matter of law.

Standards Relating to Corporate Governance”) and Appendix B (“Imputation Defenses -- Standing and in Pari Delicto”).

II. PROCESS OF EXAMINATION

Upon his appointment, the Examiner engaged Kirkpatrick & Lockhart LLP as his legal counsel and J.H. Cohn LLP as his forensic accountants and set out to marshal the massive factual data related to the conduct of WorldCom's Management, Board of Directors and service providers prior to the Company's bankruptcy filings. This examination process has been described by the Examiner in the First and Second Interim Reports and will not be repeated in this Third and Final Report.

Since the filing of the Second Interim Report on June 9, 2003, the Examiner has continued the review and analysis of millions of pages of documents and the interviews of dozens of persons knowledgeable about the issues under investigation.⁸ Consistent with the Court's initial Orders regarding his examination, the Examiner has continued to coordinate his activities with the United States Department of Justice, the United States Securities and Exchange Commission ("SEC") and other federal agencies investigating or prosecuting matters related to WorldCom, in an effort to promote efficiency and avoid unnecessary duplication of effort. The Examiner acknowledges again with deep appreciation the extensive cooperation of these government agencies. The Examiner also acknowledges the continued cooperation of the Honorable Richard C. Breeden, the Corporate Monitor appointed in connection with an action commenced against WorldCom by the SEC in the United States District Court for the Southern District of New York.

⁸ Altogether, the Examiner interviewed 49 present and former Company employees and Directors, 11 present and former Salomon/SSB personnel, 6 former Arthur Andersen personnel, 5 present and former KPMG personnel and 9 other persons with knowledge of relevant matters. Many of these persons were interviewed several times. In addition, the Examiner was present at and participated in 62 interviews conducted by counsel for the Special Investigative Committee of WorldCom's Board of Directors.

The Examiner further notes the following with respect to the process of examination since the Second Interim Report was filed with the Court. First, the level of cooperation by WorldCom and its personnel has continued to be very good, with the exception of the Examiner's investigation of WorldCom's state tax minimization program.⁹ The Company's cooperation in that endeavor has not been satisfactory. The Company was slow in producing documents and arranging for interviews of current and former Company personnel and did not produce certain documents requested by the Examiner. In addition, KPMG delayed sharing information with the Examiner, making it all the more difficult for the Examiner to pursue this area of investigation. The Company's limited cooperation in this area was a significant factor in the delay of issuance of this Third and Final Report and resulted in additional costs in the investigation. Ultimately, the Examiner believes that he gained access to all necessary information pertaining to the state tax minimization program.

Second, subsequent to the Second Interim Report, the Examiner focused his investigation more extensively on third-party suppliers of professional services to WorldCom, primarily Salomon/SSB, Arthur Andersen, and KPMG. On numerous occasions, the Examiner encountered significant difficulties in arranging for the timely production of documents by these third-party service providers and in arranging interviews with their present and former personnel. The Examiner identifies certain of these difficulties in the body of this Third and Final Report. The Examiner notes that these tactics and responses by

⁹ The Examiner notes that in the aftermath of the filing of the Second Interim Report on June 9, 2003, the Examiner was unable to conduct interviews of Company personnel for approximately 50 days. After the resignations of several senior Company officers shortly after publication of the Second Interim Report, a number of current and former WorldCom personnel whom the Examiner wished to interview decided to engage personal counsel prior to their interviews. That process necessarily took some time, resulting in the delay of many interviews until August 2003. Once the interviews resumed in August 2003, the Examiner was able to complete his investigations and the witnesses, while somewhat more guarded than witnesses interviewed before June 9, 2003, provided the information that the Examiner needed in connection with his work.

third-party service providers or their counsel contributed to a more lengthy and, ultimately, more costly investigation than would have been required if cooperation had been more forthcoming.

Third, the Examiner observes that his investigation has continued to be limited by deference to pending governmental investigations and prosecutions and the inaccessibility of certain persons with valuable knowledge and insight regarding the matters under investigation. In particular, as previously observed, the Examiner has lacked access to Messrs. Ebbers and Sullivan, as well as the former WorldCom employees who pled guilty to fraud. This is unavoidable, given pending investigations and prosecutions, but it also leaves something of a void in the “record” of the Examiner’s investigation.

Notwithstanding such difficulties and limitations, the Examiner believes that he has an adequate and sufficiently comprehensive record to conclude his investigation. As probably is the case in any investigation by a bankruptcy court examiner, and certainly in one of this magnitude, there always are other leads that could be followed and additional persons who could be interviewed. The Examiner used his judgment to report on the matters that appeared most significant and relevant to these proceedings. Based upon the review of substantial data, the Examiner believes he is in a position to reach informed and sound conclusions and to complete his investigation consistent with the Court’s July 22 and August 6, 2002 Orders.

Finally, the Examiner deems it appropriate in this Third and Final Report to observe that it is not just the entities, like Kirkpatrick & Lockhart LLP and J.H. Cohn LLP, who have supported and contributed to this effort. Rather, it is the individual partners, associates, legal assistants, accountants and staffers of these entities who have made it possible to conduct a

wide-ranging investigation and to prepare three Reports on this massive bankruptcy in a relatively short period of time. Many individuals worked tirelessly and with significant personal sacrifice to conduct this investigation and to compile the Examiner's Reports. The Examiner cannot possibly identify all those supporting staffers and professionals who contributed to this effort, but they all have his deepest gratitude, appreciation and respect.

III. SUMMARY OF FINDINGS AND POTENTIAL CLAIMS AND OBSERVATIONS ABOUT THE WORLDCOM EXAMINATION PROCESS

A. Summary of Findings and Potential Claims

The WorldCom story is not limited to the mammoth accounting fraud that has been publicly reported. The complete WorldCom story involves a Company that did not have the requisite controls and gatekeepers to ensure full compliance with the law and corporate governance principles. This Third and Final Report builds and expands upon that story. The Examiner sets forth his detailed findings and recommendations in Chapters IV-IX of this Third and Final Report. Those findings and recommendations may be summarized as follows:

WorldCom's State Tax Minimization Programs

- The Examiner has investigated two WorldCom programs, one implemented in 1998 and the second in 1999, by which WorldCom sought, among other things, to minimize the taxes that it would need to pay to state tax authorities. The Examiner observes that there is nothing wrong with a company pursuing strategies designed to minimize taxes, so long as they are properly structured and implemented. In this instance, however, one aspect of the WorldCom state tax minimization programs, WorldCom's intangible asset royalty program, was highly aggressive and is seriously vulnerable to state challenge. Indeed, many states already have threatened to pursue WorldCom for at least back taxes. To the extent that states are successful, WorldCom may owe not only back taxes, but most likely interest and penalties as well. The interest and penalties alone could amount to hundreds of millions of dollars.
- By early 1997, WorldCom recognized the need to realign its corporate structure, given its rapid growth via acquisitions over the prior eight or more years. WorldCom engaged KPMG to advise on the restructuring. KPMG, in turn, advised WorldCom that as part of the overall restructuring, it could adopt an intangible asset transfer pricing program that would provide significant state tax savings.
- In a transfer pricing transaction, i.e., a transaction between two affiliated entities, WorldCom would license certain intangible assets to its subsidiaries, which would

be charged a royalty in return for the use of the intangible assets. The subsidiaries would count the royalty charges as an ordinary and necessary business expense that was deductible for state tax purposes. WorldCom would be lightly taxed on the royalty income it received from the subsidiaries due to the favorable tax treatment of royalty income by the states in which WorldCom was subject to income taxes.

- WorldCom licensed to its subsidiaries various standard types of intangible assets, such as trademarks and trade names. These standard intangibles, however, accounted for only a small fraction of the royalties charged by WorldCom to the subsidiaries. Significantly, however, KPMG advised WorldCom that it possessed an unusual type of intangible asset — “the foresight of top Management” (“management foresight”) — that would account for the vast majority of the more than \$20 billion in royalties that the subsidiaries accrued to WorldCom from January 1, 1998 through 2001. Such “management foresight” has been defined by the Company and KPMG to the Examiner in various ways. Essentially, it appears to be former Management’s “strategy” to provide customers “end-to-end bundled services over a global network”
- “Management foresight” could support royalty charges only if it constituted an actual intangible asset, which could be commercially transferred to a third party. The Examiner has identified no persuasive legal authority for the proposition that “management foresight” constituted an actual intangible asset for licensing purposes. Further, even if “management foresight” is an actual intangible asset, the Examiner can discern no means by which the purported “management foresight” intangible asset of WorldCom could be commercially transferred to third parties. The Examiner invited the Company and KPMG to explain how such a transfer could occur, but neither provided a rational explanation.
- Regulations issued pursuant to Section 482 of the Internal Revenue Code identify intangible assets, such as patents, trademarks and similar items. “Management foresight” is not among the assets listed in the federal tax regulations, nor is it similar to any of the listed assets.
- The “management foresight” identified by KPMG as a purported intangible asset appears to have been nothing more than former Management’s vision to create a horizontally and vertically integrated corporate structure to provide a full range of Telecom services to its customers. However, the United States Claims Court has rejected the proposition that an intangible asset capable of being licensed is created in such a circumstance. Merck & Co., Inc. v. United States, 24 Ct. Cl. 73, 87-88 (1991).
- WorldCom prepared applications for favorable tax treatment of these programs that were filed with the tax authorities in both Mississippi and the District of Columbia. KPMG prepared the first drafts of both applications. However, instead of explicitly disclosing that the cornerstone of the programs was the classification of “management foresight” as an intangible asset, the applications

indicated that the royalty income would be the result of the licensing of traditional intellectual property, such as trademarks, trade names and service names and other unspecified intangible assets. The state tax authorities approved these applications based on these disclosures, which the Examiner finds to have been misleading.

- The intangible asset royalty programs may be of further questionable validity because they may be found to lack economic substance. The royalties charged during 1998-2001 were greater than \$20 billion, which far exceeded WorldCom's consolidated net income during that period. Moreover, only a handful of subsidiaries were charged the bulk of the \$20 billion. The royalty charges often represented a huge percentage (some as much as 80 to 90 percent) of these subsidiaries' net income. The WorldCom tax department also treated the royalty programs more like "paper" transactions and even increased the royalty charges in 2001 without seeking any corporate approvals, in direct violation of the legal documents that governed the royalty programs.
- Further, the legal documents that were intended to license the "management foresight" intangible asset to the subsidiaries did not do so. The licensing documents licensed only confidential and proprietary intangible assets. WorldCom's "management foresight" was not confidential or proprietary. For example, the Company gave details in numerous public filings, such as its Annual Reports on Form 10-K, of its "strategy" for providing its customers "end-to-end bundled service over a global network"
- To the extent that state taxing authorities bring actions and prevail, the Examiner believes that WorldCom has claims against KPMG. First, the Company could allege that KPMG was negligent in proposing the highly aggressive intangible asset royalty programs. Second, the Company may point to KPMG's failure to warn the Company that certain of its conclusions were highly aggressive and subject to challenge. Third, under its 1997 engagement letter with the Company, KPMG agreed to return fees it received if its tax advice proved incorrect. KPMG's fees for the 1998 restructuring amounted to at least \$6 million and its fees for the 1999 restructuring amounted to at least \$3.2 million.
- KPMG may be able to defend against some, but likely not all, of any such Company claims on the basis that the Company failed to follow some of KPMG's advice in implementing the programs. For example, KPMG recommended that the WorldCom subsidiaries actually pay the royalties to the Company. The royalties, however, were merely accrued. Similarly, an integral part of the KPMG advice was that the costs to market and advertise the licensed intangibles, including "management foresight," be borne by the Company, not the subsidiaries to which the intangibles were licensed. However, the subsidiaries in the end bore the entire marketing and advertising costs.

Investment Banking

- The Examiner observed in the First Interim Report that WorldCom used Salomon and then SSB far more frequently than any other investment bankers, paying Salomon/SSB fees of over \$100 million between mid-1996 and early 2002. The Examiner has investigated how this relationship developed and grew.
- Mr. Ebbers dominated the selection of the investment bankers used by WorldCom. From 1988 until mid-1996, WorldCom used only one investment banker, The Breckenridge Group (“Breckenridge”), an Atlanta-based firm. Thus, over the years, Breckenridge handled 11 WorldCom acquisitions, including three that closed in 1995.
- Starting no later than August 1994, Salomon sought investment banking work from WorldCom. Thereafter, particularly in 1995 and the first six months of 1996, Salomon investment bankers, sometimes assisted by Salomon Telecom research analyst Jack Grubman, made repeated unsuccessful pitches for WorldCom investment banking work. In August 1996, however, Mr. Ebbers personally engaged Salomon to be WorldCom’s banker on its merger with MFS Communications Company, Inc. (“MFS”), at a fee of \$7.5 million. Subsequent to the MFS merger, WorldCom engaged Salomon, and then SSB, on virtually every merger and acquisition, equity and financing transaction for which it was eligible.
- The Examiner concludes that a material reason for the success of Salomon/SSB in garnering WorldCom investment banking business was that Salomon/SSB repeatedly provided Mr. Ebbers with enormous allocations of IPO and secondary offering shares, on which Mr. Ebbers had gross profits of more than \$12 million.
- The initial MFS engagement of Salomon by WorldCom in August 1996 took place only two months after the first IPO allocation to Mr. Ebbers on June 10, 1996. It appears to be the first opportunity WorldCom had to retain an investment banker since the initial Salomon IPO allocation to Mr. Ebbers. Thus, on June 10, 1996, Salomon allocated to Mr. Ebbers 200,000 shares in the McLeod, Inc. (“McLeod”) IPO. Mr. Ebbers invested \$4 million and realized profits of \$2.115 million when he sold the shares approximately 4 months later. Mr. Ebbers had not even been a Salomon brokerage customer before the McLeod IPO, and yet he received by far the largest allocation among all Salomon retail customers. The next largest allocation to a retail investor was 47,500 shares. Indeed, Mr. Ebbers’ allocation of McLeod shares was the third largest of any investor, exceeded only by two large institutional investors, one of which was Fidelity Investments, the largest mutual fund complex in the United States. This allocation to Mr. Ebbers is all the more suspect since the McLeod IPO was heavily oversubscribed. Investors indicated an interest in 110 million shares, but only 10 million shares were available in the IPO.
- The evidence supports the conclusion that Mr. Ebbers received his huge McLeod allocation, at least in part, because the large allocation made it more likely that

Mr. Ebberts would award Salomon investment banking work. As noted, Salomon was engaged as WorldCom's investment banker on the MFS transaction just two months after the McLeod IPO.

- Mr. Ebberts continued to receive IPO and secondary offering shares from Salomon after June 1996. Certain of the allocations, similar to the McLeod IPO, were notable for their size:

<u>Name</u>	<u>Date</u>	<u># Shares</u>	<u>Profit</u>
McLeod Secondary Offering	11/15/96	89,286	\$390,172
Qwest	6/23/97	205,000	\$1,957,475
Nextlink	9/26/97	200,000	\$1,829,475
Metromedia	10/28/97	100,000	\$4,558,711

- At the same time that Mr. Ebberts was receiving these massive IPO allocations, WorldCom was awarding significant investment banking work to Salomon. Thus, in March 1997, Salomon acted as lead manager on a \$2 billion WorldCom debt offering, receiving over \$8 million in fees. In the summer of 1997, Salomon was engaged to be WorldCom's banker on the MCI merger, eventually receiving \$32.5 million in fees and an additional \$15.8 million as the lead underwriter on a related debt offering.
- The IPO allocations to Mr. Ebberts continued after the Salomon-Smith Barney merger in November 1997. The allocations after 1997 were smaller, apparently because SSB enacted a policy which sought to prevent the award of large IPO allocations to retail investors who could provide investment banking business to SSB. Still, Mr. Ebberts regularly commanded among the highest allocations of all SSB retail clients.
- SSB has sought to justify the huge allocations made to Mr. Ebberts on the basis that he was one of Salomon/SSB's "best" retail clients. The Examiner rejects that explanation. Mr. Ebberts was not even a Salomon retail client at all before the McLeod IPO. Subsequent to that IPO, Mr. Ebberts did maintain a Salomon/SSB account, but he never engaged in any trading in his Salomon/SSB account, except for buying and selling the lucrative IPO's. Thus, Mr. Ebberts not only was not among the "best" retail customers of Salomon/SSB, he was no customer at all outside of his receipt of disproportionate amounts of lucrative IPO and secondary offering shares.

- No person with whom the Examiner spoke admitted that the purpose of the IPO allocations to Mr. Ebberts was to obtain investment banking business. However, present and former Salomon/SSB personnel presented no other rational explanation. Thus, the circumstantial evidence regarding these IPO allocations is compelling and persuasive. It points to the conclusion that a significant factor in Mr. Ebberts' award of WorldCom's investment banking business to Salomon/SSB was the receipt of millions of dollars in personal financial favors. This constituted a breach of the fiduciary duties of loyalty and good faith by Mr. Ebberts, and the evidence supports the conclusion that Salomon/SSB knowingly aided and abetted those breaches.
- The SSB IPO allocations to Mr. Ebberts ceased in August 2000, apparently because Mr. Ebberts was financially unable to continue such purchases due to the margin loan pressure he was facing from his lenders. While the IPO allocations ended, SSB's financial favors to Mr. Ebberts did not cease.
- By the summer of 2000, Mr. Ebberts faced increasing pressure from various lenders. He had borrowed heavily to pay for certain personal investments, securing those loans with his WorldCom stock. As WorldCom's stock price dropped, Mr. Ebberts' lenders demanded more collateral. When Mr. Ebberts was unable to post additional collateral for a Bank of America margin call in late September 2000, Mr. Ebberts entered into a forward sale of 3 million shares of WorldCom stock to meet the margin call.
- The margin pressure on Mr. Ebberts did not end with his September 2000 stock sale. In October 2000, Mr. Ebberts faced more margin calls and he turned to SSB for help. SSB responded with unprecedented financial assistance in less than two weeks. SSB persuaded Citicorp USA, Inc. ("Citibank"), an SSB affiliate, not to sell any of Mr. Ebberts' stock securing its \$40+ million loan to Mr. Ebberts. SSB also persuaded Citibank to take over an \$11 million loan to Mr. Ebberts by Morgan Keegan. SSB then guaranteed to Citibank that it would have no risk of loss on the loan that had now grown to approximately \$53 million.
- The Examiner found no evidence that SSB provided similar financial assistance to any other retail brokerage customer. No SSB person interviewed by the Examiner could recall similar help to any brokerage client. The assistance required approvals from at least the highest levels of SSB, including its CEO and the head of investment banking.
- The SSB financial assistance to Mr. Ebberts continued until Mr. Ebberts stepped down as WorldCom's CEO at the end of April 2002. Within a week thereafter, when Mr. Ebberts no longer was in a position to direct the award of WorldCom's investment banking business, SSB sold all of Mr. Ebberts' WorldCom stock that had been pledged to secure his SSB/Citibank borrowings. Because the stock was not sufficient collateral for the loan, SSB suffered a loss of approximately \$2 million.

- The Examiner concludes that SSB allocated IPO shares and provided financial assistance to Mr. Ebbers because he was in a position to award, and did award, substantial investment banking business to SSB. The Examiner believes that Mr. Ebbers breached his fiduciary duties of loyalty and good faith by putting his personal interests ahead of those of the Company. The Examiner also believes that SSB aided and abetted those breaches.
- As a result of these breaches of fiduciary duties, the Company has claims against Mr. Ebbers and SSB. Indeed, SSB is jointly and severally liable along with Mr. Ebbers for these breaches. The recoveries could include return of the compensation paid to Mr. Ebbers during the period of his disloyalty, disgorgement of the IPO profits realized by Mr. Ebbers and disgorgement of the fees WorldCom paid to Salomon/SSB.

WorldCom Loans to Bernard Ebbers

- The Examiner reported in the First and Second Interim Reports about the loans and guaranty made by the Company to and on behalf of Mr. Ebbers, commencing September 6, 2000. The loans eventually grew to over \$400 million. The Examiner reports in this Third and Final Report on claims that he believes can be pursued by the Company.
- The Company has a series of claims relating to the loans and guaranty that could be pursued against Mr. Ebbers. First, Mr. Ebbers breached his duties of loyalty and good faith in seeking loans with interest rates far below a commercially reasonable rate. In accepting such interest rates, Mr. Ebbers essentially put his personal interests ahead of those of the Company.
- Second, by November 2000, Mr. Ebbers knew or should have known that his personal financial situation was precarious, making it unlikely that he could repay the loans. He should not have sought or accepted further loans without full disclosure of these facts to the Company. However, Mr. Ebbers made no such disclosures and even resisted making disclosures to the Company of his actual financial condition. When he finally did provide financial information to the Compensation Committee in early 2002, the information was misleading and inaccurate. Thus, these were additional instances where Mr. Ebbers put his personal interests ahead of those of the Company, which breached his duties of loyalty and good faith.
- Third, Mr. Ebbers breached the April 29, 2002 Separation Agreement he entered into with WorldCom. The Agreement converted his massive term loans into a single \$408 million loan, with the first loan payment of \$25 million due on April 29, 2003. Mr. Ebbers failed to make that payment, thus breaching the Agreement and making all remaining sums immediately due and payable. The Examiner understands that the Company has given notice of its contention that Mr. Ebbers

has breached the Separation Agreement in this fashion, and that the Company has foreclosed on certain collateral it holds pursuant to its loans to Mr. Ebbers.

- The Company also has claims against Max Bobbitt and Stiles Kellett, the two former members of WorldCom's Board of Directors, Compensation Committee, who approved and managed Mr. Ebbers' loans and guaranty. Messrs. Bobbitt and Kellett breached the duties of care and loyalty in multiple respects. First, they approved loans to Mr. Ebbers at very low interest rates. It may, at least for a time, have been in the Company's interest to approve loans to Mr. Ebbers to avoid having the WorldCom CEO sell substantial blocks of his WorldCom stock, but there was no reason to make such loans at a non-commercial interest rate. Second, Messrs. Bobbitt and Kellett failed on numerous occasions to review carefully Mr. Ebbers' financial condition to determine if additional loans and guaranty increases made sense, and whether Mr. Ebbers could have provided adequate security for the loans and guaranty and was likely to be able to repay them.
- The remaining former WorldCom Directors share responsibility for the fiduciary duty lapses, although not to the same degree as Messrs. Bobbitt and Kellett. The other Directors were entitled to rely on the Compensation Committee and the Committee's reports, at least so long as they provided a rational basis to have confidence in the Committee's actions. However, when the Committee continued to make loans and extended the guaranty several times, the remaining Directors had a duty to become informed, since the Examiner believes that the other Directors should not have had continued confidence in the Committee. They failed to do so and several times ratified Compensation Committee actions with virtually no data and without inquiring about or questioning the low interest rates granted to Mr. Ebbers. Accordingly, the Examiner believes that the Company has breaches of fiduciary duty claims that can be pursued against all of WorldCom's former Directors.
- The possible recoveries on these claims include the following: the difference between the interest charged Mr. Ebbers and a commercial rate; the Director fees paid during the extended period of fiduciary lapses; and the principal amounts due on the outstanding loan to Mr. Ebbers.

Responsibility for the Company's Fraudulent Accounting

- The Examiner reported in the First and Second Interim Reports on the Company's fraudulent manipulation of its financial statements from 1999 onward and the breakdown of internal controls that permitted the fraud to continue undetected for so long.
- The Examiner has previously been critical of the Company's Internal Audit Department and the Audit Committee of the Board of Directors because they failed to probe more deeply into WorldCom's financial statements. The

Examiner's further investigation does not suggest any reason to moderate that criticism.

- Nonetheless, the Examiner does not recommend that claims be pursued against the Audit Committee or members of the Internal Audit Department. The deficiencies in their performance resulted primarily from the structure of the Internal Audit Department and the limitation of its resources, as well as the mistaken deference that the Audit Committee showed to the Company's former senior financial management, rather than from any overt act or omission.
- Major responsibility for the fraud and the resulting injury to the Company must rest with Mr. Sullivan and those former Company personnel who have pled guilty to fraud. The Examiner believes the Company has claims against these former officers and employees, and quite possibly against other former employees, including Mr. Ebbers. The damages that might be awarded include disgorgement of compensation paid to the former employees during the period of disloyalty, the costs incurred for audit fees in the restatement process, and reimbursement for debt incurred by WorldCom during the period of its deepening insolvency when the fraudulent accounting went undetected.
- Since the filing of the Second Interim Report, the Examiner has conducted a more in-depth examination of the work performed by Arthur Andersen on the WorldCom audits and quarterly reviews for 1999 through the first quarter of 2002. The Examiner concludes that Arthur Andersen committed professional malpractice by negligently failing to carry out the kinds of substantive tests that were warranted by the risks of fraud and material misstatement Arthur Andersen identified, as well as the existence of a number of "red flags" relating to the Company's accounting practices. The Examiner believes Arthur Andersen failed to incorporate in its audits the needed testing of the areas where the fraud occurred, such as the "top-side" adjustments directed by former senior Management outside of the Company's normal processes for recording revenue and expenses.
- In making these observations, the Examiner is mindful that the former officers and employees who were the architects and perpetrators of the accounting fraud at WorldCom sought to avoid detection of the fraud by concealing much of their conduct. Thus, Arthur Andersen was significantly deceived by senior WorldCom personnel on a number of occasions. However, based upon the data available to the Examiner, the Examiner concludes that Arthur Andersen lacked the "professional skepticism" that an auditor is supposed to have, and tended all too often to rely on the perceived integrity and uncorroborated representations of former WorldCom Management, rather than probe to determine whether such reliance on the proffered Management representations was warranted.
- Accordingly, the Examiner concludes that Arthur Andersen was negligent and that its negligence compounded the injuries suffered by the Company and placed Arthur Andersen in breach of its contracts with WorldCom. The Examiner

believes that the Company has claims against Arthur Andersen and its personnel who worked on, or had supervisory or review responsibility for, the WorldCom engagement during the relevant period. The damages that might be awarded include the costs incurred for audit fees in the restatement process and reimbursement for debt incurred by WorldCom during the period of its deepening insolvency when the fraudulent accounting went undetected.

The Intermedia Acquisition

- The Examiner reported in previous Reports regarding WorldCom's growth by acquisitions. The Examiner was critical of WorldCom's corporate governance processes and, particularly, the scant involvement of the Company's Board of Directors in many multi-billion dollar acquisitions. In the end, however, only one acquisition, the WorldCom merger with Intermedia, announced on September 1, 2000 and closed on July 1, 2001, seemed truly questionable.
- The Examiner has pursued additional information concerning the Intermedia merger and continues to be critical of former WorldCom Management for bringing the original Intermedia merger agreement to the Board on September 1, 2000 without providing meaningful or advance data. The Examiner is similarly critical of the former Directors for passively approving the transaction on September 1, 2000, with virtually no data and without substantive discussion. This was certainly not good corporate governance. However, the Examiner concludes that if Management and the Board had better carried out their respective roles, the Board probably would have nonetheless approved the original merger on September 1, 2000. Accordingly, the Examiner does not recommend that any claims be considered with regard to the original Intermedia transaction.
- The Examiner reaches a different conclusion concerning the amendment of the Intermedia merger agreement in February 2001. At that time, Messrs. Ebbers and Sullivan instructed then General Counsel Michael Salsbury that the WorldCom Board had approved the amended merger agreement and that Mr. Salsbury was authorized to execute it on WorldCom's behalf. This was false, since the Board had not approved the transaction. Messrs. Ebbers and Sullivan breached their duties of loyalty and good faith by causing this action to be taken.
- The Examiner concluded in the Second Interim Report that the actual anticipated cost of the Intermedia merger had gone up significantly between September 1, 2000 and February 2001 – from \$2.5-3.0 billion to \$5 or possibly \$6 billion. The Examiner also concluded that WorldCom had the right to withdraw from or reject the Intermedia transaction based upon events that occurred subsequent to September 1, 2000. The Examiner believes that a vigilant and properly informed Board would have rejected the merger as of February 2001, which it had every right to do. Instead, however, the Board took no action whatsoever when Messrs. Ebbers and Sullivan, without authorization, committed WorldCom to the

amended merger. The Examiner concludes that the Directors, other than Messrs. Ebbers and Sullivan, breached their fiduciary duty of care in not learning all the circumstances concerning the merger amendment, including whether WorldCom could still back out despite the unauthorized action. Further, the Examiner concludes that the Directors also breached their duty of care in failing to take action to sanction Messrs. Ebbers and Sullivan for their unauthorized action.

- The Examiner believes that the Company has claims against Messrs. Ebbers, Sullivan and the other former Directors for this conduct. In addition to recovery of compensation during the period of disloyalty, the Company could seek damages resulting from the unsuccessful Intermedia merger.

Tracker Stocks

- In his Second Interim Report, the Examiner reported on a preliminary basis regarding WorldCom's creation of two Tracker stocks, the high-growth WorldCom Tracker and the lower-growth MCI Tracker. The Examiner concluded preliminarily that the Company's Board of Directors failed to become adequately informed prior to the announcement of the Trackers on November 1, 2000. The Examiner also observed that certain of the allocations of assets and costs between the Trackers suggested a possible bias to enhance the financial results of the WorldCom Tracker to the detriment of the MCI Tracker.
- The Examiner has now completed his investigation of matters related to the Tracker stocks. The Examiner confirms that the Directors did not become adequately informed of relevant details, such as the amount of debt to be allocated between the Trackers and the MCI Tracker dividend policy, before the Trackers were announced on November 1, 2000. However, the Examiner also concludes that if the Directors had fulfilled their duties, they probably would have nonetheless approved the Tracker stocks in the same form as proposed by Management.
- The Examiner concludes that the major cost allocations between the Trackers mentioned in the Second Interim Report – \$6 billion debt to the MCI Tracker, no cash balances in the MCI Tracker, and the MCI trade name allocated to the WorldCom Tracker and then licensed back to the MCI Tracker for \$27.5 million a year – did not violate any legal requirement. Moreover, these allocations were fully disclosed in the related proxy materials provided to investors.
- The Examiner has investigated whether major cost categories, particularly line costs and selling, general and administrative ("SGA") expenses, were fairly allocated between the Trackers. While the Examiner's investigation of this issue was limited due to the unavailability of certain former WorldCom financial and accounting personnel, the Examiner has discovered no evidence of systematic bias to favor the WorldCom Tracker over the MCI Tracker. That said, the Examiner observes that there were indeed some cost allocations that favored the

WorldCom Tracker. Further, given the magnitude of the Company's cost structure and categories, the Examiner cannot conclude with a high level of certainty that there was no systematic bias.

- The Examiner found in his Tracker investigation that from the time of the MCI merger onward, certain former members of senior WorldCom Management were reluctant to make major investments in the MCI legacy companies. This reluctance continued after the Trackers were established. A number of persons referred to this as the "harvest" mode, typified by pressure to control expenses, limit new investments, and charge higher prices, even when the long-term effect of such policies might be to drive away customers. The Examiner is concerned that this "harvest" strategy was neither adequately disclosed in WorldCom's regulatory filings, nor approved by the Board after careful deliberations.
- The Trackers were ultimately not successful, but the Examiner does not recommend that any claims be considered by the Company. The establishment of the Trackers was a result of complicated decisions and appears to have been undertaken in the good faith belief that they would better focus investors on the strengths of WorldCom's different lines of business.

B. Observations of the Process

Since the appointment of an Examiner in bankruptcy proceedings is relatively infrequent, the Examiner believes it appropriate to provide certain observations about his work and the examination process. As previously noted, the Bankruptcy Court's July 22 and August 6, 2002 Orders provided an extremely broad mandate. The July 22 Order stated that the Examiner "shall investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the arrangement of the affairs of [the Company] by current or former management, including but not limited to issues of accounting irregularities." Moreover, when appointed in August 2002, the Examiner had just 90 days to put together an experienced team of professionals, identify the issues that were going to be the subject of the First Interim Report, obtain necessary documents and information, resolve numerous issues with the Company so that the Examiner could receive documents and information in a timely manner, coordinate with governmental authorities and prepare the First Interim Report. The Examiner's job was made more demanding by the fact

that governmental and other investigations and prosecutions were extremely active and that the subject of the Examiner's investigation was receiving extensive media coverage.

The role of an Examiner is somewhat unique and is different than that of a prosecutor or civil litigator. While there are certainly similarities in objectives, including obtaining relevant documents and testimony, the Examiner did not see his role as advocating a particular position or seeking a specific result. Rather, the Examiner sought to ascertain and report on facts that he believed were important to aid the Bankruptcy Court in these proceedings in an objective, unbiased and fair manner. The Examiner recognized the significance of his work and spent considerable time taking steps to ensure the accuracy and impartiality of his work.

The Examiner believes that it would be helpful to future examiners and other similarly situated persons to provide some observations from his work during the past 18 months. These observations are as follows:

- It is critically important to hire professionals who are experienced in conducting investigations. Skills that are required to conduct an investigation are honed through experience and are typically not obtained through civil litigation. Thus, lawyers who are experienced primarily in civil litigation may not be well qualified to conduct investigations. It is equally important that these professionals recognize that their job in an investigation is to identify and report on the facts that they uncover and not to advocate a particular theory or assumption. This is particularly important in a high profile matter like the WorldCom bankruptcy, where third parties, including competitors and civil litigants, push for particular results, often on the basis of self-interest.
- In the highly visible WorldCom bankruptcy proceeding, the Examiner received numerous tips and leads from various sources. Investors and former employees who felt that they had been mistreated or defrauded provided the Examiner with information to support their claims. Lawyers for claimants bringing actions against various parties who they believed were legally responsible for the problems at WorldCom sought the Examiner's assistance in pursuing their claims. Competitors of WorldCom brought information to the Examiner's attention that they believed should be pursued.

- Given the confidential nature of his work, the Examiner was careful not to share non-public information or the scope of his investigation with these persons. However, all leads and information received by the Examiner were assessed, taking into account the potential motivations of the sources of the information. While not all of these tips and leads were fruitful, some served as valuable sources of information. It was not always immediately obvious when a small piece of information might lead to something significant and future examiners should similarly assess all indications of wrongdoing that appear within their mandate.
- Examiners have the power to seek to compel production of documents, information and witnesses under Bankruptcy Rule 2004. The Examiner initially sought the voluntary cooperation of all persons from whom information was sought, and it was only necessary to seek the issuance of subpoenas for a relatively small number of persons or entities who either refused to provide information voluntarily or who requested that a subpoena be issued. The Examiner believed that encouraging voluntary cooperation would lead to a more productive and expeditious means of obtaining information and for the most part this occurred. Unfortunately, a number of persons and entities who agreed to produce information voluntarily took longer to produce such information than desired by the Examiner and some, in the end, may have failed to produce requested data to the Examiner. This, in turn, delayed the release of this Third and Final Report. In retrospect, it likely would have been beneficial to seek the issuance of more subpoenas at the first sign that production of information was being delayed to ensure that the production schedule and scope was subject to Court oversight and review if necessary.
- Both the SEC and the Department of Justice had ongoing investigations and prosecutions at the time that the Examiner was appointed and these have continued throughout his investigation. The Examiner coordinated his efforts with those governmental agencies and recognizes the valuable assistance that they provided to the Examiner. Since the Examiner wanted to be sensitive not to take steps that could prejudice the governmental actions, the Examiner's investigation was limited in certain situations. Some of these instances have been noted in the Examiner's Reports. Future examiners should be similarly sensitive to governmental investigations and seek to coordinate efforts as appropriate.
- While documents, including electronic records, provided a tremendous source of information, interviews were the most valuable part of the investigative process. In conducting interviews, the Examiner did not require witnesses to take an oath for truthfulness, nor did the Examiner have a court reporter present to transcribe the interviews. However, the Examiner's representatives took careful notes during interviews.
- Moreover, the Examiner did not follow the Rules of Evidence or Civil Procedure in conducting the interviews and allowed counsel for the witnesses to provide information at the interviews on occasion. The Examiner structured the

interviews in this manner to promote maximum cooperation and to make the interviews less adversarial. The Examiner believes that conducting the interviews in this way was beneficial and led to more productive interviews. To the credit of interviewees and their counsel, the Examiner's interviews were marked by very few instances where serious procedural disputes arose and counsel for the interviewees almost never used tactics that might be viewed as obstructionist in a civil litigation setting.

- The Examiner chose to identify in only limited situations the persons interviewed and specific documents relied upon. Where persons and documents were identified in the Reports, the Examiner did so because he believed such information was consistent with the Court's mandate and necessary to a full report on his investigation. The Examiner generally sought not to identify witnesses, since the mere mention of an individual in some instances could cause a negative and unfair taint to that person. Moreover, the Examiner did not believe that it was within his mandate to have a role in any of the collateral proceedings related to WorldCom, such as private litigation, and thus the Examiner did not want to include more specific information than necessary. Although some detailed information may not be identified in the Reports, the Examiner has created a thorough and comprehensive record to support his findings.
- The main sources of information for the Examiner during the investigation were documents and interviews. However, the Examiner took additional steps to ensure the completeness and accuracy of his findings. Some of the more significant steps taken were to invite certain persons or entities to provide additional information, other than documents and interviews, on a particular topic or issue. For example, the Examiner shared with the Company and KPMG his initial conclusions on the WorldCom state tax minimization program discussed in this Third and Final Report. Because of the significant concerns expressed about that program, the Examiner invited both the Company and KPMG to provide any additional information that they believed appropriate. To this end, the Examiner received "white papers" from the Company and KPMG that provided additional valuable information on this subject. Similarly, the Company submitted a white paper on the Tracker stocks. In addition, the Examiner's professionals met with counsel for SSB (and separately with counsel for Mr. Grubman) at their request and received SSB's (and Mr. Grubman's) views on certain issues. This again was useful. The Examiner invited counsel for Arthur Andersen to submit views on certain subjects, but counsel declined. Finally, when each of his Reports was close to final form, the Examiner supplied drafts to the Company and received comments from the Company that were given full consideration by the Examiner. Future examiners should also seek similar information where appropriate to promote the accuracy of the examiner's conclusions.
- The Examiner issued a First Interim Report on November 4, 2002, as required by the Bankruptcy Court's Order. As previously noted, it was not possible to complete the Examiner's investigation in the initial time period allotted. The Examiner subsequently issued a Second Interim Report on June 9, 2003. The

Examiner issued the Second Interim Report to provide the Bankruptcy Court with his findings to date and a status report on his investigation. While the Examiner recognizes the benefits of providing information to the Bankruptcy Court prior to the completion of the investigation, there could be some negative consequences from such a practice. After the Second Interim Report was issued, the extent and quality of cooperation from the Company and third parties decreased in a noticeable manner. While it is difficult to state with certainty the reasons for this, several witnesses informed the Examiner that the fact that several people resigned from WorldCom as a result of findings in the Second Interim Report had an impact on their cooperation. In addition, there were several areas of inquiry left open in the Second Interim Report and a roadmap was provided to counsel and witnesses concerning the Examiner's likely future investigation. Thus, future examiners should balance the benefits of issuing interim reports with the possible difficulties in completing the investigation that may occur as a result of such interim reporting.

IV. WORLDCOM'S STATE TAX MINIMIZATION PROGRAMS

A. Introduction and Summary

On the advice of KPMG, the Company undertook two major internal restructurings: the first effective as of January 1998 and the second effective as of January 1999, after the closing of the MCI merger.¹⁰ The minimization of state taxes represented one of the goals of these restructurings.¹¹ Indeed, KPMG marketed these programs to WorldCom under the names, "State Tax Minimization" and "Total Tax Minimization™."¹² KPMG predicted that the implementation of the 1998 restructuring transactions alone could result in savings to the Company "in excess of \$25 million in the first full year and \$170 million over five years."¹³

A significant part of each of the Company's restructurings designed by KPMG was programs by which the Company was to license certain intangible assets to its subsidiaries. Under the programs, the subsidiaries were ultimately charged over \$20 billion in royalty fees over a four-year period for use of these intangible assets. The Examiner understands that the Company still has this royalty program in effect today. As discussed below, these royalty

¹⁰ Letter from A. Dale Currie, Jr., Partner, KPMG and Bob Ostrander, Partner, KPMG, to Scott D. Sullivan (Apr. 30, 1997); Letter from A. Dale Currie, Jr. and Jerry N. Smith, Partner, KPMG to Walter Nagel, Vice President - Tax, MCI Communications Corporation (Aug. 13, 1998).

¹¹ Personnel from WorldCom and KPMG identified a number of additional purposes for the restructurings, including the elimination of redundant companies, reducing the number of tax returns that the Company was required to file, aligning subsidiaries along operational lines, and implementing a method for the subsidiaries to meet their obligations to file state taxes in a timely manner. See also MCI WorldCom KPMG Tax Project, WGM-KL0106 (May 29, 1998); PowerPoint Presentation to WorldCom, Inc. by KPMG; State Tax Minimization, 1KPMG-B 010042-010234 (Mar. 19, 1997). The Examiner did not investigate these additional purposes in detail but has no basis to question the legitimacy of such purposes.

¹² State Tax Minimization or STM and later Total Tax Minimization™ or TTM™ were KPMG's names for certain tax advice and programs it offered to clients. The Examiner understands that the name changed from STM to TTM™ because KPMG recognized that the programs involved more than state tax issues.

¹³ Letter from A. Dale Currie, Jr., Partner, KPMG Peat Marwick LLP and Bob Ostrander, Partner, KPMG Peat Marwick LLP, to Scott D. Sullivan, Chief Financial Officer, WorldCom, Inc. (Apr. 30, 1997). The KPMG prediction does not identify the savings that were attributable to reduced state tax liabilities versus other reduced costs.

programs substantially reduced the Company's state tax burden in 1998 and thereafter because the subsidiaries deducted the royalty charges as ordinary and necessary business expenses and the royalty income was shifted into jurisdictions where a substantial portion of the royalty income was not subject to state tax. While the royalty programs did not directly impact the Company's federal tax obligations, they had the effect of increasing its reported net income.¹⁴

The Examiner concludes that these royalty programs, which were based largely on KPMG's advice, were not well conceived or implemented, and are vulnerable to challenge by various states.¹⁵ In particular, these royalty programs defined management foresight as an intangible asset for which royalties could be charged. "Management foresight" in this context appears to encompass the plan or strategy of the Company's former senior Management to provide end-to-end bundled services (voice, data, Internet, international) to customers over a global network. The Examiner does not believe that "management foresight" is an intangible asset.

KPMG provided this advice despite a lack of persuasive legal authority to support it. KPMG also failed to advise the Company regarding the lack of support for its advice and the attendant risks associated with the programs. Instead, KPMG portrayed its recommended royalty programs to the Company as routine, "plain vanilla" licensing arrangements.

¹⁴ Because the Company's state tax liabilities were reduced, the Company's reported tax expense was also lowered. As a result, the Company was able to report higher net income.

¹⁵ The Company faces potential state disallowance actions by many states, which could result in the Company being required to pay back taxes, interest and penalties. See Motion by the Commissioner of the Department of Revenue, Commonwealth of Massachusetts, on Behalf of Massachusetts, New York, Connecticut, New Mexico, Iowa, Illinois, Pennsylvania, North Carolina, Virginia, and Other Similarly Situated States, to Extend the Deadline for Filing Proofs of Claim ("State Motion") ¶ 5 (asserting that royalty payments by the operating companies "were apparently part of a tax avoidance scheme that was intentionally concealed from the state taxing authorities over the 3-year pre-petition-period 1999-2001"). In addition to the states that joined in the State Motion, the Examiner is aware that the Multi-State Tax Commission is examining this issue on behalf of several other states, and that the Company has entered into stipulations with at least 37 states extending the Bankruptcy Court bar date for claims submission to April 1, 2004.

The Examiner further concludes that the Company bears some responsibility for the potential liabilities it now faces in connection with the royalty programs. The Company failed in certain respects to implement KPMG's recommendations, making the royalty programs more vulnerable to possible state challenge. Moreover, the huge royalties actually generated – over \$20 billion in four years – should have caused Company personnel to question whether the royalty programs had economic substance and were properly conceived and implemented, particularly because those royalties substantially exceeded the Company's net income during the four-year period.

1. Background on Transfer Pricing Generally

A major element of the Company's restructurings involved the creation of transfer pricing programs, including the royalty programs. "Transfer pricing," as used in this Third and Final Report, means the establishment of financial terms, most notably the prices charged, between members of a group of commonly controlled entities when they engage in transactions with each other. The prices set must reflect the functions and risks taken by each party to the transaction.

A classic example of transfer pricing is when a U.S. automobile company buys cars from its foreign parent for resale in the United States. The price that the U.S. automobile company pays its foreign parent ultimately will, in large part, determine the extent to which the profit earned from the sale of a car to a U.S. consumer is earned by the U.S. automobile company or its foreign parent. The more that the foreign parent charges its U.S. subsidiary for a car, the less profit that the U.S. automobile company will earn, and vice versa. As such, transfer pricing can be an effective and proper tool used by corporations to manage their overall tax liability. Taken to its extreme and in the absence of legal restraints, however, the

foreign parent effectively could select how much income it wished to have taxed in the United States and how much income it wished to have taxed in its home country.

Another example of transfer pricing is when a single company within a large group of companies performs management or other services (such as legal, human resources, tax, accounting, and other similar services) for the other members of the group. In this situation, it is appropriate for the other members of the group to pay for these services, just as they would pay unrelated companies for these services if they were out-sourced. Similarly, a company may license trademarks, trade names or other intangible assets to its affiliates in exchange for royalty payments. Such arrangements relating to intangible assets generally pass muster so long as they are done on an arm's-length basis and a fair value is assigned for the affiliate's use of the intangible assets being licensed.

Because of the significant effect that transfer pricing can have on a company's reported income and, thus, on its tax liability, detailed rules have evolved under federal tax laws relating to transfer pricing. The federal tax regulations issued under Section 482 of the Internal Revenue Code ("Section 482") are designed to restrict a company's ability to manipulate the income of its affiliated entities to avoid U.S. tax liabilities. These regulations regulate the activities of separate entities that do not file a "consolidated" federal tax return, such as a U.S. corporation and its foreign affiliates.¹⁶

For state income tax purposes, most states require each legal entity to report its income and deductions separately, regardless of whether that legal entity is a member of a consolidated group for federal tax purposes. Thus, in most states, transactions between members of a federally consolidated group of companies have important state income tax

¹⁶ Oversimplified, a consolidated federal income tax return essentially treats all of the separate U.S. legal entities as a branch or division of a single, larger corporation. As such, transactions between members of the combined group are generally eliminated or "washed out" by reason of the combination.

consequences. The member who pays for goods or services generally is able to deduct the cost of those goods and services from its state taxable income. The member who receives payment for goods or services will include that payment as income for state tax purposes.

Although transfer pricing can have a dramatic effect on a company's state tax obligations, state laws regulating transfer pricing programs are surprisingly undeveloped. Indeed, many state taxing authorities turn to the federal transfer pricing regulations for guidance. The federal tax regulations issued under Section 482 require transfer prices among related entities to be similar to the prices that unrelated entities, treating each other at arm's length, would charge one another for the same goods or services. In short, the federal transfer pricing regulations aim to require companies to report transactions within a group of affiliated companies in a manner that reflects their true fair market value. To arrive at an arm's length transfer price requires a detailed analysis of the risks and functions undertaken by each party to the arrangement. With specific regard to intangible assets, Section 482 requires that the amount charged for use of an intangible asset be "commensurate" with the income derived from the use of that intangible asset by the licensee.

If a transaction does not satisfy the arm's-length standard, a state may disallow an overstated deduction or include additional income for an understated item of income. Depending on the specific state taxing statute and judicial doctrines applicable in that state, a state taxing authority may attack transactions that it believes do not accurately reflect the income subject to tax in that state on various grounds. These include ignoring the transaction because it is a "sham" or otherwise lacks economic substance,¹⁷ extending the reach of its taxing jurisdiction to members of the group that, absent the transaction, would not be subject

¹⁷ See, e.g., Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758, 765 (Mass. 2002) (invalidating a royalty payment deduction arrangement because it was a sham transaction).

to tax in that state,¹⁸ or requiring some form of combined reporting between related parties.¹⁹ Some states have denied, by statute, a deduction for certain payments between members of an affiliated group.²⁰

In light of the prevalence of state tax statutes requiring separate entity reporting, the creation and implementation of transfer pricing programs designed to reflect intra-group transactions are common and necessary for separate companies to report their state taxable income when operating as part of a unified business with commonly controlled affiliates. The basic state income tax planning that goes into these transfer pricing arrangements often includes an analysis of the optimal jurisdiction in which to locate certain members of the group. For example, it is not unusual or improper for companies to create special purpose entities to hold intangible assets, and for these companies to be located in states that either do not tax the entities' income at all or subject only a portion of that income to tax. Such strategies are proper so long as they meet legal and tax requirements.

The state tax benefits of such intangible assets transfer pricing arrangements are obvious. If a company deducts \$100 for its use of a trademark and is charged that \$100 royalty by a company located in a state that does not tax the \$100 of royalty income, the group as a whole has received the benefit of a \$100 deduction for state income tax purposes, but has not generated an offsetting \$100 of income subject to state income tax. The Examiner is familiar with royalty arrangements of this type. Structured appropriately, they

¹⁸ See, e.g., Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13, 18 (S.C. 1993) (holding that licensing of intangibles for use in the state created a "substantial nexus" for taxing purposes).

¹⁹ See, e.g., Alabama (Ala. Code § 40-18-39 (2003), Ala. Admin. Code § 810-3-39.06(1)(a) (2003)); Arizona (Ariz. Rev. Stat. §§ 43-941, and 43-942 (2003) (providing that the state may require combined reporting for affiliated unitary corporations that have not elected to file a consolidated Arizona return)).

²⁰ See Ohio Rev. Code Ann. § 5733.042 (Anderson 2003); Ala. Rev. St. § 40-18-35 (2003); 1998 Conn. Acts. 98-110 §20; S.B. 1949 (Mass. 2003); H.B. 1965, (Mass. 2001); Assemb. B. 2501, (N.J. 2003); H.B. 1157, (N.C. 2001).

represent valid means by which businesses may conduct their affairs and seek to minimize taxes. However, these structures are also fertile ground for state tax evasion and have the potential to distort income subject to taxation. Thus, it is critically important that these arrangements be structured to comply with all state and federal legal requirements. It is against this backdrop that the Examiner has considered the WorldCom royalty programs that KPMG recommended and designed.

2. Background of the Company's Transfer Pricing Programs

Based on KPMG's recommendations, the Company and its subsidiaries engaged in a series of transfer pricing programs as part of the restructurings. These transfer pricing programs governed the provision of various services and transfers of assets. The Examiner has not undertaken a comprehensive examination of each of these transfer pricing programs. Instead, the discrete transfer pricing issues that the Examiner addresses in this Third and Final Report involve the intangible assets transfer pricing programs, or royalty programs, that KPMG recommended and the Company implemented.

In connection with the royalty programs, KPMG concluded that "management foresight" constituted an intangible asset that could be licensed to the Company's subsidiaries in return for a substantial royalty fee. With the advice and assistance of KPMG, the Company created and documented transactions in 1998 and 1999 in which this purported intangible asset – "management foresight" – was supposed to be licensed to the subsidiaries in exchange for a royalty fee (together the "Royalty Programs," and separately the "1998 Royalty Program" and the "1999 Royalty Program").

Even for an entity as large as the Company, the magnitude of the royalties charged was breathtaking. Between January 1998 and the end of 2001, the subsidiaries were charged more than \$20 billion in royalties for their use of the Company's intangible assets, with most

of the royalties resulting from the licensing of “management foresight.” Despite attempts to obtain data, the Examiner does not know precisely how much state tax the Company saved on a consolidated basis as a result of the Royalty Programs. The Examiner is aware, however, of estimates of state tax savings from the Royalty Programs ranging from \$100 million to at least \$350 million.²¹ Regardless, it is clear that the Royalty Programs resulted in substantially lower state tax payments for many of the entities involved.

The reason for the Company’s state tax savings from the Royalty Programs is simple. The subsidiaries treated the royalty charges as an ordinary and necessary business expense. The royalty charges were then presumably deducted from the subsidiaries’ state taxable income in states where the subsidiaries had state tax obligations. The royalty charges were then presumably claimed as income by a holding company that was subject to taxation only in Mississippi, the District of Columbia and Georgia.²² By virtue of the manner in which Mississippi and the District of Columbia treated royalty income and the attributes of the holding company, the vast majority of the royalty income would not have been taxed. Consequently, under the Royalty Programs, the subsidiaries were able to deduct the royalty payments from their state taxable income without generating offsetting income subject to state taxation for the holding company that reported the royalty income.

This favorable tax structure, recommended and designed by KPMG, hinged in large part on the identification of valid intangible assets, which could be licensed and for which

²¹ The \$100 million estimate came from a current Company employee. He estimated that if the state taxing authorities completely disallowed the Royalty Programs, then the Company would have maximum exposure of roughly \$100 million in tax liability. He did not provide a basis for this estimate. Presumably, this estimate did not include interest and penalties. In a memorandum dated March 28, 2002, Arthur Andersen, the Company’s previous external auditor, estimated the exposure to the Company as of that date from the elimination of these state tax benefits at about \$350 million.

²² The Company was subject to state taxation in Georgia because it is a Georgia corporation. However, because the Company had no significant presence in Georgia, the Georgia state tax filings are not particularly relevant for purposes of this Third and Final Report.

substantial royalties could be charged. Absent the classification of “management foresight” as an intangible asset, a classification for which the Examiner has not identified persuasive legal or factual support, the amount of royalties and associated state tax benefits would have been substantially diminished.

3. State Investigations and Proceedings

On September 2, 2003, Massachusetts (on behalf of itself and eight other states) filed a motion with the Bankruptcy Court, seeking to extend the bar date for filing proofs of claims in connection with potential state tax deficiencies that resulted from the Royalty Programs. The states requested the extension of the bar date so that they could conduct tax audits of the Company’s books and records regarding the Royalty Programs. The Court granted that motion on October 7, 2003 and extended the bar date for such claims until April 1, 2004.

The states are investigating whether the Royalty Programs were “established, at least in part, for the purpose of avoiding or minimizing the payment of state income taxes by providing for the transfer of revenues from other WorldCom and MCI subsidiaries with nexus in the various states to [the holding companies].”²³ In their Motion, the states emphasized that the inter-company royalties were never paid, that the royalty charges exceeded the income actually derived from the intangible assets, and that the “royalty charges were accrued solely for purposes of reducing the state income owed by MCI and its various affiliates.”²⁴ Thus, the focus of the proposed audits is to determine whether some or all of the approximately \$20 billion in royalty charges were “intentionally concealed from the

²³ Motion by the Commissioner of the Department of Revenue, Commonwealth of Massachusetts, on behalf of Massachusetts, New York, Connecticut, New Mexico, Iowa, Illinois, Pennsylvania, North Carolina, Virginia and other Similarly Situated [sic] States, to Extend the Deadline for Filing Proofs of Claim at ¶ 3.

²⁴ *Id.* at ¶¶ 6-7.

state taxing authorities over the three-year pre-petition period 1999-2001” by shifting the royalty income into states where it was not subject to significant state tax.²⁵

4. The Examiner’s Investigation

The potential issues with the Royalty Programs came to the Examiner’s attention in the summer of 2003. At that time, a dissenting group of MCI creditors submitted materials to the Bankruptcy Court and the Examiner as part of their dispute over the proposed plan of reorganization under consideration by the Bankruptcy Court. These creditors disputed the legitimacy of the Royalty Programs in an attempt to increase their payout under the proposed reorganization plan. The creditors ultimately reached a settlement with the Company in September 2003 regarding their treatment under the reorganization plan and thus dropped their objections.

Notwithstanding the bondholders settlement in the bankruptcy proceeding, the Examiner determined to continue his investigation, which had commenced in August 2003. The Examiner’s mandate from the Bankruptcy Court was to investigate allegations of fraud, dishonesty, incompetence, mismanagement and/or irregularity in the management of WorldCom’s affairs. The allegations pertaining to the WorldCom Royalty Programs fell squarely within that mandate.

The Examiner has based this Chapter of the Third and Final Report on the facts developed through the review of documents, transcripts of depositions taken during the Company’s bankruptcy proceeding, interviews of current and former Company and KPMG personnel and discussions with current and former advisors to the Company. This part of the investigation was made more difficult and time consuming due to a lack of full

²⁵ Id. at ¶5.

cooperation by the Company and KPMG. Requests for interviews were processed slowly and documents were produced in piecemeal fashion.²⁶ In addition, despite repeated requests for e-mail files relating to the Royalty Programs, as of the publication of this Third and Final Report, the Company had failed to produce any e-mails from the files of the Company employees most intimately involved with the Royalty Programs.

The lack of timely responses to the requests for information slowed the Examiner's ability to conduct this portion of the investigation in the most expeditious or cost-effective fashion. Nonetheless, the Examiner is satisfied that he ultimately interviewed the key persons available to him with knowledge relevant to the Royalty Programs and that he has received sufficient information to support the conclusions reached in this Third and Final Report.

As part of the Examiner's investigative process, the Examiner invited the Company and KPMG to provide any data they wished that might be relevant to the Examiner's consideration of these issues. Each submitted a "white paper" to the Examiner, with the Company's provided on December 11, 2003 and KPMG's provided on December 20, 2003. These materials were useful in the Examiner's consideration of the issues.

5. Summary of Conclusions

The Examiner concludes that the Royalty Programs were flawed. While the Company is not free from fault, the Examiner concludes that KPMG rendered improper tax advice to the Company. The Company relied on this advice to its possible detriment in

²⁶ For example, interviews were requested from the Company in August 2003, but the first company-requested interview did not take place until October 23, 2003. The first interview scheduled with KPMG representatives, which required the consent of the Company, did not take place until late November 2003. Similarly, in approximately August 2003, the Examiner requested essentially all documents and correspondence relating to the Royalty Programs for the period January 1, 1997 to December 31, 2002. The Examiner had received as of mid-November 2003 approximately five boxes of documents from the Company.

implementing the Royalty Programs, and now the Company faces potential liability as numerous states question the *bona fide* nature of the Royalty Programs. In particular, the Examiner has reached the following conclusions:

a. KPMG Rendered Flawed Tax Advice and Failed to Disclose the Risks

KPMG rendered flawed advice to the Company in connection with the Royalty Programs.²⁷ The decision to classify “management foresight” as an intangible asset for which a royalty could be charged is among the most troubling aspects of KPMG’s advice. As previously discussed, this classification served as the basis for the state income tax benefits obtained by the Company under the Royalty Programs.

Based on the evidence gathered and a review of applicable law, the Examiner has not identified persuasive legal authority that “management foresight” is an intangible asset for which royalties may be charged. In the Examiner’s view, the “management foresight” that KPMG identified was not an intangible asset. Rather, at most, such “management foresight” constituted WorldCom’s strategy to create a vertically and horizontally integrated group of companies to provide bundled (i.e., voice, data, Internet, international) telecommunications services to its customers. Transfer pricing regulations do not support KPMG’s conclusion in this regard and the Court of Claims has rejected the notion that such an affiliate structure can constitute an intangible asset.²⁸

²⁷ The Examiner is aware of recent widespread publicity alleging that KPMG has marketed an array of tax shelters that may not have been in compliance with all legal requirements. The Examiner observes that while he has serious issues with the KPMG-recommended Royalty Programs, he does not view these Royalty Programs to be tax shelters in the sense of being mass marketed to an array of KPMG customers. Rather, the Examiner’s investigation suggests that the Royalty Programs were part of the overall restructuring services provided by KPMG to WorldCom and represented tailored tax advice provided to WorldCom only in the context of those restructurings.

²⁸ Merck & Co., Inc. v. United States, 24 Cl. Ct. 73, 87-88 (1991).

b. The Company's "Management Foresight" Was Not Commercially Transferable

Even if "management foresight" constituted an intangible asset, applicable rules require that such foresight be commercially transferable to an unrelated third party in order for such an asset to be eligible to support royalty charges. The Examiner investigated whether such "management foresight" could have been transferred by WorldCom to an unrelated third party and could discern no means by which such a transfer could have taken place. The Examiner invited the Company and KPMG to address this issue in their white papers, but neither provided any reasoned basis to believe that the commercially transferable criterion was satisfied.

Although the Company relied heavily on KPMG in connection with the Royalty Programs, the Examiner has not found any evidence to suggest that KPMG advised the Company that its classification of "management foresight" as an intangible asset was an aggressive tax position. In fact, current and former members of the Company's tax department told the Examiner that they believed the Royalty Programs represented "plain vanilla" programs in terms of tax planning. Thus, it appears that KPMG, having created a structure without solid legal foundation, failed to inform the Company about the risky nature of the Royalty Programs. Such a failure to warn of the risks may constitute negligence by KPMG.²⁹

c. Even If Legitimate Intangible Assets Existed, There is No Evidence That the Company Owned All of Them

Under the Royalty Programs, KPMG concluded that, to the extent that any non-routine intangible assets (or "management foresight") existed for which royalties could be

²⁹ See DuPont v. Brady, 646 F. Supp. 1067, 1076 (S.D.N.Y. 1986) (holding that an attorney's failure to communicate "the tax risk" in a tax shelter "was negligent" and a breach of his duties of due care and undivided loyalty"), rev'd on other grounds, 828 F.2d 75 (2d Cir. 1987).

charged, all of those intangible assets must have been owned by the parent company. Significantly, based on this conclusion, KPMG reasoned that all excess profits that were earned by the subsidiaries should be attributed to the parent company. The Examiner believes that KPMG failed to undertake an adequate investigation to ascertain the actual source of the excess profits, i.e., whether any of the subsidiaries owned valuable intangible assets that allowed them to earn excess profits individually. As such, KPMG's analysis and the templates that KPMG designed to implement the Royalty Programs were flawed since they failed to consider adequately any potential ownership of the intangible assets by the subsidiaries and simply attributed all of the excess profits to the parent.

d. The Company Failed to Transfer the Purported Principal Intangible Asset

A further problem with the Royalty Programs is that the underlying legal documents do not even purport to transfer "management foresight" to the subsidiaries. Instead, the legal documents, which are in the form of license agreements, appear to be customary and typical intellectual property licensing agreements, listing only ordinary intangible assets such as trademarks, trade names, "trade secrets, proprietary information, competitive data and strategies and other confidential and proprietary information."³⁰ As such, they fail to transfer the core asset that supported the Royalty Programs and also fail to reveal KPMG's aggressive and, in the Examiner's view, unsupportable classification of "management foresight" as an intangible asset.

The Company and KPMG now contend that the Company's "strategy" to provide bundled telecommunications services was the principal intangible asset licensed to the

³⁰ Trademark License and Royalty Agreement by and among WorldCom, Inc. and the Entities Identified in Exhibit "A" (Jan. 1, 1998); Intangible Assets License Agreement by and between MCI WorldCom, Inc. and MCI WorldCom Brands, L.L.C. (Jan. 1, 1999); Intangible Assets License Agreement by and among MCI WorldCom Brands, L.L.C. and the Entities Identified in Exhibit "A" (Jan. 1, 1999).

subsidiaries. However, by their terms, the license agreements only license strategies that were “confidential or proprietary.” WorldCom’s strategy to provide “end-to-end bundled services over global networks” was not confidential or proprietary. Rather, this strategy was repeatedly disclosed by the Company, such as in its annual 10-K’s.

e. Potentially Misleading Applications Filed with the State Taxing Authorities

The Company and KPMG apparently failed to explain the true nature of the Royalty Programs to the taxing authorities in Mississippi and the District of Columbia. The Company, with KPMG’s advice and assistance, sought a ruling from the Mississippi Department of Revenue in 1997 and a ruling from the District of Columbia Department of Finance and Revenue in 1998 regarding, among other things, how those jurisdictions would tax the income from the Royalty Programs. In each case, KPMG prepared the first draft of the applications for the Company’s review and comment. The Company then submitted the applications to Mississippi and the District of Columbia. The hoped-for tax treatment hinged on characterizing the income as royalties. Instead of advising Mississippi and the District of Columbia that the royalties primarily represented charges for use of “management foresight” or, as the Company and KPMG now contend, a “strategy” to provide bundled telecommunications services to customers, the applications indicated that the royalty income would be the result of the licensing of traditional and commonly accepted intellectual property such as trademarks, trade names and service names. Because these applications failed to mention that “management foresight” or the Company’s “strategy” represented the principal intangible asset being licensed, the Examiner believes these written applications were misleading.

f. The Royalty Programs Lacked Economic Substance

The Examiner also believes that the Royalty Programs lack economic substance. For the Royalty Programs to have economic substance, the subsidiaries must have been charged a fair or arm's-length royalty for the use of the Company's purported intangible assets. The Examiner questions whether the Royalty Programs had economic substance since the royalties charged (1) actually exceeded the Company's consolidated net income in each of 1998, 1999, 2000 and 2001; and (2) often represented a huge percentage (as high as 80 to 90 percent) of a subsidiary's net income. Surprisingly, no Company or KPMG personnel revisited the Royalty Programs to determine if they produced reasonable results. If they had done so, they should have questioned these results, which several witnesses admitted would have raised a red flag.

In addition, the Company failed to implement the Royalty Programs in accordance with KPMG's recommendations in at least two respects. First, instead of requiring cash royalty payments as KPMG recommended and as required by the legal documentation implementing the Royalty Programs, the Company merely established book entries to accrue the royalty charges from the subsidiaries. The subsidiaries made no attempt to pay the royalty charges. Second, according to KPMG, an important assumption underlying the Royalty Programs was that the entity that was to receive the royalties would pay for all marketing, advertising and brand support costs relating to the intangible assets. However, in practice, the subsidiaries that were charged the royalties actually paid for marketing, advertising and brand support. The failure to follow KPMG's recommendations provides further reason to doubt whether the Royalty Programs had economic substance.

g. The Company May Have Claims Against KPMG for Any Penalties and Interest Assessed by the States as Well as for the Fees Paid to KPMG

To the extent that state taxing authorities determine that the Company is liable for tax deficiencies, the Examiner believes that the Company has claims against KPMG for recovery of penalties or interest charged. If the liability stems from a finding that "management foresight" was not an intangible asset that could support the royalty charges, it would appear that KPMG's liability might be reasonably certain, since this was at the heart of KPMG's advice to the Company and that advice would have been found to be flawed. Further, KPMG's initial engagement letter with the Company expressly provides for return of fees paid in the event that its advice is found to be flawed.

It is possible, however, that a state deficiency finding would be founded instead in whole or in part on the Company's implementation failures, such as the failure of the license agreements to convey the assets that were charged for, the failure of the subsidiaries to pay the royalties, and the failure of the entities charging the royalties to pay for advertising and marketing costs. In such an instance, the Company's claims against KPMG could be reduced or even eliminated. Moreover, there may be other business reasons why the Company would not want to initiate an action against KPMG.

B. Factual Underpinnings of the WorldCom Royalty Programs

1. Pre-MCI Merger Royalty Program

a. The Origin of the Royalty Programs

The Royalty Programs had their genesis during the period when the Company rapidly acquired numerous entities and attempted to integrate them. By 1997, the sheer number of legal entities and their overlapping functions led the Company's tax department to conclude

that a comprehensive study of the Company's organizational structure should be undertaken to determine how to create a more manageable corporate structure. The ultimate goals of the restructuring were to streamline the organizational structure, decrease the number of tax returns required and minimize taxes.

The Company's tax department did not have the capacity or experience to undertake such a study on its own.³¹ Accordingly, the Company initially contacted tax professionals at Arthur Andersen to seek their guidance in developing a restructuring plan. Arthur Andersen, as the Company's auditor, frequently provided tax advice to the Company. However, Arthur Andersen apparently was not as responsive or creative as the Company's tax department would have liked. Indeed, witnesses told the Examiner that Arthur Andersen offered some "off the shelf" tax planning ideas to the Company's tax department. As a result, the Company did not view Arthur Andersen as providing the type of tailored advice that the Company's tax department believed it needed to resolve the substantial and growing problems associated with filing so many tax returns.

b. The Engagement of KPMG to Design and Implement the 1998 Royalty Program

At about the same time that the Company's tax department decided against using Arthur Andersen for the restructuring project, certain KPMG professionals based in Jackson, Mississippi, approached members of the Company's tax department about the possibility of providing tax consulting services. The members of the Company's tax department were impressed with KPMG and provided certain business and financial information to KPMG as part of an initial review, or feasibility study, of the Company's organizational structure and

³¹ The two heads of the Company's tax department were responsible for overseeing and implementing the 1998 Royalty Program. Neither individual had previous experience with transfer pricing programs or corporate restructurings.

tax position. KPMG performed the feasibility study at no obligation to the Company.³² However, KPMG and the Company had an understanding that, if the Company decided to go forward with a restructuring, KPMG would have the first opportunity to perform the work.

Based on its feasibility study, KPMG proposed a comprehensive corporate restructuring that would be consummated as part of a KPMG program entitled “State Tax Minimization” or “STM.” The program was intended to, among other things, align entities along operational lines and minimize taxes, and it included the implementation of transfer pricing programs. The Company accepted KPMG’s recommendations and formally engaged KPMG on April 30, 1997.³³

KPMG and the Company executed an engagement letter dated April 30, 1997, pursuant to which the Company agreed to pay KPMG base fees totaling \$3 million from June 1997 through March 1999 in connection with KPMG’s design, implementation and post-implementation work on the Company’s restructuring. Pursuant to the engagement letter, KPMG also could, and ultimately did, earn two performance bonuses totaling an additional \$2.5 million for its work. In addition, KPMG recouped the investment that it had made with its feasibility study when the Company agreed to pay \$500,000 to KPMG to “cover the time and expense related to the feasibility portion of the engagement.” In total, the Company paid

³² A member of the Company’s tax department stated that KPMG invested a tremendous amount of time and resources in its review. The Examiner has been informed that KPMG’s investment in the feasibility study approximated \$500,000, which was far outside KPMG’s guidelines for feasibility spending. KPMG spent this much because it was confident that the Company had to undertake some type of substantial restructuring to be able to generate separate company financials for all of its subsidiaries. Accordingly, KPMG’s professionals were confident that KPMG’s investment was prudent because they envisioned the Company becoming a substantial client, which it did.

³³ Letter from A. Dale Currie, Jr. and Bob Ostrander to Scott D. Sullivan (Apr. 30, 1997). Although it is unclear to the Examiner at what level the KPMG-recommended restructuring was approved, several former Company employees have confirmed that, at the very least, Mr. Sullivan and Mr. Myers reviewed and approved it. It does not appear that the Company’s Board reviewed or approved KPMG’s proposed restructuring and transfer pricing plans.

KPMG at least \$6 million in fees for the restructurings implemented in 1997 and 1998 under the STM project.

In its engagement letter, KPMG contractually agreed to “indemnif[y] WorldCom for claims or assessments arising from incorrect conclusions or negligence on the part of KPMG up to the amount WorldCom paid KPMG excluding situations where the risks associated with applicable implementation points were discussed and WorldCom agreed to take written responsibility for such risk.”³⁴

c. The Proposed 1998 Restructuring

(i) The Proposed Restructuring and Transfer Pricing Programs

KPMG’s restructuring program called for the elimination of redundant entities through mergers and dissolutions, as well as the creation of various transfer pricing programs. KPMG recommended that the Company implement some fairly traditional transfer pricing programs by creating several companies to perform specific functions, such as a company to own the group’s long distance network facilities, a sales company and a purchasing company. The network services company sold network services, the purchasing company provided a centralized purchasing function for the group, and the sales company managed the bulk of the group’s sales force. Each of these companies would receive payments from the other subsidiaries for the services it provided to other members of the group.

³⁴ Id.

(ii) KPMG's Decision to Classify "Management Foresight" as an Intangible Asset Represented a Key Component of the 1998 Royalty Program

(a) The Tax Savings Generated by the 1998 Royalty Program

The 1998 Royalty Program was one of the transfer pricing programs proposed by KPMG (followed later by the 1999 Royalty Program). A principal goal of the 1998 Royalty Program was to address the beliefs of KPMG that the Company should be compensated by its subsidiaries for “management foresight” because the Company’s top management had “undertaken significant activities and risks in order to position the subsidiaries to realize” excess profits.³⁵ The 1998 Royalty Program was the vehicle by which this goal would be accomplished in a tax efficient manner. Under the 1998 Royalty Program, the subsidiaries could deduct the royalty payments made to the Company for the excess profits attributable to “management foresight” and the Company would not be subject to state income tax on all of the royalty payments charged.

To achieve these tax savings, it was imperative that the charges to the subsidiaries be treated as royalties as opposed to fees for services. This distinction was not important for purposes of the subsidiaries’ state income taxes because, in either case, the subsidiaries could deduct the charges as ordinary and necessary business expenses, thereby decreasing their income that was subject to state taxation. However, this distinction was critical for purposes of lowering the Company’s state income tax obligations, on its accrual of the income from these charges.

Under Mississippi’s tax principles of apportionment, royalty income and income from services were treated differently. To the extent that the Company earned income from

³⁵ Report from KPMG ECS, Denver, to WorldCom STM File, Royalty Rate Analysis (Nov. 4, 1997) at 7.

services, all income attributable to services performed by employees in Mississippi would be subject to state income taxation in Mississippi. On the other hand, Mississippi would tax the Company's royalty income only to the extent that the subsidiaries paying such royalties earned their revenue in Mississippi. The Company obtained a ruling from the Mississippi State Tax Commission that confirmed this treatment of royalty income for Mississippi state income tax purposes. As such, if the Company had charged its subsidiaries a service fee rather than a royalty for the use of the "management foresight," most, if not all, of the income received by the Company would have been subject to state tax in Mississippi because most of the Company's top Management worked in Mississippi. Conversely, because the Company's subsidiaries did not earn much of their revenue in Mississippi, the vast bulk of the royalty income received by the Company from the subsidiaries would not be taxed in Mississippi and would not be subject to state income tax anywhere. Thus, charging a royalty rather than a service fee for "management foresight" would have a significantly better overall state tax result for the Company and its subsidiaries.³⁶

(b) The Input of KPMG's Economic Consulting Services and Classification of "Management Foresight" as an Intangible Asset

In order to achieve the tax result described above, KPMG, through its Economic Consulting Services division ("KPMG ECS"),³⁷ identified intangible assets that could be licensed to the WorldCom subsidiaries in exchange for royalties. In its report dated

³⁶ By way of example, if a subsidiary accrued a \$500 million royalty obligation to the Company under the 1998 Royalty Program, the Company would be subject to tax on that income in Mississippi only to the extent that such subsidiary actually earned revenue in Mississippi. Thus, if the subsidiary earned one fifth of its revenues in Mississippi, the Company would be required to pay Mississippi state income taxes on only one fifth of the \$500 million in royalties charged to the subsidiary, or \$100 million. While the Examiner does not have exact figures, it seems reasonable to assume that a relatively small portion of the revenue earned by the Company's subsidiaries was earned in Mississippi.

³⁷ Unless otherwise noted specifically, references to KPMG shall include KPMG ECS.

November 4, 1997 (the “1997 Report”), KPMG ECS concluded that the Company could “receive royalty payments for the use of [its] registered intangible assets, and for those intangibles created by top corporate management.”³⁸ KPMG ECS indicated in its 1997 Report that the Company occupied a unique position in the post-AT&T divestiture era because it was the first provider of bundled telecommunications services.³⁹ Through its numerous acquisitions, the Company could provide multiple bundled product and service lines (e.g., long distance, local telephone, data transmission, Internet and international communications services).⁴⁰ KPMG ECS attributed the Company’s unique position in the marketplace to the foresight and risk taking of its senior executive management.⁴¹ Thus, KPMG ECS, in its 1997 Report, specifically advised the Company that the “foresight of top management” represented a “legitimate intangible” and that the Company could appropriately charge its subsidiaries a royalty fee for this intangible.⁴² The magnitude of the royalty payments was to be determined by the amounts by which a particular subsidiary’s net income exceeded a prescribed benchmark. All profits above that benchmark were deemed to be “excess profits” attributed to the use of the Company’s intangibles and would be paid to the Company as a royalty fee.

Current and former employees of both the Company and KPMG referred to the intangible assets for which royalties were charged under the Royalty Programs as “synergies” and “strategies.” In fact, both the 1997 Report and the subsequent KPMG ECS reports used the same terms, “synergies” and “strategies,” in connection with the discussion of the

³⁸ Report from KPMG ECS, 1997 Report at 4.

³⁹ Id. at 7.

⁴⁰ Id.

⁴¹ Id.

⁴² Id.

purported intangible assets.⁴³ In the end, however, the Examiner believes that the facts support the conclusion that the Company was attempting, through the Royalty Programs, to receive compensation for the benefits that were expected to result from the foresight (or strategy) of its Management to create an integrated global telecommunications company through its numerous acquisitions. As such, to avoid confusion, the Examiner generally refers to the intangible assets allegedly created by top Management as the “purported intangible assets” or “management foresight.”

In determining the royalties to be charged for “management foresight,” KPMG ECS focused on the profitability of the WorldCom group as a whole, rather than conducting a detailed analysis of the risks undertaken and functions performed by each individual subsidiary. Thus, KPMG ECS did not analyze each subsidiary's financial history to determine to what extent (if any) a particular subsidiary might have owned and developed its own unique intangible property or had other attributes that could have given rise to "excess profits." Instead, KPMG ECS simply assumed that no subsidiary owned any such assets or had any such attributes. KPMG ECS's assumption was based on a representation by WorldCom Management that the operating companies did not own any such intangible assets.⁴⁴

This assumption was critically important to the design of the entire 1998 Royalty Program. Presumably, a subsidiary that had been earning excess profits (i.e., profits above the benchmark level) due to its own valuable intangible assets or attributes would not elect to

⁴³ Id. at 6-7; Intercompany Pricing Analysis for MCI WorldCom (Feb. 19, 1999) at 4, 46; KPMG ECS Intercompany Pricing Analysis for MCI WorldCom (June 11, 1999) at 4, 55). The 1999 reports further note that “[a]s the entity responsible for integrating WorldCom and MCI and restructuring them to achieve significantly enhanced profitability, [the Company] is entitled to the excess income generated as a direct result of the synergies.” KPMG ECS February 1999 Report at 555; KPMG ECS June 1999 Report at 46.

⁴⁴ KPMG ECS 1997 Report at 9.

pay a royalty to the Company based on those profits. Those excess profits would have been generated by the subsidiary regardless of whether it became a member of the WorldCom group. Indeed, it is conceivable that no royalty would have been appropriate for that subsidiary. KPMG's failure to conduct this analysis thus limits the reliability of the KPMG ECS study. Rather than analyze each subsidiary's risks, functions and returns in an effort to locate unique intangible assets, KPMG assumed away the issue. As illustrated later in this Chapter, this failure and the implementation of the Royalty Program led to economically indefensible results.

**(c) KPMG Failed Adequately to Disclose the
Risks of Classifying "Management
Foresight" as an Intangible Asset**

It does not appear that KPMG ever suggested to the Company that classifying "management foresight" as an intangible asset was aggressive, risky or potentially a matter of first impression from a tax planning perspective. The Examiner has also not uncovered any evidence that KPMG provided the Company with any tax authority supporting KPMG's conclusion that "management foresight" represented a legitimate intangible asset for which royalty fees could be charged.⁴⁵ In fact, none of the Company employees interviewed by the Examiner who worked closely with KPMG on the creation and implementation of the Royalty Programs believed that charging substantial royalties for "management foresight" was anything other than a "plain vanilla" royalty program.

d. Implementation of the 1998 Royalty Program

The Company worked closely with KPMG to implement the 1998 Royalty Program. KPMG requested that the Company appoint an employee to serve as the lead Company

⁴⁵ The Examiner's investigation has revealed that there is no evidence that KPMG ever considered the case law relevant to the legitimacy of its classification of "management foresight" as an intangible asset. Such case law is discussed in Section IX.C.1.b.ii, infra.

contact on the project. WorldCom appointed one of the heads of its tax department to this position. She was the logical person to take on this role since she had state income tax experience and was interested in focusing more on tax planning than tax compliance.

(i) Retention of Counsel

The lead WorldCom contact on the 1998 Royalty Program did not believe that the Company required legal counsel with strong tax capabilities in connection with the STM project. She felt that, with KPMG as the Company's tax advisor, the Company had access to all of the technical tax expertise required for completion of the STM project. Thus, she believed that a law firm that could document the restructuring transactions, including drafting various merger documents to align the numerous subsidiaries along operational lines, would be most helpful to the effort. She informed the Company's general counsel of the qualifications she believed legal counsel should possess.

Based on her recommendation, the Company retained a law firm with an office in Jackson, Mississippi to serve as counsel in connection with the STM project, including the 1998 Royalty Program. A partner with that firm acted as the lead lawyer on this engagement. That lawyer confirmed to the Examiner his understanding that his firm's role was to document the transactions required to complete the STM strategy. The Company never asked him or his firm to provide tax advice or a tax opinion or to conduct any substantive review of KPMG's tax analysis and conclusions. Company employees involved in the 1998 Royalty Program corroborated the lawyer's understanding of the scope of his firm's engagement.

(ii) The Inadequate 1998 Trademark License Agreement

One of the documents that the Company's outside legal counsel drafted for the 1998 Royalty Program was a license agreement under which the Company would license the intangible assets to certain subsidiaries in return for royalty fees. This license agreement represents a key legal document establishing the 1998 Royalty Program. To assist the Company's outside legal counsel in drafting this document, KPMG provided form trademark license and royalty agreements, which the Company's outside legal counsel assumed KPMG had used in prior KPMG-designed transfer pricing programs. The KPMG forms were standard intellectual property licensing agreements that provided for the licensing of routine intellectual property such as trademarks, trade names, patents and copyrights and the related goodwill. The form agreements did not mention non-routine intangibles such as "management foresight" as intangible assets.

Using the KPMG forms as a starting point to document the 1998 Royalty Program, the Company's outside legal counsel drafted the Trademark License and Royalty Agreement (the "1998 License Agreement").⁴⁶ As finalized, the 1998 License Agreement licensed "WCOM Intangible Assets" to the subsidiaries. The "WCOM Intangible Assets" were defined to include "WCOM Intellectual Property" and "WCOM Proprietary Information." In turn, "WCOM Intellectual Property" was defined as:

[the] registered or unregistered trademarks, tradenames, service marks and other intellectual property, including without limitation the name "WorldCom" and all variations thereof and the goodwill associated therewith

"WCOM Proprietary Information" was defined as:

⁴⁶ The Examiner finds no fault with the work of the law firm retained in connection with the Royalty Programs. It was given discrete tasks to accomplish and, based on the information that it was given, it appears that it discharged its tasks competently. Its work product, however, suffered from a lack of information from KPMG and the Company with respect to the true nature of the 1998 Royalty Program.

certain trade secrets, proprietary information, competitive data and strategies and other confidential and proprietary information used in the business of WCOM and the WCOM Companies⁴⁷

The Company's outside legal counsel told the Examiner that he attempted to capture the "essence" of KPMG's recommendations in the 1998 License Agreement. He said that KPMG's recommendations were relayed to him in various memoranda and reports provided by KPMG and the Company, which outlined the basic transactions. None of these documents provided to outside counsel identified "management foresight" as being among the intangible assets being licensed. As a result, a major disconnect existed between KPMG's royalty concept – "management foresight" as the primary intangible asset being licensed – and the document implementing that concept. The 1998 License Agreement, which was styled as a "Trademark License" agreement, specifically identified traditional intangibles like trademarks, trade names, "competitive data and strategies and other confidential and proprietary information" but not "management foresight." The Company's outside legal counsel acknowledged that he did not know that non-traditional intangibles such as "management foresight" were the principal intangibles being licensed to the subsidiaries, or that it was being licensed at all.

Although the Company's lead contact person and KPMG representatives reviewed the 1998 License Agreement at the time of its drafting, none of them pointed out that the definition of the assets being licensed failed to reflect that "management foresight" represented the principal intangible asset for which royalties would be charged. No one advised outside legal counsel that his understanding was incorrect, that the agreement was fundamentally not a "Trademark License" agreement, and no one advised him to include

⁴⁷ 1998 License Agreement at 2.

“management foresight” as the Company’s public “strategies” as an intangible asset specifically identified in the 1998 License Agreement. Accordingly, it does not appear that the 1998 License Agreement constituted an effective conveyance of any rights to the “management foresight.”⁴⁸

The 1998 License Agreement became effective as of January 1, 1998. The Examiner understands that the Company’s subsidiaries were charged almost \$1.9 billion of royalty fees in 1998 for the purported use of the "management foresight" and the other intangible assets licensed under the 1998 License Agreement. During that same year, the Company, on a consolidated basis, had a loss of \$2.7 billion. Although the 1998 License Agreement specifically required the Company’s subsidiaries to pay these accrued royalties to the Company, no actual payments were made. Instead, the accrued royalties were simply reflected as accounts payable from the subsidiaries.

e. The Misleading Mississippi Tax Ruling Request

To confirm the anticipated tax treatment of the royalty income to be recognized by the Company, the Company (through special Mississippi tax counsel) and KPMG submitted a joint request to the Mississippi State Tax Commission seeking confirmation, among other things, that royalty income generated from the subsidiaries, many of which resided outside of Mississippi, would be taxed to the Company only to the extent that the subsidiaries earned income in Mississippi. The written ruling request gave the Mississippi State Tax Commission no hint as to the true nature of the intangible assets being licensed and did not

⁴⁸ The Examiner does not believe that the term “strategies,” as contained in the previously quoted Proprietary Information definition, could encompass the concept of “management foresight.” In the Proprietary Information definition, the intangible assets included “competitive data and strategies and other confidential and proprietary information” Thus, the focus was on specific confidential competitive data or competitive strategies by which to best the competition. The Examiner does not believe that this could encompass the “vision”-type strategy of “management foresight,” which cannot reasonably be construed as some sort of confidential competitive strategy.

mention that the core intangible asset for which the Company would receive royalty payments was "management foresight." Instead, the ruling request mentioned only that the Company would engage in the licensing of certain well-established intangible assets, specifically "trademarks, service marks, and other intangibles."⁴⁹

In response to this ruling request, the Mississippi State Tax Commission issued a letter ruling to the Company that confirmed the Mississippi state tax treatment of various items of income under the 1998 Royalty Program. The Mississippi ruling repeated what the Company and KPMG indicated in the ruling request – that the Company would license intangible assets to its subsidiaries for a royalty fee. Under principles of apportionment, this royalty income would not be subject to much (if any) Mississippi state tax because Mississippi would tax royalty income only to the extent that the subsidiaries being charged the royalty earned their revenue in Mississippi. In the Company's case, most of the royalty income was charged to subsidiaries that earned their revenue outside of Mississippi.

2. The 1999 Royalty Program After the MCI Merger

a. MCI Enters the Picture

As the Company, with the support of KPMG and the Company's outside legal counsel, continued to implement the restructurings contemplated by the STM strategy, the Company announced on November 10, 1997 its agreement to acquire MCI. The Company

⁴⁹ Letter to Eddie Beck & Gerald Yates from A. Dale Currie Jr., John W. Graham, and Thomas M. Mitchell (Aug. 21, 1997) at 4. The Examiner acknowledges that, although the ruling request did not indicate the true nature of the principal intangible asset to be licensed, the lead KPMG partner on the Company's restructuring project advised the Examiner that representatives of KPMG and the Company met on several occasions with personnel of the Mississippi State Tax Commission to discuss the Company's "business vision." Although the lead KPMG partner said that they did not specifically discuss "management foresight" and whether it was an intangible asset under Section 482, he believed that the Mississippi State Tax Commission was fully aware of the nature of the 1998 Royalty Program. The Examiner must express skepticism of this explanation. Especially in view of the changing descriptions regarding the nature of the intangibles allegedly identified and licensed during the Examiner's investigation, the Examiner has no confidence that anyone, much less the applicable state tax authorities, had a sound understanding of the purported intangible assets being licensed under the 1998 Royalty Program.

and KPMG determined that the acquisition should not prevent the STM project, including the 1998 Royalty Program, from being finalized and implemented.

Beginning in early 1998, the MCI and WorldCom tax departments formed a joint task force to coordinate the business operations and tax planning for the combined enterprise's business following the merger (the "task force"). The member of MCI's tax department who was in charge of handling MCI's consumption and property tax liabilities was appointed to act as the lead MCI representative on the task force. The same WorldCom representative who had served as WorldCom's lead person on the 1998 Royalty Program was the lead representative on the task force from WorldCom.

The task force met frequently beginning in early 1998 and continuing after the consummation of the MCI/WorldCom merger, which became effective on September 14, 1998.⁵⁰ The task force, with substantial input and direction from KPMG, continued the restructuring work begun by KPMG during the prior year, including the implementation of the 1998 Royalty Program and the development of the 1999 Royalty Program. Members of the task force from WorldCom and MCI acknowledged that no one on the task force from either company had substantial expertise in developing, designing, or implementing transfer pricing programs. Accordingly, the task force relied almost entirely on experts from KPMG to provide guidance in this area.

Notwithstanding their lack of transfer pricing experience, it appears that members of the task force failed to monitor the Royalty Programs and failed to seek to understand how they worked. For example, the lead MCI representative on the task force, who later became

⁵⁰ The task force decided that KPMG should continue to act as the Company's tax advisor, and the Company and KPMG executed an engagement letter dated August 13, 1998 which provided for fees of \$3.2 million to be paid to KPMG in connection with the restructuring, including the 1999 Royalty Program. Letter from A. Dale Currie, Jr. and Jerry N. Smith to Walter Nagel (Aug. 13, 1998).

the head of the Company's tax department, professed ignorance as to numerous key aspects of the Royalty Programs, even though he became significantly involved with them. Instead, he repeatedly advised the Examiner that KPMG designed the 1999 Royalty Program and that he did not generally familiarize himself with the details of it. The Examiner is surprised that the head of the tax department was unfamiliar with the tax-sensitive Royalty Programs, particularly because they generated more than \$20 billion of accrued royalties and related tax savings over a four-year period.

The Examiner is also troubled that no Company personnel sought additional legal advice regarding the validity of the Royalty Programs, including whether "management foresight" constituted a legitimate intangible asset. The Company did not seek a confirming opinion from qualified tax counsel nor did it otherwise involve qualified tax counsel in the development or implementation of the Royalty Programs designed by KPMG. Although there is no rule of law mandating a company to obtain a confirming opinion, under the circumstances, the Examiner observes that the Company would have been prudent to have engaged qualified tax counsel to review KPMG's analysis. Since the Royalty Programs generated in excess of \$20 billion in royalty charges to the Company's subsidiaries, a program of this magnitude likely should have been reviewed carefully by qualified tax counsel in collaboration with KPMG.

b. The 1999 Restructuring Recommended and Designed by KPMG

The task force identified various areas in which the combined enterprise's business operations could be conducted more efficiently from a tax perspective. To that end, KPMG prepared several design reports as part of the STM project (which, as it expanded to include federal and international issues, was renamed Total Tax Minimization™, or TTM™, late in

1998).⁵¹ KPMG's design reports essentially established new transfer pricing programs for the Company that included, among other things, a management strategy and an intangibles licensing strategy (the 1999 Royalty Program).⁵² The 1999 Royalty Program, however, apparently simply extended KPMG's earlier conclusion that WorldCom's "management foresight" represented a legitimate intangible asset, by adding modifications to reflect the fact that MCI and its subsidiaries were to be charged royalties primarily for the privilege of joining the WorldCom group of companies.

One additional change from the 1998 Royalty Program was that the Company would no longer directly license the intangible assets to its subsidiaries. Instead, KPMG proposed that the Company segregate the intangibles into a newly created separate legal entity, MCI WorldCom Brands, LLC ("Brands").⁵³ Brands would acquire the rights to the intangibles held by the Company through a license agreement and would, in turn, license those intangibles to certain of the Company's subsidiaries.⁵⁴ One of the stated purposes of the intangibles licensing strategy was to allow the Company to measure properly the contribution of these intangibles to the operating profits of the various operating entities.⁵⁵

Just as with the 1998 Royalty Program, the 1999 Royalty Program reduced the state taxable income of the subsidiaries that were charged a royalty, thus providing potential state income tax benefits to those subsidiaries without creating any significant offsetting state tax

⁵¹ KPMG's Intangibles Licensing Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998); KPMG's Internet Integration Design Report for MCI WorldCom, Inc. (Nov. 2, 1998); KPMG's Management Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998); KPMG's Internal Financing Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998); KPMG's Synergies Planning Strategy Design Report for MCI WorldCom, Inc. (Dec. 1998).

⁵² KPMG's Intangibles Licensing Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998); KPMG's Management Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998).

⁵³ KPMG's Intangibles Licensing Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998), at 4.

⁵⁴ Id. at 5.

⁵⁵ Id. at 3.

liability for the royalty income accrued by Brands. Because Brands was a limited liability company that was wholly owned by the Company, it was generally disregarded as a separate legal entity for tax purposes.⁵⁶ Accordingly, the Company as the owner of Brands would report this income on its state tax returns in the jurisdictions in which it was subject to state income tax, which primarily were the District of Columbia and Mississippi. The District of Columbia, like Mississippi, used principles of apportionment to determine the amount of royalty income that would be subject to state income tax. Under those principles, both jurisdictions would tax the royalty income only to the extent that the subsidiaries being charged the royalties earned revenue in either the District of Columbia or Mississippi.

KPMG again looked to KPMG ECS to prepare an intercompany pricing analysis to provide support for an arm's-length charge for intangible assets. The Company relied on the analysis by KPMG ECS for its conclusion that the accrual of royalties would be deductible by the licensee subsidiaries for state tax purposes. KPMG ECS issued an initial report in February 1999 (the "February 1999 Report") and a final report in June 1999 (the "June 1999 Report" and together with the February 1999 Report, the "1999 Reports"),⁵⁷ which largely mirrored the conclusions of the 1997 Report.

In contrast to the 1997 Report, in which KPMG ECS explicitly stated that the "foresight of top management" was a "legitimate intangible," the 1999 Reports did not specifically identify the principal intangible assets being licensed. Rather, the 1999 Reports spoke in vague terms about the intangible assets being licensed, stating that any excess profits could be attributed in part to "management foresight," "management decisions and marketing strategy" and "the bundled services capability of [the Company] and its

⁵⁶ Id. at 3-5; see also Treas. Reg. § 301.7701-3.

⁵⁷ KPMG ECS February 1999 Report; KPMG ECS June 1999 Report.

[subsidiaries].”⁵⁸ In addition, the 1999 Reports indicated that any excess profits earned by the subsidiaries were made possible by the “foresight and investments made by [the Company’s] top management” and that excess profits should be attributable to the Company because the Company “formulated the strategies, made the investments and bears the risks that are projected to generate non-routine profits.”⁵⁹

As in the 1997 Report, each subsidiary was permitted to earn a level of profits comparable to the profits earned by companies that were not part of the WorldCom group but that performed functions and undertook risks similar to the WorldCom subsidiaries. Like the 1997 Report, the June 1999 Report concluded that all profits a subsidiary earned that exceeded this benchmark level (or all "excess profits") would be shifted to Brands in the form of royalty charges.

Also similar to the 1997 Report, the 1999 Reports analyzed MCI and WorldCom each as a single, consolidated entity and concluded that neither MCI nor WorldCom had earned "excess profits" on an aggregate basis historically.⁶⁰ KPMG ECS thus reasoned that, if the combined enterprise earned excess profits post-merger (as was projected by the Company’s Management), those excess profits would have to be attributable to the "strategy" of putting MCI and WorldCom together and the "synergies" that would result from the merger. However, KPMG ECS failed to analyze, just as it had not analyzed in 1997, each separate

⁵⁸ KPMG ECS February 1999 Report at 15, 18 and 19; KPMG ECS June 1999 Report at 14, 16, 18.

⁵⁹ KPMG ECS February 1999 Report at 3-4; KPMG ECS June 1999 Report at 4.

⁶⁰ During his interview, the former KPMG ECS senior manager who was the principal author of the 1999 Reports told the Examiner that a parent company of a consolidated group could have a valuable Section 482 intangible even if there were no excess profits on a consolidated basis. That is, one subsidiary of that parent could make money and another subsidiary could lose money, with the end result being that the parent company would receive royalties from the first subsidiary and nothing from the second. In this circumstance, there would be no excess profits on a consolidated basis. The Examiner notes that the KPMG templates operated entirely consistent with that view. However, under this approach, the fact that neither WorldCom nor MCI had had any excess profit on a consolidated basis pre-merger would appear irrelevant to the main KPMG assumption that any excess profits should be attributed solely to the Company’s valuable intangible assets.

subsidiary in either the MCI group or the WorldCom group to determine whether any particular subsidiary, on a separate company basis, had earned "excess profits" (i.e., profits above the benchmark level) prior to the merger. Again, the entire design of the 1999 Royalty Program was based on KPMG's conclusions, which did not include this type of analysis.

A particular subsidiary might have earned excess profits on a stand alone basis even though the group of companies, as a whole, had not. If a subsidiary had historically earned excess profits, KPMG ECS then should have examined the source of those profits and determined whether that subsidiary in fact owned any non-routine intangibles or possessed other favorable attributes (such as a particularly favorable geographic market) that could have explained the existence of such excess profits. If, following this analysis, it were found that a subsidiary held non-routine intangibles or possessed favorable attributes, all or a portion of its excess profits presumably should have been attributable to such items, rather than to intangibles licensed to it by Brands. In this situation, the subsidiary would not pay a royalty to the Company equal to its excess profits because that payment would ignore the contributions made by the subsidiary's own non-routine assets. In any event, KPMG failed to identify and then determine the appropriate source of any "excess profits" generated by such a subsidiary.

**c. The Misleading District of Columbia
Tax Ruling Request**

Because Brands conducted its operations from a location in the District of Columbia, income earned by Brands would normally have been subject to tax in the District of Columbia. Therefore, the Company and KPMG needed to ensure that Brands' royalty income was not subject to significant tax in the District of Columbia for the tax planning to work. Accordingly, the Company and KPMG prepared an application to the District of

Columbia Department of Finance and Revenue requesting favorable tax treatment of royalties by the District of Columbia.

This application was set forth in a letter from the Company to the Chief Counsel of the District of Columbia Department of Finance and Revenue. KPMG drafted the application with minor edits by the Company. Like the Mississippi ruling request, the application sought, among other things, to ensure that any royalty income earned by Brands would be taxed by the District of Columbia only to the extent that the Company's subsidiaries being charged royalties actually earned revenue there.

The District of Columbia ruling, like its Mississippi predecessor, was critical to the overall success of the Company's tax planning efforts because it practically eliminated any tax liabilities with respect to Brands' income in the District of Columbia. However, the Examiner finds the application submitted to the District of Columbia troubling. The District of Columbia application never mentioned, cited or referred to "management foresight," much less identified it as the cornerstone intangible asset licensed by Brands. Quite to the contrary, the application states that:

MCI WorldCom, Inc. will through a separate single member limited liability company engage in the management and licensing to affiliates of certain intangible assets, such as trade names, trade marks and service marks.⁶¹

(emphasis supplied.) The District of Columbia application also stated that the Company might receive income due to "[r]oyalties from affiliates for use of trademarks, service marks and other intangibles." However, this vague reference to "other intangibles" gave no hint that a purported intangible asset such as "management foresight" was within the "other intangibles" category.

⁶¹ Letter to Steve Krantz, Chief Counsel, D.C. Department of Finance and Revenue (Dec. 22, 1998) (emphasis added).

Moreover, the District of Columbia application represented that “[t]he royalty . . . income will constitute an essential and integral part of the MCI WorldCom, Inc. group’s trade or business.”⁶² Presumably, this representation was made to convince the Department of Finance and Revenue that the royalties earned by Brands arose from “transactions and activities occurring in the regular course of a trade or business.”⁶³ However, the application failed to describe the true nature of the purported intangible assets, i.e., that the subsidiaries were being charged a royalty fee for the foresight of WorldCom Management in creating a group of companies that provided bundled telecommunications services to its customers. Instead, the application suggested that the royalties to be earned by Brands came from typical and customary intangible assets like trademarks and trade names that were used by the subsidiaries in their day-to-day activities.

Presumably based on the language of the application, the District of Columbia granted the favorable tax treatment requested by the Company. With this ruling in hand, the Company implemented the 1999 Royalty Program. According to members of the task force, the 1999 Royalty Program, which resulted in the accrual of \$5.9 billion in royalties in 1999, \$7.0 billion in 2000, and \$6.5 billion in 2001, remains in place as of the date of this Third and Final Report.

d. Implementation of the 1999 Restructuring

(i) The 1999 License Agreements

As with the 1998 Royalty Program, documentation was necessary to establish the legal obligations under the 1999 Royalty Program. As an initial matter, Brands needed to obtain legal rights to the intangible assets for which royalties would be charged.

⁶² Id.

⁶³ Id.

Accordingly, Brands entered into a license agreement with the Company pursuant to which Brands licensed from the Company all exploitive rights “for the use of all post-merger brands and other intangibles.”⁶⁴ Brands and the Company executed the Intangible Assets License and Operating Agreement for the license of certain intangible assets effective as of January 1, 1999 (the “1999 License Agreement”).⁶⁵ The 1999 License Agreement did not require Brands to make any payments to the Company for the intangible assets being licensed. Instead, Brands transferred equity interests to the Company for those assets.

As of January 1, 1999, Brands entered into the Intangible Assets License Agreement with 282 of the Company’s subsidiaries, which were identified on Exhibit A to the agreement (the “Brands License Agreement,” and together with the 1999 License Agreement, the “1999 License Agreements”).⁶⁶ Exhibit A to the Brands License Agreement also sets forth the range of royalties that could be charged to the subsidiaries, i.e., benchmarks above which any profits by a subsidiary would be deemed "excess profits" and paid by the subsidiaries to Brands as a royalty. Each subsidiary would be charged a royalty based on KPMG’s conclusion that none of the subsidiaries owned non-routine intangible assets or possessed unique attributes.

In connection with the 1999 Royalty Program, the Company again asked the Company’s outside legal counsel to prepare the underlying legal documentation. As with the 1998 Royalty Program, he was not apprised of the 1999 Royalty Program’s details.

⁶⁴ KPMG Intangibles Licensing Strategy Design Report for MCI WorldCom, Inc. (Oct. 16, 1998) at 4. Under KPMG’s Intangibles Licensing Strategy Design Report, Brands would enter into license agreements with the Company’s subsidiaries “for their use of the post-merger U.S. brands and other intellectual property [not intangible property] for an arm’s-length licensing fee.” Id. at 5 (emphasis added).

⁶⁵ 1999 License Agreement between WorldCom and Brands.

⁶⁶ 1999 License Agreement among Brands, L.L.C. and subsidiaries. Not all 282 subsidiaries participated in the Royalty Program even though they were listed on Exhibit A. Mr. Sullivan executed the License Agreements on behalf of the Company, Brands and the subsidiaries.

Consequently, he initially drafted a conveyance agreement pursuant to which the Company sold intangible assets to Brands. After circulating the conveyance agreement to KPMG, and to some other members of the task force, the Company's outside legal counsel learned that he had misunderstood the transaction. The intangible assets were to be licensed to Brands and not sold to it. At that point, he indicated to the Company that he lacked experience with intellectual property law and would need extensive information about the specifics of the transactions to draft satisfactory license agreements. As a result, one of the Company's in-house intellectual property lawyers, who was then a legacy MCI employee and who eventually became the Company's main intellectual property lawyer, assumed primary responsibility for drafting the 1999 License Agreements.

The Company's in-house counsel, like the Company's outside legal counsel, was not informed of the true nature of the intangible assets being licensed. Thus, he did not receive critical information necessary for him to draft a license agreement that was consistent with KPMG's economic studies. Indeed, the Company's intellectual property lawyer never saw and did not know of the June 1999 Report until the Examiner showed it to him at his interview in the fall of 2003. This fact is all the more surprising because that intellectual property lawyer was appointed an executive officer of Brands. As such, the Examiner would have expected him to have been given a clear understanding of what Brands owned and licensed.

Because the Company's intellectual property lawyer did not have the benefit of reviewing KPMG's design reports or any other information about the 1999 Royalty Program, he used the 1998 License Agreement as the starting point for drafting the 1999 License Agreements. As a result, the operative language used in the 1999 License Agreements is

essentially the same as in the 1998 License Agreement.⁶⁷ Thus, the Brands License Agreement defined the licensed “MCI WorldCom Intangible Assets” to include “MCI WCOM Intellectual Property” and “MCI WCOM Proprietary Information.” “MCI WCOM Intellectual Property” was defined as

the registered or unregistered trademarks, tradenames, service marks and certain other intellectual property owned by MCI WCOM and licensed to Brands and all variations thereof and all goodwill associated therewith....

“MCI WCOM Proprietary Information” was defined as

trade secrets, propriety information, competitive data and strategies and other confidential and proprietary information owned by MCI WCOM and licensed to Brands.⁶⁸

As with the 1998 License Agreement, “management foresight” was not specifically identified in the 1999 License Agreements. According to the Company’s outside legal counsel, KPMG reviewed and approved the 1999 License Agreements before they were finalized.

Exhibit A to the 1999 License Agreements represents one of the most critical pieces of the Brands License Agreement because it lists all members of the MCI WorldCom group of companies, identifies the subsidiaries that would be charged a royalty and provides a range of royalty rates. Although the Examiner has been unable to confirm who drafted Exhibit A, individuals interviewed by the Examiner believe that KPMG prepared it with the assistance of Company employees and the Company’s outside counsel.

Whoever prepared Exhibit A failed to make any mention of the key intangible asset being licensed to the subsidiaries in exchange for the royalties, i.e., “management foresight.” Instead, Exhibit A states that the royalty was to be paid to Brands merely “for the privilege of

⁶⁷ 1998 License Agreement; 1999 License Agreement between WorldCom and Brands; 1999 License Agreement among Brands and subsidiaries.

⁶⁸ 1999 License Agreement among Brands and subsidiaries at 2. Patents and copyrights were not included among the licensed MCI WCOM intangible assets.

using the trade name."⁶⁹ Other internal Company documents also refer solely to the trade name. For example, the instructions to the templates created to calculate the royalty fees (as well as other charges pursuant to other intercompany agreements) under the Royalty Programs specifically state that the royalty fee is for use of the trade name. The failure to identify accurately the principal intangible assets under the main documents relating to the 1999 Royalty Program parallels the vague description of the intangible assets in the main documents relating to the 1998 Royalty Program (the 1998 License Agreement and the application to Mississippi regarding the tax treatment of royalty income).

(ii) KPMG Created the Templates Used to Calculate the Royalty Charges

KPMG designed templates to implement the Company's transfer pricing programs, including the Royalty Programs. The templates were initially created by KPMG in connection with the Company's 1998 transfer pricing programs but were updated after the MCI merger to add the operating subsidiaries that WorldCom acquired from MCI. The templates were essentially spreadsheets that were comprised of information cells and formulas to implement the intercompany charges, including to identify which subsidiaries earned "excess profits" and to calculate the amount of those excess profits and corresponding royalty charges.

KPMG initially ran the templates for the Company and continued to do so through the fourth quarter of 1999. In running the templates, KPMG employees manually input each subsidiary's net income and other relevant financial results into the appropriate cell in the templates and executed the program such that the KPMG formulas were run and the intercompany charges, including the royalty charges, were calculated. KPMG then provided

⁶⁹ Id.

the results from the templates to the Company so that its accounting department could charge the subsidiaries for the various intercompany transactions. Oddly, although the figures generated by the templates were critical to the Royalty Programs, the KPMG employee initially running the templates for the Company never reviewed or was asked to review the outcomes to determine whether they were appropriate. It is also interesting that, although KPMG often conducts a post-implementation review of its programs for its clients, KPMG did not conduct such a post-implementation review for the Company. The Examiner has been unable to determine whether such a post-implementation review was not offered by KPMG or was declined by the Company.

The Examiner notes that the templates, as designed, calculated a royalty charge for each subsidiary based solely on that subsidiary's current profits and did not take into account whether the group generated excess profits as a whole. The June 1999 Report concluded that “management foresight” was a valuable intangible asset based on management projections of excess profits for the MCI and WorldCom companies taken as a whole. In order to justify the royalty charges for this “asset,” the June 1999 Report assumed that excess profits would be achieved by the WorldCom group taken as a whole. In order to be consistent with these conclusions, KPMG or the Company presumably should have designed templates that took into consideration whether the group as a whole was generating excess profits.

(iii) KPMG’s Recommendations to Provide Economic Substance to the 1999 Royalty Program

(a) Royalties Should be Paid on a Quarterly Basis

One recommendation that KPMG made to the Company was that the Company’s subsidiaries should actually pay the royalties for the use of the purported intangible assets to Brands on a regular basis. KPMG explicitly made this recommendation to the Company on

several occasions. For example, KPMG recommended in a written memorandum that “the payments on intercompany transactions [should] be made in cash to strengthen [the Company’s] position that the intercompany payments are deductible expenditures . . . [and] strengthen [the Company’s] position that the royalty arrangements are arm’s length.”⁷⁰ Later, KPMG similarly recommended that the subsidiaries pay the royalty fees quarterly and “[t]hese payments should be made in cash rather than through journal entries.”⁷¹ Consistent with KPMG’s recommendation that the subsidiaries pay the royalties, the Brands License Agreement (and the 1998 License Agreement) required each subsidiary to pay royalties on a quarterly basis.⁷² The subsidiaries, however, never paid royalties to Brands (or the Company under the 1998 License Agreement). Instead, the royalty charges were accrued.

(b) Brands Should Have Paid for Marketing and Advertising Relating to the Intangible Assets

The Company also failed to follow KPMG’s advice in another significant respect. One of the underlying assumptions of KPMG ECS justifying the royalty payments was that Brands, as licensor of the intangible assets, would pay for advertising and promotion of the MCI WorldCom trade name and other intangibles.⁷³ In fact, the June 1999 Report specifically states that “Brands will fund and manage advertisement spending for new marketing programs of the MCI WorldCom Group.”⁷⁴ This requirement is not surprising. Such actions by Brands would lend support to the economic substance of the Royalty Programs because Brands would then have assumed the risks associated with brand

⁷⁰ Memorandum from Michael F. Carchia to MCI WorldCom TTM Files, Method for Recording Management Fee, Interest and Royalty Payments, (Dec. 9, 1998) at 3KPMG-B 090635.

⁷¹ Memorandum from Michael F. Carchia to MCI WorldCom TTM Files (first page dated Feb. 16, 1999, subsequent pages dated Aug. 2, 1999) at 3KPMG-B 181333.

⁷² See 1998 License Agreement at 3-4; 1999 License Agreement among Brands and the subsidiaries at 5.

⁷³ KPMG ECS June 1999 Report at 13.

⁷⁴ Id.

development, thereby providing additional economic justification for the royalty charges. In practice, however, the subsidiaries that paid the royalties also paid for advertising and thus assumed the economic risks associated with developing the post-merger brands for which they were being charged.

(c) The Royalty Charges Were Excessive

The Company anticipated that its profitability would increase significantly after the merger with MCI as a result of the synergies that the combined entity would generate. KPMG and the Company believed that a portion of this projected increased profitability would be attributable to the purported intangible assets allegedly contributed by top Management. The Royalty Programs were designed to compensate the Company, where top Management resided, for creating the purported intangible assets.⁷⁵ According to KPMG, the 1999 Royalty Program was intended to “[a]llow for a more accurate determination of the contribution of certain valuable intangible assets to the overall results of MCI WorldCom.”⁷⁶ As such, it appears that the purpose of the Royalty Programs was for the royalty charges to represent some portion of the Company’s overall increase in net income.

Although apparently not the intended result, the accrued royalties far exceeded the Company’s overall net income for each of 1999, 2000 and 2001. The Examiner understands that Brands accrued royalties from the subsidiaries as follows under the 1999 Royalty Program: \$5.9 billion in 1999, \$7.0 billion in 2000 and \$6.5 billion in 2001.⁷⁷ In contrast, the Company’s consolidated net income from its publicly reported financial statements was

⁷⁵ Id.

⁷⁶ KPMG Design Report Intangibles Licensing Strategy for MCI WorldCom, Inc. (Oct. 16, 1998) at 6.

⁷⁷ FTI’s Report to the Official Committee of Unsecured Creditors (March 12, 2003) (basing its analysis on MCI WorldCom’s un-restated financial statements).

\$4.0 billion in 1999, \$4.2 billion in 2000 and \$1.4 billion in 2001.⁷⁸ Individuals intimately involved with the Royalty Programs, when shown these numbers by the Examiner, expressed surprise at the results. As an example of the absurdity of the results, the Company's consolidated net income increased \$200 million from 1999 to 2000. During the same period, however, the subsidiaries' royalty payments increased by \$1.2 billion. It seems apparent that the Company's purported "management foresight" intangible asset could not have commanded such an increase in royalty payments in an arm's-length transaction.

Additionally, even if one views the economic results of the Royalty Programs by looking at the results on a subsidiary-by-subsidiary basis, the royalties charged often constituted an inordinate percentage of the subsidiaries' net income calculated before the royalty was taken into account. For example, one subsidiary, WorldCom Network Services Inc., was charged a royalty of \$2.9 billion in 1999. This company had a net loss of \$1.2 billion before intercompany charges. After receiving a net increase of \$4.6 billion through various intercompany charges, the company was left with a total net profit before the royalty charge of \$3.4 billion. Accordingly, more than 85 percent of its net income was shifted to Brands as a result of the royalty charge. Despite these incongruous results, no one at the Company questioned the economic validity of the charges.

e. 2001 Change to the Royalty Programs

In 2001, members of the Company's tax department informally determined that the excess profit thresholds under the 1999 Royalty Program should be amended in light of prevailing economic conditions affecting the telecommunications industry, i.e., comparable companies were not as profitable as they had been in 1999 when KPMG ECS performed the

⁷⁸ 1999 MCI WorldCom, Inc. 10-K (Mar. 30, 2000); 2000 MCI WorldCom, Inc. 10-K (Mar. 30, 2001); 2001 MCI WorldCom, Inc. 10-K (Mar. 13, 2002).

pricing analysis. Members of the Company's tax department consulted with at least one member of KPMG ECS and determined that it would be appropriate for the subsidiaries to pay royalties to the Company starting at lower benchmark levels of profitability. Ironically, the fact that the telecommunications sector went into a slump led to the result that the Company could charge its subsidiaries more for the privilege of being in the group.

The members of the Company's tax department involved in the 2001 change did not recall seeking any corporate approvals for this change and the Examiner has seen no evidence of such approvals. They sought no legal advice from the Company's inside or outside counsel about the legal steps necessary to amend the License Agreement. They also did not recall whether any of the Company's subsidiaries in fact approved this increase to their royalty obligations. Instead, after consulting with KPMG, the tax department personnel unilaterally changed the benchmarks by which the royalties were calculated and placed lower rates into effect. The Examiner observes that these actions are more consistent with a "paper" transaction driven by tax considerations than a structured business deal among parties acting at arm's-length.

3. The Company and KPMG Attempt to Define the Intangible Assets in 2003

The Examiner's representatives advised the Company and KPMG during the fall of 2003 that they could find no persuasive legal support for the proposition that "management foresight" was a Section 482 intangible asset that could be commercially transferred to a third party. The Examiner invited the Company and KPMG to submit an explanation of the Royalty Programs, including what "intangible assets" the Company purportedly licensed to the subsidiaries that were worth \$20 billion over a four-year period. Both the Company and

KPMG accepted this invitation and separately submitted materials attempting to explain the nature of the intangible assets that formed the basis for the Royalty Programs.

Through its bankruptcy counsel, the Company provided a letter to the Examiner, dated December 11, 2003, setting forth the Company's position. In this letter, the Company stated that the licensed intangible asset was not "management foresight" but, instead, was the "strategy of providing 'end to end bundled services over global networks.'" According to the Company, "management foresight" merely was the "source of that intangible" and "synergies" were the "fruit of that intangible."

KPMG responded to the Examiner's invitation in a memorandum dated December 19, 2003. KPMG formulated its answer somewhat differently. KPMG advised the Examiner that the licensed intangible asset had two components: "(i) an overall program to create a worldwide integrated telecommunications company including voice, data, video and Internet and (ii) expert methods and systems for integrating acquired telecommunication companies to create a single network that efficiently delivered this range of telecommunication services." Interestingly, only KPMG asserted that the intangible asset included "expert methods and systems." The Company made no such assertion in the materials provided to the Examiner.

C. The Examiner's Determinations with Respect to the Royalty Programs

The Examiner concludes that the design and implementation of the Royalty Programs were seriously flawed in several critical respects. A *bona fide* intangible assets transfer pricing program that will withstand scrutiny must, at a minimum, possess the following elements: (1) assets that constitute intangible assets within the meaning of Section 482 must exist and be commercially transferable to third parties; (2) the owner(s) of such intangible

assets must be identified; (3) an appropriate (“commensurate with income”) consideration must be established and maintained; and (4) the owner must actually transfer rights to the intangible assets in exchange for appropriate consideration. WorldCom’s Royalty Programs had serious flaws in each of these elements.

On KPMG’s advice, the Company sought to license a purported intangible asset, “management foresight.” The Examiner believes that this “asset,” as identified and described by KPMG, is not a Section 482 asset and, further, that it could not be commercially transferred to third parties. Additionally, even if “management foresight” could be viewed, under certain circumstances, as a commercially transferable intangible asset within the meaning of Section 482, there is no evidence that the Company owned it or that other valuable intangible assets were not owned by certain subsidiaries. To the contrary, KPMG failed to undertake a detailed, subsidiary-by-subsidary analysis to identify whether any unique intangible assets were owned by certain subsidiaries. Further, the royalty charges for this “asset” do not appear to be commensurate with the income derived from it, calling into question the economic substance of the programs. Finally, the legal documentation that exists failed to transfer the asset that the Company supposedly licensed to its subsidiaries.

1. “Management Foresight” is Not a Section 482 Intangible Asset

The Examiner disagrees with KPMG’s conclusion that “management foresight” or, as the Company and KPMG have more recently cast it to the Examiner, the “strategy” of providing end-to-end bundled services over global networks, was a legitimate intangible asset for which a royalty could be charged. Instead, based on the evidence that the Examiner has been provided and his review of applicable law, this conclusion lacks persuasive factual and legal support.

a. “Management Foresight” is Not Among or Similar to Any of the Section 482 Intangible Assets

The regulations under Section 482, on which KPMG relied to render its advice, do not support the conclusion that “management foresight” is an “intangible asset” for Section 482 purposes.⁷⁹ The Section 482 regulations define intangible assets as follows:

- (i) Patents, inventions, formulae, processes, designs, patterns, or know-how;
- (ii) Copyrights and literary, musical, or artistic compositions;
- (iii) Trademarks, trade names, or brand names;
- (iv) Franchises, licenses, or contracts;
- (v) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- (vi) Other similar items. For purposes of Section 482, an item is considered similar to those listed in [i through v above] if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.⁸⁰

“Management foresight” is not among the intangible assets that are enumerated in the Section 482 regulations. Furthermore, it does not appear to be similar to any of those listed intangible assets. The Examiner realizes that the label given to a particular item is not determinative as to whether it constitutes a Section 482 intangible asset. Rather, one must look to the economic substance of the item purportedly being licensed to assess whether a royalty (and the amount thereof) can be properly charged. Nonetheless, the fact that “management foresight” and “strategies” are not among the assets listed in the Section 482 regulations is one indication that the Royalty Programs were flawed.

⁷⁹ The Examiner’s analysis is based on Section 482 principles because (1) those were the principles relied upon by KPMG to render its opinions; and (2) most states are likely to utilize those principles to examine the Royalty Programs.

⁸⁰ 26 C.F.R. § 1.482-4(b).

Against this backdrop, subjective thoughts, desires, visions, aspirations and convictions held from time to time by a group of people, be they top managers or not, would not qualify as Section 482 intangible asset. Human talents, expertise and experience are, of course, a valuable (and, indeed, indispensable) element to any business organization. At times, these human qualities can have a worthy intellectual content, but they are not “assets” in the tax sense, the existence of which can be objectively verified. Consistent with this, the Section 482 regulations expressly provide that for an asset to constitute an intangible asset within the meaning of Section 482, it must have value "independent" from the services of any individual.⁸¹ Here the "management foresight" or "strategy" seems to be no more than the vision of senior WorldCom Management to pursue the strategy of providing bundled telecommunications services to WorldCom customers. This "asset" has no value beyond the services of WorldCom Management.

One can argue that “management foresight,” or something similar, could evolve into valuable intangible property in the form of objectively verifiable systems, methods and business procedures, the value of which is not dependent on the services of any individual. Such systems, methods and procedures, if actually developed, can be Section 482 intangible assets. In the course of his examination, however, the Examiner was unable to identify any evidence that the Company possessed such intangibles.⁸² Indeed, the KPMG ECS

⁸¹ Id.

⁸² The Examiner notes that no present or former Company or KPMG employee articulated during the Examiner’s interviews a meaningful definition of “management foresight.” In fact, the array of responses to the Examiner’s inquiries led the Examiner to conclude that not even the persons who were intimately involved with the Royalty Programs truly understood what purported intangible(s) were being licensed pursuant to the Royalty Programs. Further support for this conclusion can be found in the Company’s filings in the MCI Bondholders’ case, in which neither the Company nor its counsel was able to pinpoint the meaning of the intangibles purportedly being licensed, but instead provided the following wide-ranging examples of what they perceived “merger synergies” and “management foresight” to include: (1) the ability to raise and borrow money; (2) the ability to create bundled services; (3) the “first-to-market” advantage that existed; (4) the ability to protect trademarks and trade names; and (5) cost savings. In short, Company personnel were unable to provide a

professional who was intimately involved in the preparation of the 1997 Report and the 1999 Reports confirmed that he was not aware of any such proprietary systems or methods that the Company had developed.

b. Whether the Royalty Programs Purport to License “Management Foresight” or a “Strategy,” a Section 482 Intangible Asset Did Not Exist

(i) The Company and KPMG Efforts to Redefine the Royalty Programs’ Intangible Asset

In December 2003, the Company and KPMG separately submitted materials to the Examiner, attempting to explain the nature of the intangible asset(s) that formed the basis for the Royalty Programs. According to the Company, the licensed intangible asset was not “management foresight” but, instead, was the “strategy of providing ‘end to end bundled services over global networks.’” “Management foresight” was stated to be the “source” and synergies were the “fruit” of this intangible asset. The Company claimed that such a business strategy would qualify as an intangible asset under the broad definition of that term in Section 482. The Company dismissed as an “imprecise use of terminology” KPMG’s express conclusion in its 1997 Report that “foresight of top management” was a “legitimate intangible asset.”

KPMG identified the purported intangible asset(s) somewhat differently. According to KPMG, the licensed intangible asset was “(i) an overall program to create a worldwide integrated telecommunications company including voice, data, video and Internet and (ii) expert methods and systems for integrating acquired telecommunication companies to create

cogent description of the intangible asset(s) supposedly being licensed, underscoring doubt that a legitimate intangible asset ever existed.

a single network that efficiently delivered this range of telecommunication services.”⁸³ While the purported asset identified by KPMG in (i) is similar to the “strategy” described by the Company, the purported asset identified by KPMG in (ii) is different. The KPMG assertion seems to be that the Company possessed objectively verifiable proprietary methods and systems to integrate the acquisition targets into the WorldCom family of companies. Notably, the Company, which presumably should know what assets it has, did not make this assertion on its own behalf.

This lack of uniformity in the description of the purported intangible asset only underscores the ambiguity surrounding the ephemeral nature of the purported intangible assets that the Company claimed it licensed to subsidiaries in return for approximately \$20 billion of royalty accruals over a four-year period. Indeed, the intangible asset purportedly licensed by the Company has had ever-changing definitions. Based on the most recent materials submitted by KPMG and the Company, it seems that they define the purported “asset” as one of two things or a combination thereof: a business “strategy” of some sort that rises to the level of an intangible asset; and/or a business system that could be used to integrate the Company’s businesses. The Examiner observes that some persons interviewed characterized the asset that was licensed as the overall plan to “put it all together.” However, no witness interviewed (including current and former KPMG personnel) corroborated KPMG’s most recent assertion that the Company developed proprietary methods and systems to integrate acquired telecommunications companies. Also, the contemporaneous documents

⁸³ In its December 19, 2003 memorandum, KPMG limited its response to the 1999 Royalty Program. By so doing, KPMG limited the scope of its response such that it did not confront KPMG’s own choice of language set forth in the 1997 Report to the effect that the “foresight of top management” was a “legitimate intangible asset.”

do not use such terms.⁸⁴ Nonetheless, since these reformulations of the intangible asset being licensed represent the most recent positions of the Company and KPMG and were proffered at the Examiner's request, the Examiner will address them in his analysis to determine whether an "intangible asset" in fact existed that was licensed to the subsidiaries on the basis recommended by KPMG and implemented by the Company.

The Examiner does not believe that the new formulations proffered by the Company and KPMG have identified an intangible asset that could support the royalty charges. First, the Examiner fails to see how the overall WorldCom business "strategy" of putting together a group of companies that could provide bundled telecommunications services was something that could be, and was, licensed to the subsidiaries. As explained in greater detail hereafter, this business "strategy" appears to be nothing more than the benefits that inure to the members of a controlled group of companies by virtue of being vertically and/or horizontally integrated. That does not, in and of itself, constitute an intangible asset.⁸⁵

Second, KPMG, in its December 19, 2003 memorandum, asserts that the Company possessed expert methods and systems to integrate acquired companies to create a single network that efficiently delivered bundled telecommunication services.⁸⁶ As noted above, the Examiner neither has seen any credible evidence nor heard witnesses corroborate the existence of any such expert methods and systems that rose to the level of an intangible

⁸⁴ Internal Company documents specifically state that the Royalty Programs were for the use of the WorldCom tradename. Similarly, Exhibit A to the 1998 License Agreement and the Brands License Agreement expressly contain statements to the effect that the royalty charges are for the use of the MCI WorldCom tradename. The draftsmen of the License Agreements, both internal legal counsel and outside legal counsel, separately expressed the view that the license was for post-merger trademarks and tradenames of WorldCom.

⁸⁵ *Merck & Co., Inc. v. United States*, 24 Cl. Ct. 73, 82-88 (1991).

⁸⁶ In this connection, KPMG refers to management's slide presentations that were created to present the MCI transaction to the public capital markets and a 144-page proprietary document that detailed an integrated telecommunications product offering (Intelnet). It does not appear that these two documents contain any proprietary information that would justify charging over \$20 billion in royalties.

asset.⁸⁷ Moreover, to the extent that physical integration efforts were undertaken (such as integrating the historic MCI and WorldCom networks), some or all of those efforts may more appropriately be treated as services performed on behalf of the acquired company. WorldCom did not use the royalties to charge its subsidiaries for the provision of such services.

(ii) Caselaw Confirms the View that There Was No Section 482 Asset

The Examiner acknowledges that there is not a great deal of Section 482 caselaw that is directly relevant to an assessment of the Royalty Programs. However, to the extent such law exists, it supports the Examiner's conclusion that WorldCom's purported intangible asset, "management foresight" (or even the new formulations of "strategies" and integration "systems"), did not constitute a Section 482 intangible asset.⁸⁸

To support its assertion that the ability to integrate acquired companies somehow transcended the provision of a service and became an intangible asset that was licensed to

⁸⁷ KPMG in its December 19, 2003 memorandum, identified broad statements such as from a WorldCom Prospectus and news articles about WorldCom's anticipated integration efforts and WorldCom's purported expertise in integrating acquired companies. This is not persuasive proof of the existence of the types of systematic management methods and systems that rose to the level of an intangible asset in Hospital Corporation of America v. Commissioner, 81 T.C. 520 (1983), which is discussed *infra*. Indeed, the HCA Court cautioned against reliance on "the sales puffery inherent in annual reports" and proceeded to find an intangible asset in HCA only when shown evidence, including detailed manuals, of an actual management system provided by the parent to the subsidiary. *Id.* at 523-24 & n.2, 600-01. If the Company had such detailed integration management systems that it sought to license to the subsidiaries, the Examiner would have expected them to have been documented to the Examiner and to have been mentioned in the KPMG Design Reports and the License Agreements. None of that occurred, leading the Examiner to conclude that no such intangible asset exists. Further, as reported by the Examiner previously, many persons interviewed by the Examiner stated that WorldCom lacked any real systems for integration of acquired companies. Second Interim Report at 71-73.

⁸⁸ During a January 21, 2004 meeting between the Examiner's and the Company's representatives, the outside counsel of the Company suggested that the Examiner take into account the recent decision of the New York City Tax Appeals Tribunal in *In the Matter of Toys R Us-Nytex, Inc.* (January 14, 2004). US-NYTEX, INC., TAT (E) 93-1039 (CG) (New York City Tax Appeals Tribunal Jan. 14, 2004). The Examiner has found the royalty arrangement therein to be materially different from the Royalty Programs in both their design and the implementation. The Tribunal's factual and legal findings regarding the scope of what constitutes a Section 482 intangible, the evidentiary value of the transfer pricing experts' testimony, and the limitations on the application of the economic substance doctrine have not altered the Examiner's analysis and conclusions with respect to the Royalty Programs.

subsidiary companies, KPMG likens WorldCom’s purported intangible asset to the system of hospital management that was held to be a Section 482 intangible asset in Hospital Corp. of America v. Commissioner (“HCA”).⁸⁹ The Examiner agrees that the lessons gleaned from HCA are instructive when searching for an asset within the meaning of Section 482. However, the nature of the “management system” found to be an intangible asset in HCA only serves to solidify the Examiner’s conclusion that WorldCom licensed no such system via the Royalty Programs.

In HCA, the company developed a management system that it used to manage its entire network of affiliated hospitals, along with certain non-affiliated hospitals under management contracts. HCA’s areas of management expertise included establishing good relationships with medical staffs, financial controls, and accounting and staffing. HCA also provided the advantages of group purchasing, the opportunity for consultation among peers, the sharing of ideas and methods, and assistance with long-range planning. HCA compiled some of its management expertise, particularly relating to accounting and finance, in a series of manuals that were copyrighted.⁹⁰

HCA formed a new Cayman Islands company, LTD, to negotiate, enter into and perform a management contract with a Saudi Arabian hospital. LTD used HCA’s existing hospital management system as a negotiating tool to convince the Saudi Arabian hospital to enter into the arrangement and as a tool to carry out its management duties under the contract with the hospital.⁹¹

⁸⁹ 81 T.C. 520 (Tax Ct. 1983).

⁹⁰ Id. at 524.

⁹¹ Id. at 599.

The IRS asserted that some of the income from the Saudi hospital contract should be allocated to HCA from LTD under Section 482 because HCA provided services and certain intangible assets to LTD for which it was not adequately compensated. The Tax Court held that an allocation would be required as a result of services provided by HCA to LTD. Significantly, the Tax Court also held that an allocation of royalty income was required because LTD made use of HCA's intangible asset consisting of its then existing management system.⁹²

Similarly, KPMG asserts that the Company provided its allegedly unique program and systems to the subsidiaries to increase their profitability and that, in the absence of these programs and systems, the subsidiaries would not have achieved certain revenue synergies, cost synergies and income synergies. KPMG claims that some of the details of the methods and systems were referenced in the Company's annual reports, including: (i) for network development – the aggressive deployment of new facilities to meet growing customer demand in certain key areas; success in collocation; rapid increase in port capacity; the increase in the number of network switches; the swift deployment of new fiber; and quadrupling the backbone bandwidth of the UUNET internet network; and (ii) for international operations – 100 percent ownership to create a competitive advantage and lessen international termination costs; obtaining cross-border licenses and constructing a Pan-European network, the first of its type to be launched across the continent of Europe; the installation of twin transatlantic cables; and globalizing the presence of UUNET. KPMG asserts that this purported “management system” was akin to the system utilized by LTD in HCA and, thus, should qualify as an intangible asset under Section 482.

⁹² Id. at 600.

The system referred to by KPMG is patently different from that described in HCA. HCA's management system was an established and documented process that was made available to LTD, a subsidiary, to perform its obligations under a management contract with the Saudi hospital. Without these established procedures and processes, LTD (a shell corporation) would have been unable to perform its obligations. As described by the HCA court, the HCA management system included the following, among other things:

Petitioner compiled some of its expertise, particularly in accounting and finance, into a series of manuals, which in later years were copyrighted. The manuals were furnished to the hospital administrators for assistance in running the hospitals.⁹³

In a footnote, the Court described the manuals:

The manuals were titled Volume I, Shared Applications, Operations and Maintenance; Volume II, Shared Application, Patient Accounts; Volume III, HCA Services Information Systems, Shared Applications, General Accounting; Volume IV, Shared Applications, Health Care Administrative Services.⁹⁴

KPMG would have the Examiner believe that this specialized management system in HCA is substantially similar to the Company's purported expert methods and systems for integrating acquired telecommunication companies to create a single network that efficiently delivered this range of telecommunication services. The Examiner disagrees.

First, the "system" identified by KPMG, but not the Company, is nothing but a general description of the WorldCom vision of a seamless network to provide bundled services to its customers. Thus, it is not a specific and objectively verifiable system of procedures or processes provided by the Company to the subsidiaries that could then be used to generate excess profits.

⁹³ 81 T.C. at 524.

⁹⁴ Id. at 602 n.2.

Second, the “system” described by KPMG is no system at all. The development of network switches and other new facilities is simply part of WorldCom’s overall program or “strategy” to create a worldwide integrated telecommunications company. That, at best, is the business acquisition and operational model resulting from Management’s vision and foresight. Unlike HCA’s affiliate LTD, which was a newly formed shell corporation, the Examiner has seen no evidence that the WorldCom subsidiaries used this “strategy” to run their day-to-day operations. Instead, the subsidiaries could use the strategy only by replicating the overall structure of the WorldCom group, i.e., by acquiring other companies and making them part of their own “integrated” groups. They did not do this. Thus, the strategy identified by KPMG and the Company was not “used” by the subsidiaries, but instead was used by WorldCom to acquire and integrate these subsidiaries into an affiliated organizational structure. As discussed below, Merck holds that the creation of an affiliated organization structure does not constitute a Section 482 intangible asset. The failure of the WorldCom subsidiaries to apply and use this “strategy” distinguishes the Company’s strategy from the management system described in HCA.

KPMG’s description of the WorldCom intangible asset diverges from that proposed by the Company in that KPMG contends that the strategy also includes “expert methods and systems for integrating acquired telecommunication companies to create a single network that efficiently delivered this range of telecommunication services.” The Examiner has not been presented with any facts indicating that these expert methods and systems existed. Consistent with the Examiner’s conclusion, the Company has not asserted on its own behalf that any such expert methods and systems exist. As noted, in HCA, HCA had created and provided to the subsidiaries detailed manuals by which to manage hospitals. The Examiner

has no difficulty accepting that such an existing management system, that was provided to and used by HCA's subsidiary, could constitute an intangible asset. However, the Examiner discovered nothing comparable at WorldCom. Further, it is important to note again that any such management system for integrating the WorldCom group of companies is not identified in the licensing documents and no person interviewed by the Examiner suggested that this was part of the intangible asset licensed to the subsidiaries.⁹⁵

The Examiner believes that the purported licensed items, whether called “management foresight,” “strategies” or an integration system, are more akin to those held not to qualify as Section 482 intangible assets in Merck & Co., Inc. v. United States.⁹⁶ In Merck, a vertically integrated group of companies operated a unified pharmaceutical business. The IRS claimed that a separate intangible asset existed in terms of the Merck group organization – an affiliate structure, a pricing mechanism structure, and a group wide planning structure – and that such asset gave rise to profits for which the holding company could have, and should have, demanded compensation. The Court of Federal Claims rejected this assertion. The court held that Merck’s affiliate structure, regardless of how efficient or well-run, possessed nothing dramatically different from any other vertically integrated business. The court stated:

Organizational structure is not listed in the [Section 482] regulation as a recognized, independent item of intangible property. Organizational structure,

⁹⁵ On January 16, 2004, the Examiner’s representative’s provided the Company with a draft of the Third and Final Report, containing Chapter IX in substantially the same form as filed with the Bankruptcy Court. On January 21, 2004, the Examiner’s representatives met with four counsel for the Company to receive comments on the draft, including Chapter IX. The Company’s representatives had no comments on the Examiner’s draft discussion of HCA, including the Examiner’s observations that he had been provided no evidence of any systems at WorldCom similar to the HCA systems that constituted intangible assets. The Company’s failure to provide evidence of such systems, especially after being shown a draft of the Third and Final Report, further underscores the belief that such systems did not exist at WorldCom.

⁹⁶ 24 Cl. Ct. 73 (1991).

without more, is not included in the concept of an enforceable property right that would support an arm's length license agreement.

...

The Merck Group's structure of corporate entities that discover, develop, and produce essential materials in bulk quantities, manufacture, package and label end-products, and market those products is not unique to Merck. It is a type of organization common in large scale international businesses. The "methods," "programs," and "procedures" involved in such organizations are not recognized as embodying rights to property so as to qualify under the regulation as intangible property with independent value.

Defendant's intangible property argument essentially is no more than a recognition that Merck is the parent of the foreign affiliates and MSDQ. A parent corporation may create subsidiaries and determine which among its subsidiaries will earn income. The mere power to determine who in a controlled group will earn income cannot justify a Section 482 allocation from the entity that actually earned the income.⁹⁷

As such, the creation of an integrated group of subsidiaries and the power of the parent to determine which subsidiary will earn a particular type of income does not constitute a separate asset that supports a royalty charge from such subsidiaries to the parent.

To support the 1999 Royalty Program, KPMG also relies on DHL Corp. v. Commissioner⁹⁸ for the proposition that the "strategy" to provide bundled telecommunications services and the expert systems used to integrate the disparate elements are deserving of compensation. At the outset, the Examiner notes that DHL was decided by the Tax Court on December 30, 1998 and was released immediately before the January 1, 1999 effective date of the 1999 Royalty Program, which included MCI. If the DHL opinion was, as KPMG suggests, directly relevant, the Examiner would have expected KPMG's materials to reference DHL and discuss the case's importance and relevance to KPMG's conclusions. However, the KPMG materials reviewed by the Examiner do not cite or

⁹⁷ Id. at 87-88 (footnote omitted).

⁹⁸ TC Memo 1998 – 461, 76 T.C.M. (CCH) 1122 (1998), aff'd in part, rev'd in part, 285 F.3d 1210 (9th Cir. 2002).

otherwise refer to DHL. Likewise, the Company in its December 11, 2003 submission to the Examiner does not rely upon or even cite DHL. Nonetheless, since KPMG now references DHL, the Examiner has considered its relevance and concludes that DHL does not aid the analysis of the Royalty Programs.

DHL was a network of companies that operated a global package delivery service. DHL's business was conducted primarily by two related groups of companies: a U.S. company, DHL, was the common parent of the U.S. group; and a Hong Kong company, DHLI, was the common parent of the foreign group.

The IRS asserted a deficiency against DHL for transfer of its trademark to DHLI, claiming that additional value should have attached to the trademark. In valuing the trademark, the Tax Court recognized that the IRS valuation of the DHL name included the value of all of DHL's intangible assets. The Tax Court held that the DHL network delivery system constituted an intangible asset that was separate from the DHL name and that this network possessed significant value:

the evidence supports a finding that the know-how and system in place that facilitated the ability to make timely and efficient deliveries is at least as important as the name 'DHL'. . . . To a great extent the parties' [sic] experts . . . support our factual findings that the infrastructure is . . . at least as important as the name.⁹⁹

Even to the extent that the Tax Court opinion holds that the DHL network constitutes an intangible asset that is separate from the value of the tradename, there is a significant distinction between the DHL network and the purported "strategy" licensed by the Company. The DHL network was an existing operating network through which affiliated DHL companies provided a package delivery service. The affiliated DHL entities, DHL and

⁹⁹ Id.

DHLI, created and maintained their respective portions of the network independently of each other. Thus, each of these entities possessed significant intangible assets.

In contrast, the WorldCom strategy referenced by KPMG is merely the plan to create and integrate a network of telecommunications companies and not the network itself. Like DHL's network, the network created by the Company may have been valuable. However, a substantial portion of this value was created by the activities of each affiliated subsidiary who formed a part of the network. The Examiner does not believe that the Company was automatically wrong to seek compensation from the subsidiaries for its activities to create and enhance the value of this corporate structure. However, such compensation would be for services rendered and not because any intangible asset was created and licensed.

In short, the Examiner has been proffered no evidence that would lead him to conclude that discrete and separately identifiable management system intangible assets of the type described in HCA existed with regard to WorldCom. Further, the contemporaneous licensing documents make no mention of such categories of assets. Indeed, the Examiner has identified no evidence that KPMG and/or Company personnel were even aware of the HCA and Merck decisions when they developed the 1997 Royalty Programs.

Based on the evidence reviewed by the Examiner, apart from a vertically and horizontally integrated group of subsidiaries offering "bundled" services, there appear to have been no objectively verifiable methods, programs, systems, procedures (or items similar to them) that were created by the "foresight" of Management. There were no specific operating instructions or guidelines. Instead, the Royalty Programs appear to be an attempt to charge the subsidiaries for becoming and remaining part of the WorldCom group of

companies. Consistent with Merck, the Examiner concludes that the affiliate structure of WorldCom created no separate intangible asset that would support a royalty payment.

c. WorldCom’s “Intangible Asset,” if it Existed, Was Not Commercially Transferable

Assuming that “management foresight,” “strategies,” and integration “systems” were intangible assets, WorldCom also must demonstrate that these assets could be transferred in an arm’s-length transaction to a third party. The IRS has made it clear that to qualify as an intangible asset for Section 482 purposes, an asset must be “commercially transferable.”¹⁰⁰

The Examiner sought clarification from the Company, KPMG, and certain witnesses as to how “management foresight,” “strategies” and integration processes could be commercially transferable either to the subsidiaries or to a third party outside the Company’s group. The Company’s counsel informed the Examiner that any company in the WorldCom group could have been cut off from access to the group’s bundled services. This response is deficient for several reasons. At the outset, the answer makes sense only if one concludes that the “asset” being charged for is membership in an affiliated group of companies (which was what was at issue in Merck), rather than some “strategy” that was made available to the subsidiaries. Accordingly, this answer simply confirms the Examiner’s conclusion that Merck provides the controlling authority in this instance.

Perhaps recognizing the futility of arguing that the strategy articulated by the Company is commercially transferable, the Company stated in its December 11, 2003 letter

¹⁰⁰ See Prop. Treas. Reg. §1.482-4, 59 Fed. Reg. 34,971, 34,983 (July 8, 1994) (“[I]f property was not ‘commercially transferable,’ then it could not have been transferred in a controlled transaction”). This requirement was expressly stated in temporary regulations under Section 482 proposed in 1993. The IRS eliminated its reference to this requirement in the final regulations in 1994 because the IRS said it was “superfluous.” In other words, it is an embedded requirement for Section 482 purposes that an intangible asset be commercially transferable. If it is not commercially transferable, it cannot be the subject of a transfer pricing program. Thus, the asset must be susceptible of being transferred to a third party. Id. at 34,983.

to the Examiner that commercial transferability should not be given much independent weight. The Examiner disagrees. As discussed in footnote 100, the IRS position in the Section 482 regulations is clear and consistent: commercial transferability is at the core of the definition of a Section 482 intangible asset.

In the same letter, the Company then advised that, in the event commercial transferability is required, it ought to be tested by the willingness of a third party to pay royalties to be enabled “to enter a market or make more money.” This is indeed the proper standard under Section 482, which requires that payments be tested on the basis of what unrelated third parties, dealing with each other at arm’s length, would have paid under similar circumstances. The Examiner concludes that a third party likely would pay nothing (let alone \$20 billion) for the strategies and business plans that were publicly disclosed by the Company and were thus freely available to anyone.¹⁰¹

Further, the Examiner identified no evidence that the Company possessed any valuable intangible property in the form of objectively verifiable systems, methods and procedures that could have been transferred to third parties or for which third parties in an arm’s-length transaction would have been willing to pay. Significantly, the Company identified none as well. Therefore, the Examiner views the Company’s interpretation of commercial transferability as a statement that a third party would be willing to pay a royalty for the privilege of being acquired by the Company in anticipation of becoming a member of a unique corporate group that would enable it “to enter a market or make more money.” This explanation lacks merit. In addition to suggesting that companies should pay to be acquired,

¹⁰¹ As demonstrated in Section IV.C.4, infra, the Company publicly described its bundled services strategy, starting no later than early 1997.

it simply restates the basic teaching of Merck: being a member of an affiliated group, no matter how well run, does not, without more, support a royalty charge payable to the parent.

In its December 19, 2003 letter, KPMG acknowledges that “[t]he history of the regulations under Section 482 imply that an asset must be ‘commercially transferable’ to be a Section 482 intangible.” KPMG goes on to say, however, that “[i]n the case of the Management Intangibles, they were transferred to the members of ... [the Company’s group] when the MCI companies joined the WorldCom group in the merger. Accordingly, the Management Intangibles meet the commercially transferable requirement of Section 482.” Beyond the fact that KPMG provided no support for this conclusory assertion, this explanation is the same, in substance, as the Company’s: a third party allegedly would be willing to pay to become part of the WorldCom group. For the reasons articulated above, the Examiner finds this approach to lack merit.

Notwithstanding all of the Company’s and KPMG’s after-the-fact rationalizations about commercial transferability, the Examiner learned during an interview that the key KPMG ECS person who conducted the economic studies stated that the issue of commercial transferability was never considered by KPMG. The Examiner views this as a significant flaw on the part of KPMG because the “management foresight” asset, if it existed, was not commercially transferable and KPMG appears to have missed this point completely as part of its planning for and advice to WorldCom.

2. Even if Valuable Section 482 Intangible Assets Existed, There is No Evidence That the Company Owned All of Them

KPMG concluded that if there were nonroutine intangible assets that existed, WorldCom, the parent company, owned all of them. This conclusion was central to the structure of the Royalty Programs. If the parent company did not, in fact, own all non-

routine intangible assets in the WorldCom group, it could not charge the subsidiaries as if it did. Instead, it would have been necessary to modify significantly the Royalty Arrangements.

KPMG ECS appears to have assumed away the entire ownership issue based on a representation received from the Company's Management, as referenced in its 1997 Report. Thus, in the 1997 Report, KPMG ECS notes that "WorldCom believes that the operating companies do not own any non-routine valuable intangible assets." Therefore, it appears that KPMG ECS relied on the Company's representation to this effect instead of analyzing whether the Company's representation was accurate. KPMG's conclusions in this regard, therefore, are of dubious reliability.

In 1999, KPMG ECS questioned whether the same conclusion was accurate after MCI joined the WorldCom group. KPMG ECS concluded that since neither WorldCom nor MCI on a consolidated basis had any excess profits when compared to other comparable companies, any such profits, should they be realized, should be attributed to the parent company. This conclusion again ignored the possibility that some of the existing operating members of the WorldCom or MCI Group of companies could have owned and developed their own significant non-routine intangibles.

Neither KPMG nor the Company apparently undertook any analysis with respect to whether any of these separate legal entities had earned excess profits pre-merger. Had it done so, it may have found that nonroutine intangible assets existed and contributed to pre-merger excess profits by specific subsidiaries. For example, if one MCI subsidiary had, prior to the merger with WorldCom, earned excess profits (i.e., profits above a level of a comparable competitor), that subsidiary may have earned those excess profits because of

some unique intangible possessed by that subsidiary prior to the MCI/WorldCom merger. However, KPMG and the Company ignored the attributes of each separate entity pre-merger and treated them all as identical. KPMG and the Company thus ignored the possibility that nonroutine intangibles existed and that they may be owned by separate subsidiaries. While it is possible that no subsidiary owned such assets, KPMG failed to undertake any analysis to confirm that fact.

This failure is a critical potential fatal flaw in the Royalty Programs. The royalty charges were predicated on the conclusion that not one subsidiary in the MCI WorldCom Group owned nonroutine intangible assets. By definition, therefore, excess profits if earned by any subsidiary had to be attributable to intangibles owned by the parent. However, KPMG never analyzed whether this assumption was true. In the absence of that analysis, excess profits earned by the subsidiaries (\$20 billion over a four-year period) could have been earned by any number of things: intangibles owned by the parent; intangibles owned by the subsidiaries; favorable geographic location; and so forth. As a result, the KPMG ECS Reports represent merely the first step in identifying the existence of potential intangible assets but fail to analyze effectively the entity (or entities) that owned such assets, if any in fact existed.

It is not inconceivable that a subsidiary might on a stand alone basis, have owned valuable intangibles or possessed valuable rights that could give rise to “excess” profits. Each subsidiary brought increased value to the group, and they together provided the “bundled” services that were so highly valued. The strategy would not have had any value if it were not carried out by the subsidiaries. As such, the subsidiaries constituted an integral part of the execution of the strategy because they were the embodiment of the strategy.

Indeed, consistent with the conclusion that the subsidiaries may have owned nonroutine intangible assets, it was the subsidiaries and not the holding company who undertook the risks and financed the marketing and advertising for this market strategy. However, due to KPMG's failure to analyze the issue thoroughly, the Royalty Programs attributed none of the value to the subsidiaries.

3. The Royalties Did not Meet the Section 482 "Commensurate with Income" Standard

The Royalty Programs led to economic results that defied reality. In the federal Section 482 area, courts have consistently held that it is the results of an allocation that must be reasonable, not the details of the methodology employed.¹⁰² Under Section 482, royalty payments by a controlled party for the use of an intangible must be "commensurate with the income" attributable to such intangible.¹⁰³ The Section 482 regulations elaborate on this requirement by providing that in the case of a license of an intangible covering more than one year, the consideration charged needs to be reviewed and may have to be adjusted on a yearly basis.¹⁰⁴ Thus, even if the consideration for the license was at arm's-length at the time entered into, a subsequent adjustment may be required based on the actual income attributable to the intangible.

The fact that neither the Company nor KPMG monitored or periodically reviewed the actual Royalty Programs' results simply perpetuated the economic problems with the Royalty Programs. In fairness to KPMG, its June 1999 Report indicates that its analysis and conclusions were based on projections that, if not realized, would cast doubt on the analysis

¹⁰² See, e.g., Bausch & Lomb, Inc. v. Comm'r, 92 T.C. 525 (1982), aff'd, 933 F.2d 1084 (2nd Cir. 1991); Eli Lilly & Co. v. United States, 178 Ct. Cl. 666 (1967).

¹⁰³ IRC § 482.

¹⁰⁴ 26 CFR § 1.482-4(f).

and conclusions. The Company, despite this admonition, failed to review the actual results to confirm the existence of excess profits derived from an asset held solely by the parent.

There were several “red flags” that support a conclusion that the economic results stemming from the Royalty Programs defied reality. First, the accrued royalties, which were intended, according to KPMG’s June 1999 Report, to provide for “a more accurate determination of the contribution of certain valuable intangible assets to the overall results of MCI WorldCom,” far exceeded the reported net income of the Company on a consolidated basis. Thus, in 1998-2001, the following were the results:

<u>Year</u>	<u>Accrued Royalties</u>	<u>Consolidated Company Net Income (Loss)</u>
1998	\$1.8 billion	(\$2.7 billion)
1999	\$5.9 billion	\$4.0 billion
2000	\$7.0 billion	\$4.2 billion
2001	\$6.5 billion	\$1.4 billion

The lack of excess profits on a Group-wide basis over a sustained period of time (1998-2001) is consistent with a conclusion that the parent company did not possess a unique intangible asset that gave rise to excess profits.

Second, many WorldCom subsidiaries were charged an exorbitantly large percentage of their income as a royalty. For example, in 1999, one subsidiary, WorldCom Network Services, Inc. earned net income of \$3.4 billion but was charged a royalty of \$2.9 billion. The royalty comprised more than 85 percent of WorldCom Network Services, Inc.’s net income. The Examiner finds it difficult to believe that an unrelated third party would agree

to pay more than 85 percent of its profit for the benefit of a “strategy.” Nonetheless, royalties in excess of 50 percent of profits appear to have been routine and for some subsidiaries, the royalties charged may have sometimes exceeded 90 percent of their net income.¹⁰⁵ At a minimum, these financial results should have led to serious questions whether royalties were “commensurate” with the income derived from the so-called “foresight” intangible.

The Examiner believes that KPMG, as creator of the templates, had an obligation to advise the Company if data came to its attention that suggested the templates were not properly calculating the royalties. In fact, such data were apparent to KPMG. First, through the end of 1999, KPMG personnel performed the template calculations. Thus, for 1998, KPMG personnel must have known that the accrued royalties amounted to \$1.8 billion for 1998, a year when WorldCom had a \$2.7 billion loss. That should have put KPMG on notice that the 1998 Royalty Program was producing questionable, if not absurd, results.

Second, in 2001, KPMG knew or should have known that the anticipated extraordinary profits upon which its 1999 Report assumed the existence of the valuable intangibles never came to fruition and that the Company needed to make a downward adjustment in royalty benchmarks. As detailed more fully elsewhere, in 2001, the WorldCom tax department consulted with KPMG regarding the Royalty Programs. KPMG personnel discussed with WorldCom tax personnel the appropriateness of lowering the threshold levels of profitability above which all income would be shifted to Brands. This would have been an appropriate time, if not before, for KPMG to inquire about the bona fides

¹⁰⁵ For example, internal Company documents indicate that Telecom USA earned profit of \$2.7 billion in 1999, but was charged a royalty of \$2.6 billion (more than 95 percent of its net income). However, the Examiner observes that these documents may combine multiple legal entities or comprise only a portion of a larger legal entity.

of the Royalty Programs in light of three years of actual results. There is no evidence, however, that KPMG advised the Company to make a downward adjustment to the absurdly high royalties.

4. The License Agreements Did Not Transfer the Intangibles for Which Royalties Have Been Charged

Apart from the significant problems with the Royalty Programs based on Section 482 principles, the portion of the accrued royalties that were based on the purported “strategy” or “foresight” assets (as compared to trademarks or trade names) suffers from another critical defect. These assets do not appear to have been licensed to the subsidiaries.

The license agreements licensed trademarks, trade names and the right to use WorldCom “Proprietary Information.” Proprietary Information, in turn, was defined as “trade secrets, proprietary information, competitive data and strategies and other confidential and proprietary information” Accordingly, the license agreements, fairly read, license strategies that are competitive, confidential and proprietary.¹⁰⁶ This reading also comports with common sense. A third party would not pay a royalty for a strategy that it could access from publicly available sources. The “value” in a strategy that is licensed is the fact that the third party is getting something that it cannot otherwise obtain on its own in a cost-effective manner.

The “strategy” of creating bundled end-to-end services was not a competitive strategy and, in any event, was public knowledge and was not confidential or proprietary. By way of example, the 1997 WorldCom 10-K that was issued in early 1997 stated as follows under the “Strategy” section:

¹⁰⁶ Certain witnesses stated their belief that the term “strategies,” which was a licensed asset, would have included synergies and foresight. The Examiner does not believe that the synergies and foresight, which apparently served as the foundation for most of the \$20 billion of royalties, can be shoehorned into the term “strategies” or into a vague “catch all” “Proprietary Information” provision.

The Company's strategy is to become the premier provider of business communications services in the world . . . The MFS Merger has allowed the Company to take advantage of the Congressional intent behind the Telecom Act and the FCC Interconnect Order by bringing together the leading growth companies from four key telecom industry segments: long distance, local, Internet and international. Consistent with this strategy, the Company believes that the MFS Merger enhances the combined entity's opportunities for future growth, creates a stronger competitor in the changing telecommunications industry, allows provision of end-to-end bundled service over a global network, and provides the opportunity for significant cost savings for the combined organization.

(emphasis supplied.) Accordingly, since the WorldCom "strategy" was not confidential or proprietary, the license agreements, by their express terms, did not license this purported intangible asset to the subsidiaries.

5. KPMG's Failure to Advise WorldCom of the Risks Unique to the Royalty Arrangements

Given the lack of significant support for KPMG's characterization of "management foresight," or as it now asserts, "strategies," as an intangible asset under Section 482, KPMG may be faulted for several things. KPMG concluded that the purported intangible asset was a legitimate intangible asset under Section 482 for tax purposes. KPMG then stretched further by concluding, without the necessary analysis, that this asset was owned entirely by the Company, could be licensed by the Company and a royalty could be charged. KPMG also dismissed, again without appropriate analysis, the very real possibility that some discrete subsidiaries within the group may have owned nonroutine intangible assets but that the existence of such assets was hidden by the group's overall performance. In so doing, KPMG ignored or misapplied authorities and, later, facts that KPMG either knew about, or should have known about that would have illustrated the tenuous nature of this position.

Regardless, KPMG failed to tell the Company that there was any doubt or risk regarding its Section 482 analysis.¹⁰⁷ The Examiner has not found any evidence to suggest that KPMG suggested to the Company that its recommended tax advice was novel or aggressive. Indeed, members of the Company's tax department uniformly characterized the Royalty Programs as "plain vanilla" transfer pricing programs that did not present any significant or unusual tax risks. In addition, the Examiner has not uncovered any evidence that KPMG or KPMG ECS provided the Company with any legal authority supporting or questioning the conclusion that "management foresight," synergies, or strategies may, under any circumstances, constitute legitimate intangible assets for which a royalty may be charged.

In fairness, KPMG did perform certain analyses regarding more typical potential challenges to the hoped-for state tax savings. For example, KPMG reviewed and provided to WorldCom personnel the applicable state laws regarding the ability of states to subject Brands (or MCI WorldCom) to taxation by reason of their licensure of these "assets." These analyses appear to have been shared appropriately with the Company. As such, the Company was aware that some degree of risk or uncertainty existed with respect to the Royalty Programs. However, these disclosures appear to relate primarily to risks inherent in most transfer pricing-based state tax planning. The Examiner is not aware of disclosures made with regard to the unique aspects of the Royalty Programs that gave rise to risks, including particularly the risks associated with the Section 482 advice.

¹⁰⁷ See DuPont v. Brady, 646 F. Supp. 1067, 1076 (S.D.N.Y. 1988) (finding that an attorney's failure to communicate "the tax risk" in a tax shelter "was negligent" and a breach of his duties of due care and undivided loyalty.), rev'd on other grounds, 828 F.2d 75 (2d Cir. 1987).

6. There is a Significant Risk that the KPMG-Recommended Royalty Programs May Be Found to Be Lacking Economic Substance

The Company took actions that could adversely affect the state tax consequences of the Royalty Programs. A general principle of federal tax law is that a transaction must have economic substance independent of tax savings to be respected for federal tax purposes.¹⁰⁸ Many states also apply the economic substance doctrine to determine whether transfer pricing programs such as the Royalty Programs should be respected for state tax purposes.¹⁰⁹ A transaction without economic substance can be treated as a “sham” and disregarded in determining a taxpayer’s tax liability.¹¹⁰ Whether a transaction has economic substance depends on the facts and circumstances surrounding the transaction. If the Royalty Programs lack economic substance, the deductions taken by an affiliate for accrued royalties may be disallowed.

The Company and KPMG, to their credit, took steps to give the Royalty Programs economic substance, independent of state tax savings. Thus, the non-tax business purposes of the Royalty Programs were stated to include: (1) allow for a more accurate determination of the contribution of the intangible assets to the overall results of the Company; (2) achieve protection of the intangibles from liabilities arising from the normal business activities of the Company; and (3) promote the value of the intangible assets by highlighting their contribution to the overall results of the Company. The Examiner acknowledges these purposes and, for purposes of this analysis, accepts them as true.¹¹¹

¹⁰⁸ See Gregory v. Helvering, 293 U.S. 465, 469 (1935).

¹⁰⁹ See e.g., Syms Corp. v. Commissioner of Revenue, 765 N.E.2d 758, 765 (Mass. 2002).

¹¹⁰ See id. at 762.

¹¹¹ Moreover, Brands was created as an entity with at least four trademark lawyers as employees. Brands also had an actual office in the District of Columbia. This is a far cry from structures where an intangible asset holding company has no office and no employees but has a part-time officer who is paid a nominal amount per

Nevertheless, several factors detract from their purported economic substance. While no single factor would necessarily cause the Royalty Programs to fail, these factors, in the aggregate, may support a conclusion that the Royalty Programs lacked economic substance. Thus, as described more fully above, factors that sharply undercut the economic substance of the Royalty Programs are that the accrued royalties from 1998 through 2001 (i) far exceeded consolidated Company net income and (ii) represented a huge percentage of the income generated by the subsidiaries who were charged royalties. Other factors that cause the Examiner to question the economic substance of the Royalty Programs are set forth below.

a. Failure to Pay for Advertising

The WorldCom entities licensing the purported intangible assets to the subsidiaries failed to pay the costs of developing and protecting the assets that were licensed. One such cost involved the marketing and advertising costs associated with developing and supporting the trade names, trademarks and any other intangibles licensed to the subsidiaries. Even though the 1999 Royalty Program specified that Brands would pay for advertising and marketing relating to the intangible assets, Brands did not, in fact, undertake these activities. Instead, the subsidiaries funded all of the advertising and marketing expenditures. In this way, the subsidiaries bore the burdens and took the risks associated with developing and protecting the very asset ostensibly being charged for.

Two senior KPMG ECS employees told the Examiner that this fact alone would have caused them to “reevaluate” the propriety of the entire 1999 Royalty Program. The failure to pay for advertising in accordance with KPMG’s advice appears to be the fault of the Company.

year and is subcontracted for from a service provider who makes such personnel available. Accordingly, Brands as an entity was imbued with some actual substance.

b. The 1999 Royalty Program Was Treated by the Company's Tax Department as a Mere Paper Transaction

The legal documentation surrounding the 1999 Royalty Program states that “[the agreement] may not be modified, supplemented or amended except in writing signed by Brands and the applicable MCI WCOM Company. . . .”¹¹² As such, for any amendment to be effective, it needed to be in writing and executed by the parties.

In 2001, the WorldCom tax department amended the royalty rates after consulting with KPMG. The Company and KPMG determined that the telecommunications industry had become less profitable since 1999. Based on this conclusion, the tax department lowered the threshold level of profitability above which all income would be shifted to Brands and deemed “excess profits.” Ironically, at a time when the telecommunications industry was less profitable, this change had the effect of increasing the amounts charged to the subsidiaries for the purported benefits they derived from being in the WorldCom group of companies. To the Examiner’s knowledge, the tax department sought no legal advice for this amendment, sought no corporate approvals, and failed to document the amendment after the fact. This modification further highlights that the Company may not have treated the Royalty Programs as real business arrangements with actual economic substance.

c. Failure to Pay the Royalties

WorldCom and its operating companies also failed to comply with the payment provisions contained in the license agreements. The 1998 License Agreement and the Brands License Agreement expressly required that the royalties be paid on a quarterly basis. This requirement was consistent with KPMG’s recommendations that the royalties be paid in cash rather than simply accrued or made via journal entries “to strengthen MCI WorldCom’s

¹¹² 1999 License Agreement among Brands and subsidiaries at 7.

position that the intercompany payments are deductible expenditures.”¹¹³ By requiring actual payments, the license agreements appeared to be arm’s-length, typical and customary license agreements.

In spite of the plain language of the license agreements and KPMG’s recommendations, the tax group at WorldCom and MCI WorldCom never appeared to view it as a *bona fide* obligation. Thus, the Company employee in charge of state tax compliance stated that he did not know whether the Company intended that the royalties would ever be paid. Further, a Company employee involved with the Royalty Programs stated that “everyone involved knew that actual payments would have been preferable” and, in fact, would have been a “perfect world solution,” but that opening new accounts for each legal entity subsidiary and making cash payments was not feasible. To the Examiner’s knowledge, no royalties were ever paid. They were instead accrued and became part of the accrued payables and receivables among members of the WorldCom group.

The Examiner doubts that the failure to pay the accrued royalty charges, without more, would cause the Royalty Programs to lack economic substance. Indeed, the Examiner is not aware that the Royalty Programs are unique in this regard within the framework of the Company’s other intercompany arrangements. However, this failure to adhere to the license agreements could be a negative factor among others in determining whether the Royalty Programs had economic substance. The Examiner has identified no evidence to suggest any fault by KPMG on this issue. Rather, the fault appears to lie with WorldCom, which failed to follow KPMG’s advice.

¹¹³ KPMG ECS June 1999 Report (although the February 1999 Report states that Brands will accrue income in the form of royalties, the June 1999 Report does not mention any accruals; it repeatedly states that MCI WorldCom, the only entity being compensated under the model contained in the June 1999 Report, will be “paid” by the subsidiaries).

7. Confusing and Misleading Legal Documents

As noted above, the Examiner does not believe that “management foresight” or, as now-formulated, a “management strategy,” was in fact licensed to the subsidiaries based on the documents evidencing that “transfer.” Instead, the agreements appear to license only traditional, well-established intangible assets, like trademarks, trade names and other proprietary information.

As with the license agreements, the applications made to Mississippi and the District of Columbia taxing authorities for favorable tax treatment in connection with the Royalty Programs contained no hint as to the true nature of the main intangible assets being licensed. Instead, the applications mention only that WorldCom would engage in the licensing of certain intangible assets, such as trade names and trademarks and other unspecified traditional intangibles. The clear import of the applications was that the Company was doing nothing out of the ordinary. It appears misleading for KPMG and WorldCom to omit specific reference to the main assets that formed the basis of the Royalty Programs in the submissions to the applicable state taxing authorities. KPMG personnel have defended their actions based on notions that (1) they described to Mississippi personnel the true nature of the Royalty Programs; and (2) the states would not care to examine or understand the detailed analysis necessary to comprehend the Royalty Programs.

The Examiner cannot conclude that the state of Mississippi or the District of Columbia truly understood the nature of the Royalty Programs. Company and KPMG personnel themselves appear not to have understood some of the features of the Royalty Programs. The KPMG ECS 1997 Report asserts that “management foresight” is a legitimate intangible, but the Company now says that the Company’s “bundled service capacity” strategy was the transferred intangible. KPMG now maintains that expert systems and

methods existed, but the Company does not claim to have such assets. In short, putting the best face on it, the “true” import of the Royalty Programs appears to have changed over time. As such, if KPMG and the Company cannot cogently describe the principal intangible assets licensed under the Royalty Programs today, after being subjected to litigation discovery and the Examiner’s investigation, it would have been difficult for KPMG to have done so several years ago.

D. Causes of Action Against KPMG

Based upon the matters discussed above, the Examiner concludes that KPMG likely rendered negligent and incorrect tax advice to the Company regarding the Royalty Programs. Accordingly, the Examiner believes that if the Company is held liable for tax penalties and interest by any state that invalidates the Royalty Programs, the Company has claims against KPMG under the legal theories of negligence and contractual indemnification. The Examiner recognizes that there may be business or other reasons why the Company may decide not to pursue such claims against KPMG.

1. Negligence¹¹⁴

a. Legal Standards

Under Mississippi law, negligence standards govern malpractice actions.¹¹⁵ To establish a negligence claim, a plaintiff must prove “a duty, a breach of that duty, damages, and proximate cause.”¹¹⁶

¹¹⁴ The Examiner believes that Mississippi law likely will apply to any negligence/malpractice claim against KPMG for damages in connection with the Royalty Programs. Although KPMG’s efforts took place in multiple jurisdictions, various factors point to Mississippi. The Company’s headquarters were located in Mississippi and KPMG performed work on the Royalty Programs at its Mississippi office. Further, KPMG met with WorldCom personnel in Mississippi to explain and recommend the Royalty Programs and several members of the task force WorldCom created to assist KPMG in implementing the Royalty Programs resided in Mississippi, including one who was a key member of the task force and WorldCom’s main liaison with KPMG.

¹¹⁵ Mississippi Law of Torts, § 4.7.

Thus, a person who negligently renders tax or accounting advice can be held liable for all losses that result from that advice.¹¹⁷ For example, in Touche Ross, an auditor negligently failed to disclose certain financial improprieties of which it had become aware, based upon the unlawful conduct of the president of the auditor's client. An insurance company relied upon the negligently prepared financial statements in extending insurance coverage to the audited party. The court held that the trial court had properly instructed the jury that it should permit recovery against the accounting firm for the reasonably foreseeable harm resulting from the firm's negligent auditing practices.¹¹⁸

Comparative negligence principles apply in Mississippi.¹¹⁹ Under comparative negligence principles, fault is apportioned according to the wrongdoer's degree of culpability.

b. KPMG Owed a Duty to the Company

The duty of a professional "is to do what a reasonable and prudent person practicing that profession or occupation would do under the same circumstances."¹²⁰ As a tax consultant, therefore, KPMG was under a duty to provide reasonable advice to the Company regarding the proposed Royalty Programs.

¹¹⁶ Rolison v. City of Meridian, 691 So. 2d 440, 444 (Miss. 1997); Miss. Law of Torts, § 4.7.

¹¹⁷ Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 322 (Miss. 1987).

¹¹⁸ Touche Ross, 514 So. 2d at 323. Ultimately, the Court held that fraudulent misconduct of the company's president was an intervening cause that relieved the auditor of liability. See id. at 322. In the case of the Company and KPMG, however, there is no intervening unlawful conduct in connection with the Royalty Programs.

¹¹⁹ See Breaux v. Grand Casinos of Miss., Inc., 854 So. 2d 1093, 1097 (Miss. Ct. App. 2003).

¹²⁰ See Miss. Law of Torts, § 4.7.

c. KPMG Breached Its Duty to the Company Because It Gave Erroneous Tax Advice and Failed to Disclose Risks

The Examiner believes that a fact finder likely would conclude that KPMG provided negligent and erroneous tax advice to the Company and that it also failed adequately to disclose the unique Section 482-related risks associated with the Royalty Programs. Most of the reasons for these conclusions have been previously stated in earlier discussion and need not be repeated at length.

First, KPMG likely erred in advising WorldCom that “management foresight” and an overall business strategy were intangible assets that could be licensed for a royalty under the Royalty Programs. The federal tax regulations do not support that conclusion and the Examiner is aware of no case law that provides support. Further, even if “management foresight” or an overall business strategy was an intangible asset, the Examiner can find no basis to believe that they were commercially transferable or that WorldCom, as opposed to the operating subsidiaries, owned those assets. For these and the other reasons provided earlier, the Examiner concludes that the KPMG tax advice to designate “management foresight” and management strategies as intangible assets for which a royalty could be charged was likely in error.

Second, KPMG concluded that the parent company owned all nonroutine intangible assets that existed within the group, but reached this conclusion without any consideration of the subsidiaries’ historic levels of profitability that, based on KPMG’s logic, might have suggested that discrete subsidiaries may have owned nonroutine intangibles. KPMG then designed templates that implemented this conclusion to churn out state income tax deductions when it knew, or should have known, that the premise underlying the templates (no subsidiary owned nonroutine intangibles) had not been adequately analyzed or tested.

Moreover, the Royalty Programs represented very aggressive tax planning, at best. Despite the lack of legal authority to support the classification of "management foresight" as an intangible asset, it appears that KPMG failed to disclose to the Company the unique tax-planning risks that the Royalty Programs presented. Instead, current and former employees of the Company interviewed by the Examiner consistently indicated that they understood the Royalty Programs, as presented by KPMG, to be a routine, tax-planning device. This failure to disclose risks, if proved to a fact finder, is a basis for KPMG liability.¹²¹

As noted above, the Company did not possess significant experience in transfer pricing programs. Current and former members of the Company's tax department have said that no one at the Company had any real experience with transfer pricing programs prior to engaging KPMG. Accordingly, the Company relied almost exclusively on KPMG (a purported expert with respect to such matters) to provide guidance with respect to the design and to some extent the implementation of the Royalty Programs. Given such lack of Company expertise, the Examiner believes it was all the more imperative that KPMG carefully disclose the risks so that Company personnel could make an informed decision whether to adopt the Royalty Programs and accept the risks. This did not occur, thus supporting a negligence claim.

2. Contractual Indemnification

KPMG agreed in its April 30, 1997 WorldCom engagement letter to "indemnif[y] WorldCom for claims or assessments arising from incorrect conclusions or negligence on the part of KPMG up to the amount WorldCom paid KPMG excluding situations where the risk associated with applicable implementation points were discussed and WorldCom agreed to

¹²¹ See DuPont, 646 F. Supp. 1076 (holding that tax advice was negligent where attorney failed to disclose risks to client). KPMG's failure to disclose the risks provides the predicate for a negligence claim.

take written responsibility for such risk.”¹²² As detailed above, KPMG was likely negligent and probably rendered incorrect tax advice in advising the Company to implement the Royalty Programs without disclosing the associated Section 482 risks to the Company or obtaining the Company’s written acceptance of those risks.

Accordingly, if the Royalty Programs are invalidated by any states, any assessment of penalties and interest by the states against the Company would probably represent “claims or assessments arising from incorrect conclusions or negligence” on the part of KPMG. KPMG, therefore, would be contractually obligated to indemnify the Company for any such assessments, up to the amount of fees paid by the Company to KPMG.¹²³

3. Damages

It is beyond the scope of the Examiner’s investigation to estimate the penalties and interest that might be assessed if states were to succeed in finding the Company liable for back taxes. The Examiner observes, however, that penalties and interest frequently can amount to as much as the back taxes and thus the liabilities faced by the Company could be substantial.

4. Defenses

KPMG may assert several possible defenses. First, KPMG may argue that because transfer pricing, particularly pertaining to intangible assets, is a complex area of tax law, the Royalty Programs, even if ultimately disallowed, were not demonstrably unlawful when recommended to the Company. Such an argument seems unpersuasive. The Company could respond that in light of such complexity, KPMG had a greater responsibility to alert it to the potentially significant risks of these Royalty Programs.

¹²² Letter from Dale Currie to Scott D. Sullivan (Apr. 30, 1997) at 6.

¹²³ As noted earlier, WorldCom paid KPMG at least \$6 million in fees relating to the 1998 restructurings.

Second, KPMG may argue that it exercised reasonable care in the performance of its duties and that its advice, even if not agreed to by one or more states, was not negligent. For reasons already discussed, the Examiner believes that this argument is not likely to prevail, especially in view of the lack of precedent to support the classification of “management foresight” and “strategies” as intangible assets. Further, the reasonable care argument can be rebutted by reference to recent cases that have disallowed programs substantially less aggressive than the KPMG program.¹²⁴

Third, KPMG may argue that it and the Company were in pari delicto and that KPMG should therefore escape liability. See Appendix B. However, the evidence shows that the classification of “management foresight” and “strategies” as intangible assets originated primarily with KPMG, not with the Company, and that KPMG played the lead role in designing the Royalty Programs.¹²⁵

Fourth, if a state disallows the Royalty Programs due to the Company’s conduct, such as its failure to have subsidiaries make actual payments or the failure of Brands to pay for advertising, then KPMG may be able to prove contributory negligence. However, since Mississippi is a comparative negligence state, this is not likely to be a complete defense.

¹²⁴ In re Sherwin-Williams Co., No. 816712, 2003 WL 21368741 (N.Y. Tax App. Trib. June 5, 2003) (transfer pricing arrangement that included transfer of traditional intangible assets, such as trademarks); See also, Syms Corp. v. Comm’r of Revenue, 765 N.E.2d 758 (Mass. 2002).

¹²⁵ According to a former KPMG employee, the Royalty Programs grew out of discussions with Management on their vision for the Company. These witnesses stated that senior Management at WorldCom told KPMG that the network and sales companies should earn what typical network and sales companies earn. The parent should get the excess because the “marriage maker” had the foresight and strategy to take advantage of a unique time in the telecommunications industry when the regulatory climate was opening up. This does not change the fact that KPMG provided the advice that the strategy and foresight intangibles could support royalty charges.

V. WORLDCom MAINTAINED IMPROPER RELATIONS WITH INVESTMENT BANKERS

A. Introduction and Summary of Conclusions

The Examiner has investigated WorldCom's relations with its investment bankers and, particularly, whether WorldCom's investment banking work was awarded disproportionately from August 1996 onward to Salomon and its successor, SSB, due to Salomon/SSB financial favors to Mr. Ebbers. The Examiner concludes that Salomon/SSB gave extraordinary financial favors and assistance to Mr. Ebbers, which were intended to and did influence Mr. Ebbers to award WorldCom investment banking business to Salomon/SSB. As a result, the Examiner believes that WorldCom could pursue claims against Mr. Ebbers for breaches of his fiduciary duties of loyalty and good faith to WorldCom and against CGM, successor to SSB, for aiding and abetting such breaches. A summary of this investigation and its conclusions is presented in this Section A. The details of the Examiner's findings are set forth in the remaining portions of this Chapter IV.

1. The Examiner's First Interim Report

In the First Interim Report, the Examiner noted that public officials and members of the financial media had suggested that an unhealthy relationship existed between WorldCom and Salomon/SSB. First Interim Report at 81. Thus, as of the date of that Report, November 4, 2002, the Examiner reported that the following facts had begun to emerge:

1. In the transactions we had reviewed to date, SSB and its predecessor, Salomon collectively received more engagements from WorldCom than any other investment banking firm during the five years prior to WorldCom's bankruptcy.
2. SSB and its predecessors also allocated millions of dollars of valuable IPO's to a number of WorldCom

directors, including particularly Mr. Ebbers. These directors, in turn, sold their IPO shares for an aggregate profit of more than \$18 million.

3. Until April 2002, Jack Grubman and SSB repeatedly gave WorldCom's stock its highest ratings, enthusiastically urging investors to purchase WorldCom shares, even at times when Mr. Grubman was privately advising WorldCom Management and the WorldCom Board on business strategy, acquisitions and investor relations.

Id. at 82-83.

The Examiner noted that, although he did not intend to duplicate the investigations of regulators and government authorities, he intended to investigate the following issues:

(i) whether Mr. Ebbers and/or other WorldCom officers and Directors exploited their corporate positions for private gain or otherwise breached their fiduciary duties to the Company (Id. at 82, 86);

(ii) whether Salomon/SSB allocated valuable IPO's to Mr. Ebbers and other WorldCom Directors because of their status as significant private customers or because of their ability to direct investment banking business to Salomon/SSB (Id. at 87-88);

(iii) the extent to which WorldCom and its key officers did have an unhealthy relationship with Salomon/SSB (Id. at 83);

(iv) whether Mr. Grubman had an unhealthy relationship with WorldCom and may have combined with corporate insiders to exaggerate WorldCom's current and future financial strength (Id. at 82, 88);

(v) whether Mr. Grubman's enthusiastic recommendations of WorldCom stock until April 2002 were because he simply "got it wrong" or whether he had improper motivations for enthusiastically recommending the stock (Id. at 97); and

(vi) whether the Company has grounds to recover monies, such as IPO profits, as a result of conduct that is determined to be improper (Id. at 86).

2. Additional Investigation

Since publication of the First Interim Report, the Examiner has conducted an extensive further investigation of these issues. First, the Examiner continued to collect and review numerous additional documents. These documents have included documents received from the Company, the SEC, and from Salomon/SSB and its successor, CGM. These materials also included lawsuits that have been filed in connection with the collapse of WorldCom and other regulatory matters, including the April 23, 2003 action against CGM and Jack Grubman as part of the Global Settlement between the SEC, the New York Attorney General and others with various investment firms and individuals (the "Global Settlement").

Second, the Examiner has interviewed numerous individuals with knowledge of the matters under investigation. These have included current and former Company personnel involved in investment banking activities and in dealing with analysts, as well as current and past Salomon /SSB personnel who were involved in relevant transactions.

The Examiner's investigation of these matters has been made difficult by several factors. Most importantly, Mr. Ebbers, a chief focus of this investigation, Mr. Sullivan, who was heavily involved in matters pertaining to investment banking and relations with analysts, and Mark Lewis, Mr. Ebbers' personal financial advisor, all refused to be interviewed.

In addition, the cooperation of Salomon/SSB and its successor, CGM, has been disappointing. A pattern developed whereby production of documents sought by the Examiner was often untimely, with documents pertinent to a particular interviewee frequently not produced until the day of an interview or until after an interview was completed. The Examiner also faced difficulties in arranging interviews of many present and former SSB officials. These and other problems complicated the Examiner's work and extended the process. However, in the end, the Examiner was able to interview key present and former Salomon/SSB personnel and to obtain the information necessary to complete his investigation.

3. Summary of Findings

a. The Extraordinary IPO and Secondary Offering Allocations to Mr. Ebbers

The IPO and secondary offering share allocations to Mr. Ebbers by Salomon/SSB from June 1996 until August 2000 were extraordinary in size. Despite intensive examination, Salomon/SSB never provided the Examiner with a rational justification for these allocations, and, in fact, some of the explanations were false. The timing of the allocations in relation to the award of significant investment banking business to Salomon/SSB is highly suspicious, particularly coupled with the inadequate explanations. The Examiner concludes that the share allocations were intended to and did influence Mr. Ebbers to award WorldCom investment banking business to Salomon/SSB.

It is obviously difficult to prove, with certainty, that the Salomon/SSB IPO allocations to Mr. Ebbers were made for the purpose of obtaining WorldCom's investment banking business, especially since Salomon/SSB has denied that there was any connection between the share allocations and WorldCom's engagement of Salomon/SSB as its lead

investment banker. Nevertheless, the Examiner concludes that the evidence strongly supports the conclusion that the extraordinary allocations to Mr. Ebberts were made to obtain and then to keep WorldCom as an investment banking client. The evidence further supports the view that this Salomon/SSB effort was successful, since Salomon/SSB came to be WorldCom's preferred investment banker on both acquisitions and financings, receiving over \$100 million in fees from 1996 onward.

The first Salomon IPO allocation to Mr. Ebberts was 200,000 shares in McLeod in June 1996, at a time when Salomon was actively seeking (previously without success) WorldCom investment banking business and, in fact, had suggested to WorldCom a potential transaction with MFS as its next acquisition. Mr. Ebberts' allocation on this IPO was more than four times larger than any other Salomon retail customer and was larger than the allocations to all but two large institutional customers receiving allocations in this IPO, including Fidelity Investments, the largest mutual fund complex. Mr. Ebberts became a retail brokerage customer of Salomon with this allocation, having done no prior brokerage business through Salomon.

Despite the fact that Mr. Ebberts' brokerage account was opened in Salomon's Los Angeles office, the contemporaneous documents indicate that the request for Mr. Ebberts' McLeod allocation originated with someone at Salomon in New York. Indeed, the two Los Angeles-based Salomon retail brokers who subsequently had responsibility for Mr. Ebberts' account could not recall having any role in Mr. Ebberts' 200,000 McLeod share allocation. Notwithstanding the extraordinary size of this allocation and the fact that this was the beginning of Mr. Ebberts' relationship with Salomon as a retail customer, the Examiner was unable to obtain a satisfactory explanation of how this allocation came about.

One former Salomon Managing Director advised the Examiner that Mr. Ebbers' McLeod allocation came about because Mr. Ebbers helped increase investor interest in the offering, which had been "stone cold" at the outset. The Managing Director recounted that at some point during the marketing, Mr. Ebbers agreed to make a "sizable" investment in the McLeod IPO and to permit his name and his commitment to a sizable investment to be used in the marketing effort. Accordingly, the Managing Director stated that the large McLeod allocation to Mr. Ebbers was a reward for his help in marketing the offering. A Salomon investment banker on the transaction gave a similar account, stating that senior McLeod management wanted Mr. Ebbers' interest in the offering to be made known to potential investors and that they wanted Mr. Ebbers to receive a large allocation.

The Examiner has received significant contrary evidence about these explanations and no affirmative support. First, none of the other persons interviewed by the Examiner recalled Mr. Ebbers' involvement in the IPO, and the contemporaneous documents made no mention of his involvement. Second, the contemporaneous documents show that the deal was substantially oversubscribed at a relatively early stage, resulting in an increase in the number of shares offered and the offering price. No person interviewed by the Examiner corroborated the Managing Director's statement that the McLeod IPO was "stone cold" at the outset. Third, despite the purported use of Mr. Ebbers' name in marketing the deal, Salomon documents showing eventual allocations referred to Mr. Ebbers as "Account X," thus concealing his identity from the rest of the underwriting syndicate. It would seem that if Mr. Ebbers' name actually had been material to marketing this IPO, his name and the size of his investment would have been made known to the other members of the syndicate.

Finally, neither the Managing Director nor the investment banker who offered this explanation could recall how Mr. Ebbers came to receive a 200,000 share allocation, which was disproportionate to allocations made to other retail and institutional investors. For example, while Mr. Ebbers received 200,000 shares, a wealthy Salomon retail customer, who had been a Salomon retail customer since 1994 but who did not control investment banking business, received “only” 47,500 shares after seeking 300,000 shares. Similarly, Putnam Management Co., Inc., a large established institutional client, sought 1.2 million shares but ended up with 200,000 shares, the same as Mr. Ebbers. This enormous allocation to Mr. Ebbers is all the more difficult to understand since the IPO was heavily oversubscribed. By the pricing date, there were indications of interest for more than 110 million shares, or roughly 11 times the approximately 10 million shares available to be offered.

Mr. Ebbers sold his McLeod shares within four months of the allocation and made a profit of more than \$2 million on an initial investment of \$4 million. This was more than a 50 percent return on an investment held just four months, or the equivalent of a yearly return of more than 150 percent.

WorldCom’s first opportunity to award investment banking business to Salomon came just two months after Mr. Ebbers received the McLeod IPO allocation in June 1996. At that time, Salomon was awarded its first WorldCom investment banking engagement, as financial advisor on the MFS acquisition. Mr. Ebbers personally engaged Salomon on WorldCom's behalf. Salomon received a fee of \$7.5 million for this transaction. From that point until 2002, Salomon/SSB was WorldCom’s primary investment banker, taking a leading role in more than 20 transactions and receiving more than \$100 million in fees.

Indeed, in October 2000, a SSB employee described WorldCom as “the number one fee generating client” of the investment bank.

The lucrative IPO’s and other stock allocations from Salomon to Mr. Ebbers continued in 1996 and 1997. Four of these -- 89,286 shares in a McLeod secondary offering in November 1996, 205,000 shares in an IPO for Qwest Communications International, Inc. (“Qwest”) in June 1997, 200,000 shares in an IPO for Nextlink Communications, Inc. (“Nextlink”) in September 1997, and 100,000 shares in an IPO for Metromedia Fiber Network, Inc. (“MFN”) in October 1997 -- were also extraordinary in size. Mr. Ebbers sold his additional shares in McLeod and his shares in Qwest, Nextlink and MFN for a profit aggregating \$8,736,227. Indeed, he sold 140,000 of his Qwest shares just days after he had purchased them, gaining an instant profit of over \$850,000 on an initial investment of \$3,080,000.

At the same time these allocations were being made to Mr. Ebbers in 1996-1997, Salomon was again being engaged by WorldCom for significant investment banking business. In March 1997, Salomon acted as lead manager on a \$2 billion WorldCom debt offering, receiving over \$8 million in fees. In September 1997, WorldCom engaged Salomon for the MCI transaction, eventually receiving \$32.5 million in fees for the acquisition and an additional \$15.8 million in fees for a related debt offering. In October 1997, Salomon received approximately \$1.5 million in fees as a Deal Manager on an exchange of MFS Notes.

After the Salomon-Smith Barney merger in November 1997, Mr. Ebbers continued to receive SSB IPO allocations, but in lesser amounts. There is evidence that at the time of the merger, senior Smith Barney management felt that Salomon had engaged in “spinning,” or

the awarding of IPO allocations to corporate executives in return for investment banking business from their companies. Thus, SSB in November 1997, at the time the merger became effective, issued a written policy which prohibited spinning. Salomon had not had any such policy. This resulted in much smaller IPO allocations to Mr. Ebbers, generally not more than 25,000 shares per IPO.

Notwithstanding the smaller IPO allocations after November 1997, Mr. Ebbers still appears to have been the largest single individual retail recipient of shares in many of the IPO's he received. Moreover, he made approximately \$1.4 million in additional aggregate profits from these post-merger allocations.

Following is a summary chart of Salomon/SSB IPO and secondary offering allocations to Mr. Ebbers:

Salomon/SSB IPO and Secondary Offering Share Allocations to Mr. Ebbers

Issuer	Trade Date	Shares Allocated	Total Gain (Loss)
McLeod	06/10/96	200,000	\$2,155,000
Tag Heuer	09/26/96	5,000	\$2,250
McLeod Secondary Offering	11/15/96	89,286	\$390,172
Qwest Comm.	06/23/97	205,000	\$1,957,475
TV Azteca	08/15/97	1,000	\$937
Box Hill Systems	09/16/97	5,000	\$23,125
Nextlink Comm.	09/26/97	200,000	\$1,829,869
China Mobile	10/16/97	2,000	(\$8,000)
Metromedia Fiber	10/28/97	100,000	\$4,558,712
Teligent	11/21/97	30,000	\$76,563
EarthShell	03/23/98	12,500	(\$73,945)
Rhythms Netconnections	04/06/99	10,000	\$66,900
Juno Online Services	05/25/99	10,000	(\$6,662)
Juniper Networks, Inc.	06/24/99	5,000	\$860,125
Focal Comm.	07/27/99	5,000	\$100,700
Williams Comm.	10/01/99	35,000	(\$804,405)
Radio Unica	10/18/99	4,000	\$8,010
Chartered Semiconductor	10/29/99	5,000	\$291,250
UPS	11/09/99	2,000	\$17,625
KPN Qwest	11/09/99	20,000	\$371,926
Tycom LTD	07/26/00	7,500	\$32,813
SignalSoft	08/02/00	5,000	\$59,094
Total Profit (excluding losses)			\$12,802,546

b. Mr. Ebbers Was Not a “Best Customer” of Salomon or SSB

Shortly after the announcement of WorldCom’s accounting irregularities in summer 2002, Congress sought from SSB an explanation for the extraordinarily large IPO allocations made to Mr. Ebbers and certain other WorldCom Directors and officers. In response, in August 2002, SSB stated that the IPO recipients, including Mr. Ebbers, were some of Salomon/SSB’s best individual retail customers and therefore qualified for the beneficial treatment. This explanation, as it relates to Mr. Ebbers, is misleading at best and most likely false.

Mr. Ebbers was not even a Salomon customer before he received his extraordinary 200,000 share allocation in McLeod. Then, after opening a Salomon brokerage account with that allocation, Mr. Ebbers never did any trading in his Salomon/SSB account other than buying and disposing of his IPO and secondary offering shares. Thus, to the extent Mr. Ebbers had account balances that placed him among the top Salomon/SSB individual customers, they were balances created solely by the lucrative allocations he was receiving. Indeed, most of Mr. Ebbers' assets were held, and all of his non-IPO securities transactions were conducted, through accounts at other brokerage firms during the relevant period.

Furthermore, former and current Salomon/SSB personnel advised the Examiner that they generally tried to allocate IPO and secondary offering shares to long-term investors. Salomon/SSB personnel advised that it was harmful to a stable secondary market to allocate shares to investors who sold their shares soon after purchase. However, Mr. Ebbers was not a long-term holder of his IPO shares and even engaged in "flipping" them on a number of occasions. For example, Mr. Ebbers sold 140,000 of the 205,000 Qwest shares he received in June 1997 on the day that he paid for them. Mr. Ebbers' flipping was obvious to Salomon/SSB personnel, since he routinely sold the stock directly from his Salomon/SSB account. Notwithstanding such conduct, Mr. Ebbers continued to receive massive IPO allocations.

Thus, there is strong evidence to support the conclusion that Mr. Ebbers did not receive his extraordinary IPO allocations because he was a "best customer" of Salomon or SSB. Rather, the evidence strongly suggests that he received them because he was in a position to award, and did award, significant WorldCom investment banking business to Salomon and SSB.

c. SSB's Extraordinary Assistance on Mr. Ebbers' Loans

SSB IPO allocations to Mr. Ebbers ended in August 2000, apparently because Mr. Ebbers was experiencing significant financial difficulties that prevented his investment in additional IPO shares. However, the financial favors granted by SSB to Mr. Ebbers did not end. Indeed, they continued in an extraordinary fashion, as SSB came to Mr. Ebbers' assistance when he faced margin calls from his many lenders.

In the 1990's, Mr. Ebbers had become extremely wealthy, with most of his net worth represented by the approximately 19 million WorldCom shares that he owned. These shares were valued at over \$1 billion for a substantial period of time. During this time, Mr. Ebbers began to invest personally in a wide range of assets, as previously reported by the Examiner, from investments in shipyards and timber farms to a 600,000-acre Canadian ranch.

Mr. Ebbers did not pay for these investments by selling his WorldCom stock. Rather, he financed many investments by taking out huge loans and securing those loans with his WorldCom stock. Over the years, Mr. Ebbers borrowed large amounts from Bank of America, PaineWebber and Morgan Keegan. So long as WorldCom's stock price remained high, there was plenty of collateral to support the loans.

Mr. Ebbers' lenders also included Citibank, an SSB affiliate. In 1999, an SSB broker helped to arrange for Mr. Ebbers to receive a \$60 million loan from Citibank to help refinance his Canadian ranch. The loan, which appears to have been made on commercially reasonable terms, was secured with a pledge of WorldCom stock.

By September 2000, WorldCom's stock price had declined to a point where Mr. Ebbers was under margin pressure from his lenders, including Citibank. Early in September 2000, Mr. Ebbers borrowed \$50 million from WorldCom, as previously reported by the Examiner, to meet margin calls from his lenders. He also received a \$10 million cash

bonus from WorldCom at the same time. However, these amounts were not enough to meet Mr. Ebberts' needs. Thus, in late September 2000, when WorldCom's Compensation Committee turned down a second loan request and Mr. Ebberts failed to post additional security for a Bank of America loan, Mr. Ebberts entered into a forward sale for 3 million WorldCom shares to meet a Bank of America margin call. WorldCom's stock price dropped more than \$2 per share on the day in early October 2000 that Mr. Ebberts' forward sale was announced.

Notwithstanding the WorldCom loan and bonus and the stock sale, Mr. Ebberts, in October 2000, was still facing more margin pressure due to the continuing decline in WorldCom's stock price. Mr. Ebberts then turned to SSB for help. Mr. Ebberts requested that SSB provide financial assistance so that he could avoid further sales of his WorldCom stock in the face of additional margin calls. An SSB broker quickly mobilized support at the highest levels of SSB, and within two weeks SSB provided the requested assistance.

In an unprecedented transaction for a retail brokerage customer, Citibank and SSB entered into an arrangement whereby Citibank took over Mr. Ebberts' loan from Morgan Keegan (approximately \$11 million at the time). At the same time, SSB guaranteed Citibank against any loss on the combined Citibank/Morgan Keegan loan, which then amounted to approximately \$53 million, all secured by Mr. Ebberts' WorldCom shares. As part of the transaction, SSB agreed to go unsecured on the loan to Mr. Ebberts for up to \$10 million, i.e., SSB would allow the value of the WorldCom stock securing the loan to fall to \$10 million below the loan amount before SSB would sell any of Mr. Ebberts' stock. Citibank and SSB were also prepared to take over Mr. Ebberts' PaineWebber loan of approximately \$49 million under a similar arrangement, but this transaction was never implemented.

SSB's CEO, SSB's head of investment banking and SSB's Executive Committee were actively involved in arranging this assistance to Mr. Ebberts. Mr. Grubman also played an active role. Thus, this financial assistance was unique and involved the attention of the highest levels of SSB. SSB personnel have confirmed that to their knowledge, this financial assistance provided to Mr. Ebberts was unprecedented and nothing similar has ever been provided to any other retail brokerage client. Moreover, SSB personnel also confirmed that this type of financial assistance had not been provided to any other executive of a corporate client of SSB.

The SSB assistance to Mr. Ebberts continued after October 2000. For example, in November 2000, WorldCom's stock had fallen further, to the point where SSB had the right to sell Mr. Ebberts' stock securing the \$53 million loan. SSB refrained from any such sale of Mr. Ebberts' stock. Similarly, by June 2001, WorldCom's stock price had again fallen to a level where Mr. Ebberts was under further margin pressure. In an arrangement brokered by SSB's then chairman of investment banking, SSB entered into a "gentleman's agreement" with Mr. Ebberts whereby the value of his WorldCom stock securing the loan was permitted to reach 100 percent of the amount of the outstanding loan before any margin payment was required. Citibank's written agreement with Mr. Ebberts required that the outstanding loan be no greater than 75 percent of the value of the shares. As a further accommodation, SSB agreed in early 2002 to release a lien on Mr. Ebberts' Colorado townhouse so that Mr. Ebberts could receive the sale proceeds of over \$1 million.

Mr. Ebberts, in turn, expressed his gratitude to Citibank and SSB for their assistance. In January 2001, after SSB had helped Mr. Ebberts avoid margin calls, Mr. Ebberts met with SSB and Citibank personnel and told them that he was considering replacing Bank of

America with Citibank as WorldCom's lead commercial bank because he was angry at Bank of America for its personal treatment of him on its loan to him. The Examiner has been informed by Company personnel that Mr. Ebbers never followed through on his suggestion. However, it is clear Mr. Ebbers expressed a willingness to use his corporate position to award corporate business to Citibank and SSB in return for their favorable treatment of him personally.

d. Mr. Ebbers Controlled WorldCom's Investment Banking Engagements

There is little doubt that Mr. Ebbers was the ultimate decision-maker on behalf of the Company for all significant transactions (M&A, equity and financings) where the Company engaged an investment banker. Until the August 1996 MFS transaction, Breckenridge was LDDS/WorldCom's exclusive investment bank. Two months after Mr. Ebbers' receipt of the 200,000 share allocation on McLeod, Mr. Ebbers engaged Salomon as WorldCom's MFS financial advisor. We have seen no evidence that any other investment bank was considered for this assignment. From that point on, Salomon, and then SSB, acted as WorldCom's lead investment banker.

The following chart summarizes those investment banking engagements of which the Examiner is aware:

Salomon/SSB Investment Banking Engagements With WorldCom

Transaction	Date of Engagement¹²⁶	Fees Paid to Salomon/SSB
MFS Merger	8/14/96	\$7,500,000
\$2 billion High-Yield Offering	3/18/97	\$8,611,850
Exchange Offering for MFS Bonds	5/15/97	\$1,519,086
MCI Merger	8/25/97	\$32,500,000
\$6.1 billion Investment-Grade Offering	7/31/98	\$15,850,532
Nextel Merger (unconsummated)	4/99	No fees ¹²⁷
Sprint Merger (unconsummated)	9/19/99	No fees ¹²⁷
\$5 billion Investment-Grade Offering	5/10/00	\$9,973,764
Intermedia Merger	8/31/00	No fees ¹²⁷
Tracker Stocks	9/27/00	\$3,500,000
\$11.9 billion Investment-Grade Offering	4/18/01	\$23,076,012
Block Trade of News Corp. Shares	2/17/02	\$4,289,708
Total Fees Received		\$106,820,952

¹²⁶ This represents the date of the engagement letter or the date that the transaction was entered on Salomon/SSB's "Control Group Database," whichever is earlier.

¹²⁷ The anticipated fees if the Nextel and Sprint transactions had been consummated would have been \$15 and \$32.5 million, respectively. No fees were ever negotiated as to Intermedia. The Examiner observes, however, that Chase Securities, which WorldCom retained after SSB withdrew from advising WorldCom on Intermedia due to a conflict, was paid \$5 million for its Intermedia work.

e. Mr. Grubman's Analyst Reports

We have compared Mr. Grubman's reports with those of other analysts during the relevant time period and found that he was relatively consistent with other analysts in terms of his ratings and projected earnings per share for the Company. Mr. Grubman's reports stand out, however, in his rhetorical praise of the Company and in his projected Target Price for its stock, where he was consistently higher than others.

The Examiner investigated whether Mr. Grubman actually believed what he wrote or whether he privately had doubts about WorldCom. The Examiner has identified no evidence that Mr. Grubman did not believe what he published about WorldCom. Similarly, the Examiner has identified no evidence that Mr. Grubman (or anyone else at SSB) had any advance knowledge of the financial fraud reported by WorldCom on and after June 25, 2002.

4. The Examiner's Recommendations

There is substantial evidence to support the conclusion that Mr. Ebbers awarded investment banking work to Salomon/SSB because those entities provided substantial financial benefits to him personally. Such personal receipt of the financial favors in exchange for WorldCom's investment banking business would support a claim that Mr. Ebbers breached his fiduciary duties of loyalty and good faith to WorldCom. See Appendix A. Such evidence similarly would support the conclusion that Salomon/SSB knowingly aided and abetted Mr. Ebbers' breach of fiduciary duties. Id.

Accordingly, the Examiner believes that the Company has claims against Mr. Ebbers and CGM due to the apparent fiduciary duty breaches and the Salomon/SSB role in inducing such breaches. The remedies against Mr. Ebbers might involve recovery of compensation paid during the period of disloyalty, as well as potential disgorgement of his IPO and secondary offering profits. With regard to CGM, the remedies might include disgorgement

of all or a portion of the fees paid to Salomon/SSB during the same period, as well as joint and several liability on claims against Mr. Ebberts.

B. The Investment Banking Investigative Process

The Examiner addresses in this Final Report the results of his investigation into WorldCom's use of investment bankers.¹²⁸ This effort has taken longer and has required more resources than most other areas reported on by the Examiner. Given this circumstance, the Examiner reports about the investigative process, including the cooperation or lack thereof that he has encountered.

1. WorldCom's Cooperation

WorldCom's cooperation with respect to the investment banking investigation was good. The Examiner sought extensive documents from the Company concerning its investment banking relationships, especially with Salomon/SSB. While the Examiner would have preferred more rapid responses to certain document requests, the Examiner concludes overall that WorldCom responded appropriately to these requests.

The Examiner reaches the same conclusion with regard to interviews of past and current WorldCom personnel with investment banking knowledge. Thus, WorldCom produced for interviews members of the Investor Relations Department and helped to

¹²⁸ The Examiner is aware of allegations regarding misconduct in connection with the administration and operation of the WorldCom, Inc. Stock Option Plan (the "Option Plan"), particularly with respect to SSB's role as its exclusive outside administrator. In response to such allegations, the Examiner reviewed relevant WorldCom and SSB documents and interviewed certain WorldCom personnel. Based on that review, the Examiner has not identified any WorldCom wrongdoing warranting further report.

The Examiner has not investigated the relationships between individual WorldCom employees and their SSB brokers, primarily because many of them involve pending claims which are currently in litigation, and also because SSB's administration of the Option Plan was the subject of an investigation by the New York Stock Exchange ("NYSE"). In a Hearing Panel Decision, dated October 1, 2003, SSB was fined \$1 million by the NYSE for failing to supervise brokers dealing with WorldCom employees in the administration of the Option Plan. The NYSE investigation found, among other things, that SSB brokers in Atlanta failed adequately to warn WorldCom employees of the risks involved in following the brokers' advice to exercise their options, hold the stock and borrow from SSB the money needed to pay the purchase price and taxes.

facilitate the interview of former personnel with knowledge about investment banking relations.

2. Cooperation by Third Parties

The Examiner reports mixed success in obtaining cooperation from third parties. First, the cooperation was good with regard to WorldCom's other investment bankers (like Breckenridge) and lenders to Mr. Ebbers (like Bank of America). Interviews were arranged in a timely manner and relevant documents, to the extent requested, were produced.

Second, the Examiner is disappointed by SSB's cooperation. The greatest difficulty pertained to obtaining documents in a timely manner, so that they were available for review by the Examiner's representatives in advance of interviews where they would be relevant. On a number of occasions, documents arrived at the time of, or after, pertinent interviews.¹²⁹ The Examiner also had difficulty in arranging for interviews of present and former Salomon and SSB personnel. Eventually, all requested interviews were obtained, but scheduling problems disrupted the investigatory process and caused delays.

C. Mr. Ebbers Made Salomon/SSB WorldCom's Primary Investment Bank

In his First Interim Report, the Examiner noted that WorldCom engaged Salomon and SSB more frequently than any other investment bank. First Interim Report at 83. Since publication of that Report, the Examiner has examined more closely WorldCom's selection of investment banking firms. As a result, the Examiner now can provide a more complete

¹²⁹ For example, David Trautenberg, an SSB retail broker who dealt with Mr. Ebbers, was interviewed on August 13 and 14, 2003. It was not until August 14, 2003, however, that certain documents relevant to him were produced. Another example involved Eduardo Mestre, former head of Salomon/SSB investment banking, who developed close relations to Mr. Ebbers. Mr. Mestre was interviewed by the Examiner's representatives on August 22, 2003, with the obvious expectation that relevant documents would be produced before the interview. However, certain documents relevant to Mr. Mestre's role in WorldCom investment banking issues were not received by the Examiner until the following week. In fact, SSB produced documents responsive to the Examiner's requests as late as January 2004.

account of the Company's use of investment bankers from its earliest days as LDDS until the 2002 bankruptcy filing.

- LDDS and WorldCom used Breckenridge exclusively as its financial advisor until it replaced Breckenridge with Salomon on the MFS acquisition in August 1996; and
- Starting with the MFS acquisition and continuing until the bankruptcy filing, WorldCom engaged Salomon/SSB on virtually every major transaction for which it was eligible.

The Examiner describes in this portion of this Chapter the development of these investment banking relationships. Thereafter, in succeeding portions of the investment banking discussion, he describes the reasons why he has serious concerns about how Salomon/SSB became and remained WorldCom's dominant investment banker.

1. Mr. Ebbers was WorldCom's Ultimate Decision-Maker for Hiring Investment Banks and Salomon/SSB's Efforts to Get WorldCom Business Were Focused on Him

There is little doubt that Mr. Ebbers was the ultimate decision-maker on behalf of the Company when it came to selection of investment bankers. For example, a Breckenridge representative who worked with Mr. Ebbers on all of the LDDS/WorldCom transactions done by his firm over an 8-year period (1988-1996) confirmed that Mr. Ebbers made the decision to hire Breckenridge and also decided what its fees would be.

Salomon recognized from the outset that Mr. Ebbers was critical to obtaining WorldCom's investment banking work. Thus, after Mr. Grubman joined Salomon in 1994, he arranged in August 1994 for Mr. Ebbers to meet in New York with some of Salomon's senior investment bankers, including Mr. Mestre, then co-head of Salomon's investment banking group. See Appendix 1, at 1. Thereafter, in early 1995, Mr. Grubman again arranged for a meeting between Salomon investment bankers and Messrs. Ebbers and

Sullivan. Id. These meetings underscored that Mr. Ebbers would play a key role in the award of any WorldCom investment banking business to Salomon.

Thereafter, later in 1995 and in the first half of 1996, Salomon continued its efforts to obtain WorldCom investment banking business. Salomon's communications were addressed for the most part to Mr. Sullivan and occasionally to Mr. Myers. Id. at 1-2. Salomon's investment banker who prepared the letters and had most of the telephone and face-to-face contacts explained that this was done because Mr. Sullivan was the individual at WorldCom who best understood "the numbers," and that Mr. Ebbers would not want to see pitch-type materials without Mr. Sullivan seeing them first. Mr. Ebbers, however, was still very much part of the process. This is confirmed by Salomon correspondence obtained from Mr. Sullivan's WorldCom files, some of which appear to bear his handwriting forwarding them on to Mr. Ebbers with comments.

Further, the contemporaneous documents also leave little doubt that in Salomon's and SSB's view, Mr. Ebbers was the ultimate decision-maker in hiring investment banks for WorldCom. For example, a March 1996 Salomon letter to Mr. Sullivan regarding a potential WorldCom bond offering concluded with: "Perhaps we can get Bernie, Jack [Grubman] and Eduardo Mestre our Co-Chairman of Investment Banking together for dinner with us in Jackson at some point in the near future. Just let me know what might work for Bernie's schedule." Id. at 1. Similarly, when WorldCom finally decided to engage Salomon on the 1996 MFS transaction, it was Mr. Ebbers who made the first two phone calls to Salomon about the engagement, underscoring his central role. Id. at 2-3. This central role never ended. Thus, in spring 2001, when SSB sought the sole lead position on WorldCom's \$11.9 bond offering, SSB investment bankers had Mr. Grubman call Mr. Ebbers directly.

2. Breckenridge's Lead Role Until 1996

During the 8-year period from 1988 to 1996, LDDS, and later WorldCom, engaged Breckenridge as financial advisor for 11 acquisitions. Breckenridge was a small, Atlanta-based investment banking firm. LDDS became a Breckenridge client in 1988 when an investment banker, who had performed work for LDDS, joined Breckenridge. In 1988, Breckenridge completed its first investment banking engagement for LDDS and, thereafter, until August 1996, Breckenridge was LDDS/WorldCom's banker on every M&A transaction where the Company hired an investment banker.¹³⁰

¹³⁰ The Examiner has not identified any other financial advisors engaged by WorldCom during this period. Each of the Breckenridge engagements was acquisition-related. During this period, WorldCom appears to have had no occasion to engage any investment bankers on financing transactions. Rather, WorldCom appears to have relied on NationsBank for financing, and it was not until 1997 that WorldCom sought financing through any public offering.

Following is a list of the Breckenridge transactions for LDDS/WorldCom prior to the MFS transaction:

Date¹³¹	Subject / Target Company	Nature of Transaction
1988	Telephone Management Corp.	Acquisition
1989	Advantage Companies, Inc.	Acquisition
July 1991	Mid American Communications Corp.	Acquisition
Pre-1992	Phone America of Carolina, Inc.	Acquisition
N/A	Telephone Management Corp.	Acquisition
1992	Advanced Telecommunications Corp.	Acquisition
9/93	Metromedia Telecomm. Group and Resurgens Communications Group	Acquisition
12/30/94	IDB Communications Group	Acquisition
01/05/95	WilTel (subsidiary of Williams Telecomm. Group)	Acquisition
09/30/95	Military Communications Centre, Inc. and Healan Communications	Acquisition
09/30/95	Impact Telecommunications Inc.	Acquisition

Some of these transactions were substantial in size: Advanced Telecommunications - \$850 million; Metromedia and Resurgens - \$1.25 billion; IBD - \$936 million; and WilTel - \$2.5 billion. First Interim Report at 14-16.

A Breckenridge representative interviewed by the Examiner explained that over the years, his main LDDS/WorldCom contact was Mr. Ebbers. He got to know other persons at WorldCom, such as Mr. Sullivan, but he emphasized that on all transactions, Mr. Ebbers had the dominant role.

3. Salomon's Emergence as WorldCom's Investment Banker on the MFS Transaction

Salomon started to seek WorldCom investment banking work shortly after Mr. Grubman's arrival in 1994. A chronology of those efforts is attached as Appendix 1.

¹³¹ The dates are the dates on which the acquisitions were completed.

Salomon's goal was to stay visible to WorldCom in the hope that Salomon eventually would be engaged on some sort of work.

On June 6, 1996, Salomon investment bankers attended a meeting with Messrs. Sullivan and Myers where they discussed a document they had prepared entitled "Project New Wave." The document included an analysis of MFS and its then-pending acquisition of UUNET, a transaction in which Salomon served as financial advisor to MFS. Significantly, the document also included an analysis of a possible WorldCom/MFS merger. One of the Salomon investment bankers who was involved in preparing the document and in the meeting with Messrs. Sullivan and Myers could not recall how it was that Salomon came to prepare the document. However, she said it made sense to suggest an MFS transaction to WorldCom, particularly because MFS was a company with which Salomon was intimately familiar and for which relevant information was readily available.

On June 6, 1996, Mr. Ebbers took steps to open his first brokerage account with Salomon. Mr. Ebbers apparently opened this account for the sole purpose of having an account into which Salomon could place the McLeod IPO shares that would soon be allocated to him. Thus, four days later, on June 10, 1996, Mr. Ebbers received his extraordinary 200,000 share allocation in the McLeod IPO. See Section V.D.2.a, infra.

In July and early August 1996, there were confidential meetings between WorldCom and MFS executives. Appendix 1 at 2. Then, some time between August 7 and August 9, Mr. Ebbers called Mr. Grubman and informed him that WorldCom might, within the next week, engage Salomon as financial advisor in connection with a contemplated merger with MFS. Mr. Grubman relayed this information to Mr. Mestre who alerted another banker to the possible transaction. About a week later, on August 13, 1996, Mr. Ebbers called

Mr. Grubman again and asked him to arrange a meeting for him and Mr. Sullivan later that day with Salomon's investment bankers. See id. at 2-3.

The Salomon investment banker assigned coverage responsibility for WorldCom had a distinct recollection of how she learned about the WorldCom/MFS transaction and Salomon's engagement as WorldCom's financial advisor. She received a call on August 13, 1996 asking her to come to Mr. Grubman's office. When she arrived, Messrs. Ebbers and Sullivan were there with Mr. Grubman. She was informed that WorldCom would seek to acquire MFS. She then recalled Mr. Ebbers "bantering" with Mr. Grubman about whether Salomon would be hired by WorldCom for the transaction. Her reaction was that it was "strange" and "unusual" to have this kind of meeting in an analyst's office. She recalled being thankful that the meeting occurred after the market had closed at 4:00 P.M. She left the meeting after approximately 10 minutes to notify Salomon's Compliance Department of the pending transaction. She also recalled meeting later that evening with Messrs. Ebbers and Sullivan in Mr. Mestre's office to begin planning the details of the engagement.

The Examiner notes that on its face, WorldCom's engagement of Salomon to be its lead investment banker on the MFS transaction made sense for a number of reasons. First, MFS was a huge transaction for WorldCom. At approximately \$12 billion, this was more than four times larger than any previous transaction and would be the first WorldCom acquisition that would be dilutive to earnings. In such circumstances, it made sense to engage a well-known Wall Street firm with analysts who likely would support the transaction. Second, Salomon had the benefit of being quite familiar with both MFS and WorldCom, which would be a significant help on a transaction that was to move rapidly.¹³²

¹³² A former Salomon banker explained that Salomon had ready access to MFS data, given its role in a 1996 MFS equity offering and the 1996 MFS merger with UUNET. Salomon also had access to WorldCom data

A former Salomon investment banker expressed the view that Breckenridge would have had a difficult time handling the transaction, given its lack of familiarity with MFS and the speed of the transaction. Third, Salomon had already prepared the Project New Wave document and thus was already focused on this specific transaction. The foregoing being said, the Examiner observes that other investment banks had credentials similar to those of Salomon, but he has seen no evidence that any other investment banks were considered for the engagement.

4. Salomon/SSB's Lead Role from 1996 to 2002

After the MFS transaction, Salomon, and later SSB, emerged as WorldCom's primary investment banker and financial advisor. Mr. Sullivan made clear to Breckenridge that MFS was not a one-time event. Rather, Mr. Sullivan advised the Breckenridge representative that Salomon would be WorldCom's lead investment banker thereafter.

Salomon/SSB's role as WorldCom's primary investment banker and financial advisor is reflected in the following summary of M&A and equity transactions in which WorldCom engaged an investment banker/financial advisor, starting with the MFS transaction.

because Salomon had modeled for WorldCom a potential M&A transaction in approximately April 1996. See Appendix 1 at 2. That transaction never went forward. In any event, this unsuccessful work for WorldCom, as well as the meetings and other pitches that had been ongoing since early 1995, provided Salomon with significant data about WorldCom.

WorldCom M&A and Equity Transactions from MFS Through 2002

Date of Engagement ¹³³	Subject / Target Company	Summary of Transaction	Approximate Size of Transaction	WC Investment Firm	Role of Firm	Fees ¹³⁴
8/14/96	MFS	WorldCom acquisition	\$12 billion	Salomon Breckenridge	Financial Advisor Financial Advisor	\$7,500,000
8/25/97	MCI	WorldCom acquisition of MCI and investments in The News Corporation and Avantel	\$37 billion	Salomon	Financial Advisor	\$32,500,000
11/98 ¹³⁵	OzEmail Limited	WorldCom acquisition / tender offer	\$322.8 million	Merrill Lynch	Financial Advisor; Dealer Manager (on tender offer)	
April 1999 ¹³⁶	Nextel Communications, Inc. (not consummated)	Planned WorldCom acquisition of Nextel	\$16.9 billion	SSB	Financial Advisor	\$15,000,000 (not paid)
March 24, 1999	Wireless One	WorldCom acquisition (pursuant to bankruptcy)	\$22.6 million	DLJ	Financial Advisor	
March 24, 1999	CAI Wireless Systems, Inc.	WorldCom acquisition	\$476 million	DLJ	Financial Advisor	\$5,764,530
9/19/99	Sprint (not consummated)	WorldCom planned acquisition of Sprint	\$119 billion	SSB	Financial Advisor	\$32,500,000 (not paid)
8/31/00	Intermedia Communications, Inc.	WorldCom acquisition	\$5.8 billion	Chase Securities, Inc.	Financial Advisor	\$5,000,000
9/27/00	Tracking Stock	Establishment of separate Tracking stocks for WorldCom and MCI businesses	N.A.	SSB; J.P. Morgan Securities	Financial Advisors	\$3,500,000 each to SSB and JPM

¹³³ Unless otherwise noted, this represents the date of the engagement letter, or the date the transaction was entered on Salomon/SSB's "Control Group Database," whichever is earlier.

¹³⁴ The fee information generally is based on information provided by SSB to investigators and released in connection with the Global Settlement. Where fee information is not included, the Examiner did not have access to reliable information.

¹³⁵ Date based on a draft engagement letter dated November 18, 1998, faxed by Merrill Lynch to WorldCom on December 11, 1998.

¹³⁶ Date and fees on the Nextel engagement are based on a draft engagement letter dated April 2, 1999, sent from SSB to WorldCom on April 30, 1999.

Date of Engagement¹³³	Subject / Target Company	Summary of Transaction	Approximate Size of Transaction	WC Investment Firm	Role of Firm	Fees¹³⁴
2/17/02	News Corp.	Block Trade of Shares	\$1.2 billion	SSB J.P. Morgan Securities	Joint Global Coordinators and Lead Managers	\$4,289,708 (SSB)

Thus, during the relevant period, Salomon/SSB was WorldCom's financial advisor on every significant M&A and equity transaction in which the Company retained an investment firm,¹³⁷ except the Intermedia acquisition. In that instance, WorldCom initially engaged SSB to be its financial advisor but retained Chase Securities, Inc. after SSB withdrew because of a conflict.¹³⁸

¹³⁷ SSB shared financial advisor status with J.P. Morgan on the Tracker stocks.

¹³⁸ The other equity transactions in which WorldCom engaged an investment firm other than Salomon were much smaller transactions: a \$322.8 million tender offer to OzEmail; and two related acquisitions totaling approximately \$500 million.

A review of WorldCom's public debt offerings reveals similar results:

WorldCom's Debt Transactions

Date¹³⁹	Summary of Transaction	Approximate Size of Transaction	WC Investment Firm	Role of Firm	Fees
3/18/97	High Yield Offering	\$2.0 billion	Salomon	Deal Manager / Sole Bookrunner	\$8,611,850
5/15/97	MFS Exchange Offers and Consent Solicitations		Salomon Goldman, Sachs & Co.	Dealer Managers	\$1,519,086 (Salomon)
7/31/98	Public Debt Offering	\$6.1 billion	SSB	Deal Manager / Lead Underwriter / Sole Bookrunner	\$15,850,532
05/10/00	Public Debt Offerings	\$5 billion	SSB J.P. Morgan	Joint Deal Manager / Sole Bookrunner Joint Lead Manager	\$9,973,764 (SSB)
12/19/00	Private Debt Offering	\$2 billion	J.P. Morgan	Lead Manager	
4/18/01	Public Debt Offering	\$11.9 billion	SSB ; J.P. Morgan	Co-Lead Managers / Underwriters	\$23,076,012 (SSB)

Thus, WorldCom engaged Salomon/SSB on more debt transactions than any other firm, although it did retain J.P. Morgan as lead underwriter or joint lead underwriter on two significant bond offerings.

D. The Extraordinary Nature of Mr. Ebbers' IPO and Secondary Offering Allocations from Salomon and SSB

From June 1996 through November 1997, Salomon allocated over 748,000 IPO shares and 89,286 secondary offering shares to Mr. Ebbers, on which he realized gross profits of about \$11 million. During the same period, Salomon was engaged as financial advisor to WorldCom on four engagements on which it earned fees of approximately \$65 million. The extraordinary size and circumstances surrounding the stock allocations to

¹³⁹ This represents the date of the engagement letter, or the date the transaction was entered on Salomon/SSB's "Control Group Database," whichever is earlier. If neither were available, the date of transaction was used.

Mr. Ebbers, together with their timing, support the conclusion that they were intended to, and did, influence Mr. Ebbers' decision to hire and to continue to hire Salomon and later SSB as WorldCom's lead investment banker.

After Salomon's November 1997 merger with Smith Barney, Mr. Ebbers received 121,000 IPO shares over a 33-month period, netting him profits of over \$1,800,000 (excluding losses). Although smaller in size, the post-merger allocations were received under circumstances suggesting they were again intended to, and did, influence Mr. Ebbers to continue to engage SSB as WorldCom's primary investment banker.

The Examiner acknowledges again that it is difficult to be certain that these massive IPO and secondary offering allocations to Mr. Ebbers were provided, in whole or in part, for the purpose of getting and/or keeping WorldCom investment banking business. Similarly, it is difficult to prove that these financial favors did, in fact, influence Mr. Ebbers' repeated selection of Salomon/SSB as WorldCom's banker, particularly since Messrs. Ebbers and Sullivan have been unavailable for any interviews. Nevertheless, the facts and inferences reasonably available to the Examiner forcefully lead to the conclusion that the allocations to Mr. Ebbers, who clearly was not a "best" Salomon/SSB customer at any time, are indicative of a willingness of Salomon/SSB to allocate IPO's to Mr. Ebbers in the expectation that Salomon/SSB would benefit in return. They equally suggest that Mr. Ebbers was willing to trade WorldCom's corporate business for personal financial favors.

1. IPO's in General

a. IPO's -- A Basic Overview

The term "IPO" generally refers to a company's first issuance of stock to the public, or its Initial Public Offering. Typically, a company seeking to issue an IPO ("issuer") will retain an underwriter, usually an investment banking firm. The underwriter will advise with

respect to the structure of the offering, purchase a specific number of shares of stock at a fixed price and then resell those shares to its institutional and retail customers. For most IPO's, a company will retain an investment bank to be the lead underwriter, which will, in turn, assemble a “syndicate” of other investment banking firms and selling group members to ensure that all of the IPO shares are sold.

Underwriters generally seek to allocate approximately 80 percent of the shares to institutional investors and the remaining shares are sold to individual retail investors.¹⁴⁰ The shares allocated for sale to institutional investors are typically referred to as the “Institutional Pot.” The shares sold to individual retail investors are commonly referred to as the “Retail Retention.” Some shares are sold to individuals identified by the issuer, commonly referred to as the “Friends and Family Program” or the Directed Share Program (“DSP”). DSP shares come from the Retail Retention and generally constitute no more than approximately 5 percent of the total issue.

“Hot” IPO’s¹⁴¹ often have generated substantial returns for investors in a very short period of time with a disproportionately low level of risk. Consequently, IPO’s in such companies historically have been in high demand, and investment banking firms generally allocate shares from the Retail Retention to their best or preferred retail customers. The practice of giving preference to a firm’s best retail customers is long-standing and widely used, and is not currently prohibited under the applicable federal securities laws or National Association of Securities Dealers, Inc. (“NASD”) or NYSE rules. However, securities

¹⁴⁰ Institutional investors generally are considered more sophisticated than individual retail customers. A former Salomon/SSB Managing Director explained that if the portion of an issue purchased by institutional investors falls much under 80 percent, there is a danger that this will be viewed as a signal that sophisticated investors lack interest in the IPO, thus hurting its chances of succeeding.

¹⁴¹ An IPO is considered “hot” if it immediately sells in the secondary market at a significant premium to its initial offering price. SSB, through its counsel, has defined a “hot” IPO as an offering that gains 20 percent or more on the first day of trading.

regulators have opposed allocation of IPO's to corporate executives in return for investment banking and other business, a practice commonly referred to as "spinning."

b. Rules, Regulations and Industry Practices

During the Congressional investigation of SSB's sales of IPO shares to corporate executives, SSB stated in a letter to Congressmen Oxley and LaFalce, dated August 26, 2002, that "[e]xisting rules and industry practice give firms a broad range of discretion in granting IPO allocations, and we believe we acted well within that broad range." Quoting from an SEC release regarding IPO allocations, SSB further asserted that "broker-dealers are free to establish their own procedures for allocating shares to investors" Allocation of New Issues of Securities, October 18, 1994. However, in a portion omitted by SSB, the SEC also stated in the same release that a broker-dealer has discretion to determine the manner in which it allocates IPO shares "as long as" the exercise of that discretion "is not conducted in a fraudulent manner and is consistent with the rules of broker-dealers' self regulatory organization (SRO)." Id. Indeed, the SEC unequivocally stated that "there are no specific SEC rules governing the [allocation] process" but "when allocating shares in a securities offering, broker dealers must adhere to the general antifraud and manipulation provisions of the federal securities laws." Id. Furthermore, it is clear from the Global Settlement, which included allegations of illegal "spinning" against SSB, that it is the view of securities regulators that improper allocations of IPO's to corporate executives of investment banking clients can violate those provisions.

Some investment banks, recognizing that disclosure of such practices cannot realistically be made, implemented policies that impose limits on their discretion to allocate IPO shares. Salomon never adopted any such policies. In contrast, SSB issued a policy

statement dated November 28, 1997, at the time of the merger of Salomon and Smith Barney, that set forth the following:

It is impermissible to link directly or indirectly, the personal brokerage relationship of an executive of a corporate client or prospect with his or her company's activity. Specifically, shares may not be allocated to an executive of a corporate client or prospect as a *quid pro quo* for receiving investment banking or other business from his or her corporate employer.

Furthermore, just as offering an inducement in return for corporate business is impermissible, so also is the receipt of valuable gifts by corporate executives in return for awarding such business. Basic principles of corporate governance require that companies have policies prohibiting the receipt of money and other things of significant value from vendors who do business with the company, as well as policies to prohibit management from awarding corporate business in return for significant personal favors.

The Examiner inquired whether WorldCom, prior to its bankruptcy filing, had any policy related to receipt of things of value from vendors and, if so, what it was and who was responsible for monitoring and enforcing it. The Examiner identified a WorldCom Procurement Code of Ethical Conduct, that appears to have been prepared in spring 2000 and which, on its face, would have barred the receipt of gifts of greater than \$75 from WorldCom vendors. The Examiner has not identified evidence that the Code was ever actually implemented. Similarly, the Examiner has been unable to identify any code or similar restrictions in earlier years, leading the Examiner to conclude that WorldCom had no such policy. In any event, if there were any such code or policy, it clearly was not enforced as to Mr. Ebbers.

c. IPO Allocation Processes at Salomon and SSB

(i) IPO Allocations at Salomon

The IPO allocation process at Salomon generally followed the same procedures as outlined above. Salomon investment bankers, joined by representatives of the Equity Capital Markets (“ECM”) Department and often a research analyst, would pitch a company to manage its IPO. If Salomon were chosen as the underwriter, it would work with the issuer and counsel to prepare the offering documents and file them with the SEC.

After public release of information regarding the offering, including the approximate number of shares to be issued and the range of possible prices, efforts would be made to stimulate interest in the offering. A number of techniques would be pursued. First, Salomon engaged in pre-marketing activities, such as informing its institutional traders, sales personnel and retail brokers about the upcoming offering and developing sales materials for its traders to use to educate institutional investors about the offering. Second, the issuer, along with Salomon investment bankers, engaged in “road shows” to solicit interest from institutional investors.

Third, and related, Salomon’s institutional traders/sales personnel would contact institutional investors and seek to interest them in the offering, including making arrangements for road show visits or conference calls with the issuer and/or Salomon personnel, including analysts such as Mr. Grubman. Fourth, Salomon’s retail brokers would contact retail clients to obtain indications of interest. The purpose of this process was to find out how much actual interest there was from institutional and retail clients. If the offering appeared oversubscribed, that would suggest a higher offering price and/or the possibility of increasing the number of shares to be issued. There does not appear to be a typical time

period from the start of actual marketing to the final pricing of the IPO. A period of one to three weeks would appear to be a normal range.

During the marketing efforts, Salomon's Syndicate Desk, which was part of the ECM Department, would keep track of the indications of interest being received from customers. Typically, the indications of interest would be communicated to the Syndicate Desk by institutional traders/sales personnel and retail brokers. The Syndicate Desk, in turn, would prepare computerized reports, called Detail Deal Reports, on which it would note the indications of interest that had been received as of a particular date. These reports also typically contained brief notes or "color" regarding many of the indications of interest, such as whether potential investors had attended any road show meetings or had spoken with a Salomon analyst, such as Mr. Grubman, whether they would be long-term holders and whether they were likely to purchase in the aftermarket. The Syndicate Desk would periodically update the Detail Deal Reports as indications of interest changed.

Toward the end of the marketing process, the Syndicate Desk would determine how many shares would go into the Institutional Pot and Retail Retention. The issuer would advise Salomon about the size of the DSP program and the employees and/or friends of the issuer who should be offered DSP shares from the Retail Retention. Salomon's Syndicate Desk had no discretion regarding the DSP allocations.

On the "pricing date," the price at which the stock would be offered and the exact number of shares in the offering were fixed. Sometimes the number of shares to be offered would be increased, especially when the offering was heavily oversubscribed. The pricing typically would be completed late in the afternoon on the day when the final road shows were completed. The pricing generally was determined in a conference call involving

representatives of the issuer, one or more Salomon investment bankers and one or more ECM representatives.

Once the offering was priced and the exact number of shares to be offered was agreed upon, allocations would be determined by Salomon's Syndicate Desk, based upon the indications of interest from its institutional and retail customers and also on the nature of the overall demand for the offering. The tentative allocations would be entered onto a new, updated Detail Deal Report.

Allocations on the Detail Deal Report included both the Institutional Pot and the Retail Retention. The Retail Retention was entered as an aggregate number, and individual allocations from the Retail Retention were generally left to the retail brokers to allocate among their clients. However, on some occasions, where a large allocation was proposed for an individual retail client such as Mr. Ebbers, those allocations would be separately listed and satisfied from the Institutional Pot.

Once final allocations were determined by the Syndicate Desk, customers were notified regarding the number of shares they were allocated. This usually occurred the morning after the pricing. Trading in the secondary market commenced shortly thereafter on that same day.

The Examiner sought to determine the factors considered by the Syndicate Desk and Salomon's retail brokers regarding the allocation of IPO shares among customers, especially in hot IPO's where the indications of interest far outstripped the number of shares being offered. Apparently, there were no strict criteria, but a number of factors routinely were considered: (i) some large institutional investors, such as Fidelity and Putnam, would almost always be allocated a large number of shares if they had indicated such an interest;

(ii) whether the investor was a good Salomon trading customer in terms of buying and selling a lot of shares or holding significant assets with Salomon; and (iii) the “color” about a potential investor, including the degree of interest shown by the investor during the marketing process.

Another important consideration was whether the investor was viewed as a likely long-term investor or whether, in contrast, the investor was likely to “flip” the shares, i.e., sell them in the after-market soon after the IPO was issued. In planning for a successful IPO, the lead underwriter strived to create a stable secondary market. The investment bankers hoped that the share price would increase after trading began, but the bankers also sought to avoid significant price swings. One way to avoid such price swings was to allocate IPO shares to investors, both institutional and retail, who were viewed as likely long-term investors. As a general practice, the Syndicate Desk sought to avoid allocations to “flippers,” i.e., institutions or retail customers who had a history of selling the stock soon after it was acquired.

There was no exact definition of how quickly a person would have to sell IPO shares to be considered a flipper or how long an investor would have to hold IPO shares to be considered a long-term investor. However, the Examiner has been informed that any sale within a one or two week period and possibly up to a month would be viewed as flipping, and that a person or institution that sold the shares within one year was not a long-term investor. Salomon had no formal policy against allocating IPO shares to investors who had a history of flipping their shares, but persons interviewed indicated that the likelihood of an investor flipping the stock was generally a negative factor when allocations were being considered.

**(ii) Salomon's Retail Brokerage Business and
the Private Wealth Management Group**

Two retail brokers, Richard Olson and David Trautenberg, were recruited by Salomon from Morgan Stanley in 1994 to join Salomon's Private Investment Department in its Los Angeles office. The Department catered to wealthy retail customers and had approximately 60 brokers firmwide. Messrs. Olson and Trautenberg worked together as a team at Morgan Stanley and continued to do so at Salomon. They catered to high net worth individuals and executives of investment banking and corporate clients, first of Morgan Stanley and then of Salomon.

Shortly after Messrs. Olson and Trautenberg joined Salomon, the Private Investment Department was disbanded.¹⁴² After negotiations with Salomon,¹⁴³ Messrs. Olson and Trautenberg elected to stay at Salomon, and they named their group the Private Wealth Management ("PWM") Group. At that time in 1995, and continuing until the Smith Barney-Salomon merger in November 1997, they were the only Salomon retail brokers. Both were located in Los Angeles, but made periodic trips to New York. Mr. Trautenberg eventually relocated to New York in 1998, and he and Mr. Olson ended their arrangement in 1999.

Mr. Ebberts became a PWM Group client upon his receipt of the McLeod IPO allocation in June 1996. Initially, he was serviced primarily by Mr. Olson, but at some point in 2000, Mr. Ebberts was reassigned by SSB management to Mr. Trautenberg. Prior to the reassignment, Mr. Ebberts had complained to a SSB investment banker that he was

¹⁴² It appears that certain trading practices by Salomon retail brokers in Hong Kong caused Salomon to conclude that the Private Investment Department presented greater risks than it was willing to assume, leading to the termination of the entire Department, except for Messrs. Olson and Trautenberg.

¹⁴³ Messrs. Olson and Trautenberg had employment agreements calling for substantial severance payments if they had left Salomon at the time of the termination of the Private Investment Department. It appears that those severance obligations played a role in the Salomon decision to continue a small retail brokerage unit comprised of Messrs. Olson and Trautenberg after the Private Investment Department was disbanded.

dissatisfied with the number of “ideas” being presented to him by Mr. Olson. At the time Mr. Ebbers’ account was switched to Mr. Trautenberg, he had not received any IPO allocations for more than eight months. Immediately after the switch, Mr. Ebbers received IPO allocations in July and August 2000, resulting in profits of \$91,907 within days of the offerings.

With respect to IPO allocations, the PWM Group generally would solicit indications of interest from their clients and submit them to the Salomon Syndicate Desk. In most cases, the allocations were to be satisfied from the Retail Retention. However, in some cases, the PWM Group submitted a separate list of indications, generally larger in size, and requested that they be satisfied from the Institutional Pot. The only criterion they used to decide whether to request an allocation from the Institutional Pot was the size of the order.

(iii) IPO Allocations at SSB

The IPO allocation process at SSB was similar to the process at Salomon, except that after November 1997, the PWM Group now represented two of approximately 12,000 retail brokers firmwide. After discussions between the firms, it was agreed that the PWM Group would be treated as a separate branch for IPO allocation purposes. The PWM Group was also guaranteed to be among the “top five” branches in each IPO allocation in terms of shares available for distribution to its clients. SSB also implemented a guideline that IPO allocations to individuals generally would not exceed 25,000 shares. Thus, the size of IPO allocations to the PWM Group’s customers were generally smaller after the merger.

2. Mr. Ebberts' IPO and Secondary Offering Allocations From Salomon in 1996-1997 Were Extraordinarily Large and Received Under Highly Suspicious Circumstances

a. The McLeod IPO Allocation to Mr. Ebberts

Salomon allocated 200,000 shares to Mr. Ebberts on the McLeod IPO in June 1996. Given strong demand and competition for allocations on this IPO, by both institutional and individual investors, the size of Mr. Ebberts' allocation was extraordinary in comparison to others. Mr. Ebberts not only received the highest allocation among all Salomon retail accounts, but his allocation was more than four times that of any other individual. The extraordinary nature of his allocation compared to other PWM Group clients is demonstrated in the following chart:

PWM Client	Shares Allocated¹⁴⁴
Bernard Ebberts	200,000
Customer 1	47,500
Customer 2	25,000
Customer 3	20,000
Customer 4 (5 family members)	10,000
Customer 5	7,500
Customer 6	7,500
Customer 7	6,000
8 other PWM clients	5,000 each

Further, and even more remarkably, Mr. Ebberts' 200,000 share allocation was exceeded only by two institutions – Fidelity (250,000 shares) and Firststar Investment Management (215,000 shares) – and it equaled that of eight other well-established institutions. Further, as demonstrated by the following chart, Mr. Ebberts' allocation was also

¹⁴⁴ Where DSP information was available, IPO tables in this Third and Final Report do not include allocations to individuals under the DSP because those allocations were mandated by the issuer and were not subject to Salomon's control.

extraordinary in that he received a larger percentage (20 percent) of his indication of interest (1 million shares) than all but two institutions with comparable interests.

**Largest McLeod IPO Allocations to Institutional Investors
with Indications of Interest of 1,000,000 Shares or Greater**

Name	Percent Allocated	Allocation	Indication of Interest
Fidelity	20.8%	250,000	1,200,000
Bernard Ebbers	20.0%	200,000	1,000,000
Capital Guardian Trust	20.0%	200,000	1,000,000
Alliance	16.7%	200,000	1,200,000
Dreyfus Corporation	16.7%	200,000	1,200,000
Putnam Management Co. Inc.	16.7%	200,000	1,200,000
State Street Research & Management	16.7%	200,000	1,200,000
Firstar Investment Management Co.	14.3%	215,000	1,500,000
Capital Research & Management	13.3%	200,000	1,500,000
Massachusetts Financial Services	13.3%	200,000	1,500,000

In addition, when comparing Mr. Ebbers to the 57 institutional investors that sought one million shares or more (the same or more than Mr. Ebbers apparently sought), the favoritism is obvious – the average institutional investor received approximately 9 percent of its indication of interest compared to Mr. Ebbers’ 20 percent. See Appendix 2.

Mr. Ebbers’ McLeod allocation is all the more surprising and questionable because he had not been a Salomon brokerage client prior to this allocation. Notwithstanding his non-client status, Salomon treated Mr. Ebbers as a long-established institutional client, allocating all 200,000 of his shares from the Institutional Pot.

Salomon’s enormous allocation of McLeod shares to Mr. Ebbers is questionable for an additional reason. As of June 1996, Salomon had been seeking, without success, WorldCom investment banking engagements for almost two years. Indeed, on June 6, 1996, the same day Mr. Ebbers opened his Salomon account and just four days before the McLeod

offering was priced, Salomon investment bankers presented a proposal regarding a WorldCom/MFS merger to WorldCom. Two months after that, in the aftermath of the McLeod IPO allocation, Mr. Ebbers awarded the MFS merger engagement to Salomon, netting Salomon \$7.5 million in fees.

Further questions about Mr. Ebbers' McLeod allocation are raised from an examination of sequential versions of the Detail Deal Report generated on June 10-11, 1996, detailing the progression of possible allocations to Mr. Ebbers and to various other individuals and institutions. The Report, prepared by the ECM Syndicate Desk, lists indications of interest and allocations for institutional customers, as well as some individuals, broken down by the branch office which submitted the order. The information was kept on a computer and updated as the deal progressed. The PWM Group was listed as a single entry.

Three versions of the Detail Deal Report, each dated June 10, 1996, the pricing date for the transaction, show the progression of Mr. Ebbers' McLeod allocation. On June 10, at 12:36 P.M., Mr. Ebbers was not listed at all on the Report. The Examiner inquired why this was the case, since the ECM Syndicate Desk apparently had been informed by no later than June 7, 1996 that Mr. Ebbers had an interest in purchasing one million McLeod shares. No explanation was provided. Indeed, the person who prepared the Detail Deal Reports, and whose handwritten notes on June 7, 1996 reflected Mr. Ebbers' interest in purchasing one million shares, recalled no details regarding Mr. Ebbers' allocation.

The next version of the Detail Deal Report was at 5:08 P.M. on June 10. On the computer-generated version of this report, Mr. Ebbers' name again was not present. However, Mr. Ebbers' name is handwritten on the first page under no particular branch office as receiving 125,000 shares from the "Allocated Pot." The individual who wrote in

Mr. Ebbers' name was unable to recall why he did so. Mr. Ebbers' indication of interest in purchasing one million shares was not listed.

Approximately four hours later, on a 9:47 P.M. version of the Report, Mr. Ebbers is listed as "Account X" and appeared for the first time in computer-generated form under the New York office, not in the Los Angeles office where the PWM Group resided. An entry of 150,000 shares for Mr. Ebbers from the "Allocated Pot" is crossed out and replaced by a handwritten notation of 200,000 shares. Again, the person who wrote the 200,000 share entry could not recall why he did so.

On the final version, dated June 11 at 1:18 P.M., the first day of trading on the offering, Mr. Ebbers was again listed as "Account X," receiving 200,000 shares from the "Allocated Pot" under the New York branch office. None of the versions, including this one, listed any indication of interest for Mr. Ebbers, whereas virtually every other customer had such an entry.

Mr. Ebbers sold all of his shares from the McLeod IPO within approximately four months, realizing a profit of \$2,155,000.¹⁴⁵ Although not short enough to be considered "flipping," former Salomon personnel agreed that Mr. Ebbers would not be considered a long-term investor in McLeod for purposes of the allocation process.

Standing alone, the size and circumstances of Mr. Ebbers' 200,000 share McLeod allocation are suspicious. Other circumstances make the allocation even more suspicious. First, Mr. Ebbers was not a Salomon retail customer prior to this allocation, and the allocation to Mr. Ebbers was made at precisely the time that Salomon was seeking

¹⁴⁵ Mr. Ebbers' McLeod profits would have been approximately \$390,000 greater, except for the fact that in September 1996, he gave 20,000 McLeod shares to a relative and 20,000 McLeod shares to his financial advisor, Mark Lewis. The Examiner is not aware whether any consideration was paid to Mr. Ebbers for these shares.

investment banking work from WorldCom in connection with a possible MFS transaction. Further, this IPO was highly oversubscribed, with approximately 10 million shares to be allocated compared to indications of interest for 110 million shares. Nevertheless, Mr. Ebberts received the third highest allocation of any investor.

The foregoing circumstances caused the Examiner to seek information about the McLeod allocation to Mr. Ebberts from the beginning of the Examiner's SSB interviews in early July 2003. Every person we spoke to from July 9 to late October 2003 had no explanation for the huge allocation to Mr. Ebberts.¹⁴⁶

Finally, in an October 22, 2003 interview, a former Salomon Managing Director and co-head of ECM at the time of the McLeod IPO, explained that the allocation to Mr. Ebberts was a reward to Mr. Ebberts for agreeing to invest a substantial amount of money in the offering and for allowing the fact that he was to be a sizable investor to be used in marketing the offering. According to this executive, Salomon allegedly was having difficulty generating interest in the offering. Indeed, according to this former Salomon employee, the offering was "stone cold" during its early stages.

At some point approximately midway through the road show period, the Managing Director said that Mr. Ebberts agreed to make a substantial investment in the offering and to allow his name to be used in selling the IPO to other potential investors. The use of Mr. Ebberts' name was said to be important because Mr. Ebberts was viewed as a "pioneer" in capitalizing on the deregulated telecommunications market and a "thought leader" in the sector. Thus, if he was prepared to make a major investment, that would give the offering

¹⁴⁶ Moreover, the Examiner's counsel made repeated requests of SSB's outside counsel during this time period for an explanation as to this allocation, but no credible reason was provided.

credibility because “smart money” or a “strategic investor” was investing.¹⁴⁷ The former Salomon Managing Director did not recall the amount of Mr. Ebberts’ proposed investment or how Mr. Ebberts was first persuaded to invest in McLeod. Nor did he recall the identity of any investors to whom Mr. Ebberts’ name was given.

The former Salomon Managing Director also stated that at some point during the process of deciding how many shares Mr. Ebberts was to receive, he received two telephone calls asking that Mr. Ebberts be given more shares -- one from McLeod’s CFO and one from a Salomon investment banker working on the transaction. The Managing Director did not recall how the decision to award Mr. Ebberts 200,000 shares was made or with whom he discussed it, although he said the decision was made by Salomon management senior to him. He also did not recall an allocation as large as 200,000 shares to an individual on any other IPO before or after McLeod.

The Examiner subsequently interviewed the Salomon investment banker who worked on the McLeod transaction and who was referred to by the former Managing Director. The banker stated that Mr. Ebberts was viewed as a “strategic investor” and that senior McLeod management, particularly the McLeod CFO, wanted Mr. Ebberts to make a large investment in the IPO. This banker believed that Mr. Ebberts’ role as a strategic investor had been revealed in the McLeod prospectus but that was incorrect. The prospectus listed four investors, including Clark McLeod and another individual, as indicating interests in purchasing large amounts of shares in the IPO, but it said nothing about Mr. Ebberts. These

¹⁴⁷ It is not clear how Mr. Ebberts’ name was purportedly used in the marketing. At one point, the former Managing Director stated that he believed he had used Mr. Ebberts’ name during the “morning calls,” which are the daily calls broadcast to Salomon’s institutional salespersons and retail brokers during which reports would be made about pending IPO’s and other matters. He later suggested that might not be accurate and he may just have advised Salomon’s institutional traders orally and on an individual basis that Mr. Ebberts was prepared to make a sizable investment in McLeod.

same four investors were listed as “Strategic Investors” in a May 16, 1996 McLeod sales document prepared by Salomon, but, again, Mr. Ebbers was not listed among this group.

The banker also advised the Examiner that it was important to McLeod senior management that Mr. Ebbers’ investment be made known, but he could not recall any details about how such knowledge was communicated to investors, if at all. The banker had no recollection of calling the ECM Managing Director to urge that Mr. Ebbers receive more shares. He similarly had no recollection that the McLeod IPO had been in difficulty at the outset.

The explanation described above does not alter the Examiner’s conclusion that the enormous McLeod allocation to Mr. Ebbers was most likely for the purpose of obtaining WorldCom investment banking business. First, aside from the two individuals referred to above, no one else in a position to be familiar with Mr. Ebbers’ supposed involvement had any recollection that the allocation to Mr. Ebbers was a reward for his alleged help in marketing this IPO, and there is no credible evidence that it was used for this purpose. Interviews conducted by the Examiner revealed the following:

(i) The person on the ECM Syndicate Desk who worked closely with the former Managing Director, sat next to him and kept track of indications of interest, had no recollection of how Mr. Ebbers’ allocation came about. He believed that the PWM Group in Los Angeles had made the proposal, which is not the case, as established by contemporaneous documents and interviews with the PWM Group brokers.

(ii) Mr. Grubman, who was extensively involved in the McLeod IPO, helping with the pitch to land the business in the first place and then participating in pre-marketing and marketing activities, had no recollection of Mr. Ebbers’ involvement. He recalled that

McLeod's business plan involved fitting within a "regulatory wrinkle" that took careful explanation before people understood it. Mr. Grubman stated that Clark McLeod, McLeod's founder, had an excellent record with a prior company he founded and was very persuasive in selling the IPO once the road show process got under way.

(iii) Neither Mr. Olson nor Mr. Trautenberg, who later became Mr. Ebbers' brokers, was able to explain the allocation.

Second, the reported assistance of Mr. Ebbers in marketing the McLeod IPO is not reflected in any of the contemporaneous documentation:

(i) As noted above, a McLeod road show document prepared by Salomon and dated May 16, 1996, identified four strategic investors who would be identified in the road show process as supporting the IPO. Mr. Ebbers was not identified as one of the strategic investors. The prospectus filed with the SEC mentions the same four investors, again with no reference to Mr. Ebbers. If Mr. Ebbers had subsequently become such a "strategic investor," the Examiner would have expected that there would have been contemporaneous documentation to that effect. SSB provided no such documentation.

(ii) The Institutional Pot Book lists in alphabetical order all recipients from the Institutional Pot and, among other things, their indications of interest and their allocations. Mr. Ebbers is listed as "Account X," receiving 200,000 shares. Former Salomon employees explained that the use of letters rather than individual names was to avoid possible solicitation of these retail customers by other syndicate members, who would be given documents showing allocations from the Institutional Pot. However, if Mr. Ebbers' name and his substantial investment were actually used in marketing the McLeod IPO, it is difficult to understand why he should be given anonymity in a document disseminated to other

syndicate members who also had responsibility for marketing. Indeed, it would be expected that for marketing purposes, Salomon would want other members of the syndicate and other investors to see verification of Mr. Ebbers' investment and its size.

(iii) According to the former Managing Director, he was aware no later than June 5, 1996, and possibly earlier, that Mr. Ebbers was prepared to make a multi-million dollar investment in the McLeod IPO. The Examiner has determined that the ECM Syndicate Desk apparently learned no later than June 7, 1996, that Mr. Ebbers had expressed an interest in purchasing one million shares in the offering. The Examiner also has determined that it was important for the Syndicate Desk to keep track of indications of interest as the marketing proceeded. The Examiner has reviewed a June 7, 1996 Detail Deal Report with a large number of indications of interest from various investors totaling more than 66 million shares. Mr. Ebbers' name is not listed on this Report.¹⁴⁸ It would seem that if Mr. Ebbers had indicated an interest in purchasing one million shares in the offering and had allowed his name to be used in the marketing, that would have been noted on the Detail Deal Report. The individual who prepared the Report and who prepared the handwritten list containing Mr. Ebbers' name and "1MM" written next to it had no explanation why Mr. Ebbers did not appear on the June 7 Report.

Third, not only did no other witness corroborate the Managing Director's recollection that Mr. Ebbers rescued a "stone cold" IPO, the contemporaneous documentation does not support that view. The Evidence reflects:

(i) News articles at the time reported no difficulty marketing the McLeod IPO. In fact, they reported that the transaction originally was for 10,000,000 shares at \$16 per share,

¹⁴⁸ This same document indicates that the PWM Group had submitted indications of interest for 2 million shares. The Examiner has confirmed that Mr. Ebbers was not among the clients on whose behalf the PWM Group sought shares.

but eventually had 12,000,000 shares at \$20 per share. One Salomon document shows that as of June 5, 1996 -- just eight days after the significant road shows began (see discussion below) -- the Syndicate Desk had received “real” indications of interest for 31,720,000 shares, at a time when a total of 7,944,445 shares would be offered for sale to institutional and retail customers in the IPO, an over subscription of four times the shares available.¹⁴⁹ Indeed, the same document shows that based on the over subscription as of June 5, Salomon was recommending increasing the size of the offering from 10 to 12 million shares and the price from the \$16 to \$18 range to the \$18 to \$20 range per share.

(ii) In the road show process, Salomon’s salespersons would speak with investors promptly after a road show meeting or conference call to get the investors’ reactions. Usually, indications of interest were not immediately provided but traders could get a sense in these conversations for how the IPO was likely to do by the comments or “color.” These comments would then be passed on to the Syndicate Desk, which kept track of them as well as the indications of interest as they came in. The McLeod road show began in New York on May 20, 1996, with a one-on-one meeting with an institutional investor. This meeting ultimately resulted in the investor indicating an interest for 580,000 shares. The following week, when the road show began in earnest in Los Angeles on May 28, 1996,¹⁵⁰ investor reaction was quite positive. The five institutions who attended in Los Angeles eventually indicated interest in purchasing 3.7 million shares. The same day, a one-on-one meeting was held in San Diego, followed later by a 500,000 share indication of interest. Later in the same

¹⁴⁹ As of June 5, 1996, the McLeod IPO was tentatively set at 10 million shares, but 2,055,555 shares were reserved for Mr. McLeod and other existing investors in the company.

¹⁵⁰ Although the McLeod road show technically started with the one-on-one meeting in New York on May 20, 1996, the remaining meetings and other events that week were limited to three one-on-one meetings and one conference call with investors in the United Kingdom. Those investors eventually indicated an interest in purchasing over 1.1 million shares.

week, on May 30, 1996, a breakfast meeting was held with two institutional investors in Wisconsin, who sought to purchase 1.3 million shares. Indeed, virtually all of the color comments recorded in connection with these roadshows were positive. Thus, these and other contemporaneous documents and the interviews conducted by the Examiner provide virtually no support for the concept that this IPO was in trouble at the outset.

Fourth, CGM's letters to Congress, dated August 26 and 30, 2002, do not mention the "strategic investor" rationale for providing any IPO allocation to WorldCom officers and Directors. If this had been one of the bases for IPO allocations to Mr. Ebbers or others, the Examiner would have expected that to be included in CGM's letters.

Finally, even assuming that McLeod representatives and a Salomon investment banker had lobbied Salomon's Syndicate Desk for a sizable allocation to Mr. Ebbers because of his help in marketing the transaction, that still would not explain the extraordinary allocation of 200,000 shares. If the large allocation to Mr. Ebbers was the result of a request from Mr. McLeod, one would think it would have come from the DSP rather than the Institutional Pot. In fact, three PWM clients did receive allocations of 50,000 shares each from the McLeod DSP.

In sum, the evidence strongly suggests that the large McLeod IPO allocation to Mr. Ebbers was used as an inducement to Mr. Ebbers to award WorldCom investment banking work to Salomon.

b. The November 1996 McLeod Secondary Offering to Mr. Ebbers

On November 15, 1996, McLeod raised approximately \$128 million via a combination follow-on and secondary offering of 4,768,903 shares (the "McLeod Secondary Offering"). Salomon was the lead underwriter for that offering, which was managed like an

IPO, including road shows and solicitation of indications of interest from institutional and retail customers. In a secondary offering, as in the earlier IPO, Salomon was looking for long-term investors.

Mr. Ebbers was allocated 89,286 shares on this secondary offering, for a total investment of \$2.5 million. Mr. Ebbers' allocation was by far the highest among the four PWM Group clients who received shares in the offering.¹⁵¹

McLeod Secondary Offering Allocations to PWM Group Clients

PWM Group Client	Shares Allocated
Bernie Ebbers	89,286
Customer 1	35,714
Customer 2	15,000
Customer 3	10,000

Further, like on the McLeod IPO, Mr. Ebbers was treated as well or better than many institutional customers. He received a larger allocation than 43 of the 60 institutions receiving shares on this offering, exceeded only by the 17 institutions listed in the following chart:

McLeod Secondary Offering Allocations to Institutions

Institutional Client	Shares Allocated
Essex Investment Mgt. Co.	575,000
Meridian Investment Co.	500,000
Ardsley Partners	350,000
Rosenberg Capital Mgt.	300,000
Fidelity Mgt. & Research	300,000
Corestates Investment	250,000

¹⁵¹ The Examiner did not receive documents showing the indications of interests of individual PWM Group clients on this offering. However, the Institutional Pot Book for this offering lists the PWM Group as indicating an interest for 120,000 shares and receiving an allocation of 150,000 shares – 30,000 more shares than it requested for its clients. No institution receive more shares than it requested. Thus, this appears to be another instance of the PWM Group and its clients, particularly Mr. Ebbers, being treated favorably in comparison to institutions.

Wellington Thorndike	230,000
Invista	205,000
Dean Witter Asset	175,000
Founders Cap Mgt. Corp	165,000
Janus Fund Inc.	109,000
Morgan (JP) Investment	100,000
Perpetual Unit Trust	100,000
Strong Capital	100,000
Tudor Arbit	100,000
Warburg	100,000
Bankers Trust Co.	90,000
Bernard Ebbers	89,286

Similar to his conclusions on the McLeod IPO, the Examiner concludes that the allocation is highly suspicious. As of November 15, 1996, Salomon was continuing to work for WorldCom on the MFS acquisition, which closed in December 1996. See Appendix 1 at 3. Subsequent to the McLeod IPO and prior to the McLeod Secondary Offering, Mr. Ebbers engaged in no trading in his Salomon account other than buying and selling IPO shares. Indeed, between September 23 and October 22, 1996, just prior to the McLeod Secondary Offering, Mr. Ebbers sold all of his McLeod IPO stock.¹⁵² On November 1, 1996, Mr. Ebbers had the proceeds of all his sales and the resulting interest wired to an account at Guaranty National, leaving nothing in his Salomon account.

Thus, as of the date of the McLeod Secondary Offering on November 15, 1996, Mr. Ebbers had not demonstrated that he was a “best customer” of Salomon. Indeed, in a very real sense, he was not a customer at all, since his account balance apparently was zero. Further, he had “flipped” the shares on the Tag Heuer IPO allocation, and by selling all of his McLeod IPO shares four months after he bought them, he showed he was not a long-term

¹⁵² In addition, on September 26, 1996, Mr. Ebbers purchased 5,000 IPO shares from Salomon in Tag Heuer International valued at \$97,750. He sold all the shares within a week for a \$2,250 profit. This is an obvious example of Mr. Ebbers flipping IPO stock.

investor, particularly not in McLeod. Indeed, a former Salomon Syndicate Desk employee confirmed that Mr. Ebberts' sale of his McLeod IPO shares in September-October 1996 should have been a negative factor in connection with his eligibility for an allocation in the McLeod Secondary Offering. Nevertheless, on November 15, 1996, Mr. Ebberts received his large allocation in the McLeod Secondary Offering.

Mr. Ebberts held the 89,286 shares from that offering for approximately seven months, until late June 1997, when he sold them for a profit of \$390,172. While not an instance of flipping, it is another indication that Mr. Ebberts was not a long-term investor.

c. The June 1997 Qwest IPO Allocation to Mr. Ebberts

In late June 1997, Salomon allocated 205,000 shares to Mr. Ebberts on the hot IPO of Qwest Communications. The Examiner concludes that like the McLeod allocations, the evidence suggests that it was made in whole or in part to induce Mr. Ebberts to award investment banking business to Salomon.

Subsequent to the McLeod Secondary Offering and prior to Qwest, Mr. Ebberts engaged in no trading in his Salomon brokerage account. Thus, Mr. Ebberts simply held the 89,286 McLeod shares from the Secondary Offering.

During this period, Salomon's investment banking activity for WorldCom was active. Thus, in March 1997, Salomon acted as lead manager on a \$2 billion WorldCom debt offering, receiving over \$8 million in fees. In May 1997, Salomon was engaged along with Goldman as financial advisor to WorldCom on its exchange offering for MFS Bonds, garnering total fees of over \$1.5 million for Salomon.

In spring 1997, Salomon was selected as lead underwriter for Qwest's proposed IPO. As on the McLeod offering, Mr. Grubman assisted in obtaining this engagement by participating in the pitch for the business. Thereafter, also similar to McLeod, Salomon

marketed the offering. The pricing was on June 22 or June 23, and trading commenced June 23, 1997. The offering was heavily oversubscribed, with over 90 million shares sought for 12,285,000 shares available (excluding the DSP). The offering price was \$22 per share and within several days the price stood at \$28.75 per share, an increase of more than 30 percent.

The circumstances surrounding the large Qwest allocation to Mr. Ebbers are similar to those on the McLeod IPO. Again, demand and competition were high for shares on this offering. Again, Salomon treated Mr. Ebbers as an institutional customer – listing him as an unnamed account to the larger syndicate and allocating 200,000 of his shares from the Institutional Pot (the other 5,000 coming from the Retail Retention).

On or about June 20, 1997, Salomon’s PWM Group submitted indications of interest for its clients. With regard to Mr. Ebbers, the Group indicated that Mr. Ebbers sought to purchase 500,000 shares and the PWM Group requested that Mr. Ebbers’ shares come from the Institutional Pot rather than from the Retail Retention.¹⁵³

Affiliation with WorldCom was clearly a factor in urging an award of large allocations in this IPO. Thus, in a memorandum sent by the PWM Group on or about June 20, 1997, to Salomon’s ECM Group, only five PWM Group clients, four individuals, including Mr. Ebbers, and one partnership, were listed under a request for Institutional Pot orders. There four of the individuals were noted as being related to WorldCom. Next to their names, under a heading entitled “SB [Salomon Bros.] Affiliation,” three of the four individuals are listed with an association to WorldCom -- e.g., Don Sturm – “Owns

¹⁵³ The fact that the PWM Group submitted this large indication of interest on Mr. Ebbers’ behalf did not mean that the Group actually expected to obtain that much stock for Mr. Ebbers. The Group often would submit indications that were larger than they wished in the expectation that it might help to get a larger allocation than otherwise would be the case.

13,000,000 WCOM;” Jim Crowe – “Past President WCOM/MFS;” and Bernie Ebbers – “Chairman of WorldCom.” The fourth individual, Walter Scott, was listed as “Chairman of Peter Kiewit,” but he was also a WorldCom Board member at the time.¹⁵⁴

Mr. Ebbers’ allocation of 205,000 shares was more than any other Salomon retail client, except for an allocation of 250,000 shares to Mr. Scott.¹⁵⁵ Notably, the only other individual allocations that even came close to those of Messrs. Ebbers and Scott were a 170,000 share allocation to Mr. Crowe, then-Chairman of WorldCom, and a 135,000 share allocation to Mr. Sturm, a very large holder of WorldCom stock. The extraordinary nature of Mr. Ebbers’ allocation, as well as those of the other individuals associated with WorldCom, is demonstrated in the following chart:

Qwest IPO

PWM Client	Shares Allocated
Walter Scott ¹⁵⁶	250,000
Bernard Ebbers	205,000
James Crowe ³⁹	170,000
Donald Sturm	135,000
Customer 1	15,500
Customer 2	15,000
Customer 3	12,000
Customer 4	11,000

¹⁵⁴ By contrast, a wealthy telecom investor who was a PWM client, but not affiliated with WorldCom, sought a Qwest allocation of 100,000 shares but was allocated only 15,000 shares.

¹⁵⁵ Mr. Ebbers received 41 percent of his indication of interest of 500,000 shares, whereas Mr. Scott received 19 percent of his indication of interest of 1,350,000 shares.

¹⁵⁶ Mr. Scott resigned from WorldCom within days of his 250,000 shares Qwest IPO allocation. On July 16, 1997, less than one month after the allocation, he sold all of his Qwest IPO shares for a profit of \$2,375,000, more than a 43 percent return on his initial investment of \$5,500,000. Similarly, within four days after his allocation, Mr. Crowe resigned as WorldCom Chairman. He sold all of his Qwest IPO shares approximately two months later on August 27, 1997, for a profit of \$3,527,500, nearly doubling his initial investment of \$3,740,000. In a Salomon audit of the PWM Group conducted in late 1997, Messrs. Crowe’s and Scott’s accounts, along with Mr. Ebbers’, were “flagged” as indicative of flipping shares on the “hot” Qwest IPO. Indeed, four of the six accounts flagged as flippers by the auditor, were the same four individuals noted by the PWM Group as requesting shares from the Institutional Pot and having a WorldCom affiliation (Messrs. Ebbers, Crowe, Scott and Sturm).

Customer 5	11,000
Customer 6	10,000
Customer 7	10,000

Furthermore, with this allocation, Mr. Ebbers received more shares than all but 9 Institutional Pot customers. In addition, when compared to all institutional investors who sought allocations of 500,000 shares or more, not a single institutional investor received a higher percentage allocation than Mr. Ebbers, underscoring the extraordinary treatment he was afforded. See Appendix 3. Following is a comparison of Mr. Ebbers' allocation with other Institutional Pot allocations:

Investor	Percentage Allocated	Allocation	Indication of Interest
Bernard Ebbers	41	205,000	500,000
Account X ¹⁵⁷	30	300,000	1,000,000
Cap. Guardian	26	300,000	1,150,000
Soros Fund	26	300,000	1,150,000
State Street	20	225,000	1,150,000
Scott	19	250,000	1,350,000
Putnam	17	390,000	2,300,000
Janus	17	290,000	1,725,000
Fidelity	15	525,000	3,475,000
Wellington	11	250,000	2,300,000
Rosenberg Cap.	11	225,000	2,000,000

Mr. Ebbers ordered the PWM Group to sell 140,000 of his 205,000 shares within four days after the stock was allocated to him, netting him an immediate profit of over \$862,500. This would meet even the narrowest definition of "flipping." Within a little over two

¹⁵⁷ The Examiner was unable to determine the identity of Account X, but it appears to have been an institutional investor.

months, Mr. Ebbers sold the remainder of his Qwest shares. In total, he gained \$1,957,475, a 43 percent return on his \$4.51 million initial investment in just two months or a 260 percent return on an annualized basis.¹⁵⁸

d. The Nextlink IPO Allocation to Mr. Ebbers

The next extraordinary IPO allocation to Mr. Ebbers occurred on September 26, 1997 when Mr. Ebbers was allocated 200,000 shares in the Nextlink IPO.¹⁵⁹ Between the Qwest and Nextlink IPO's, Mr. Ebbers' only trading activity was as follows: first, he sold his Qwest IPO and McLeod Secondary Offering shares. Second, in August 1997, he was allocated 1,000 shares in the TV Azteca IPO, which he sold the same day for a small (\$937) profit. Third, in early September 1997, Mr. Ebbers was allocated 5,000 shares in the Box Hill Systems IPO, which he sold 7 days later for a profit of \$23,125.

During this period, Salomon's investment banking business with WorldCom continued to be very active. On August 25, 1997, Salomon's Control Group was notified of the potential WorldCom/MCI merger. On this mega-deal, Salomon eventually received \$32.5 million in fees as financial advisor and an additional \$15.8 million in fees as lead underwriter for a related debt offering in the summer of 1998.

Contemporaneous Salomon documents show that Mr. Ebbers received his 200,000 shares in the Nextlink IPO from the Institutional Pot and that he was once again listed anonymously to the larger syndicate, this time as "Account W." There were only four

¹⁵⁸ On July 10, 1997, Mr. Ebbers wrote Mr. Sullivan a check for \$555,085.01. The memo line of the check appears to state "Qwest." This notation, along with the timing of the check, suggests that some of the proceeds from Mr. Ebbers' sales from his Qwest IPO allocation may have gone to Mr. Sullivan. The Examiner was unable to gather further information about this check and the circumstances under which it was written.

¹⁵⁹ In addition to his 200,000 shares, Mr. Ebbers' two daughters were each allocated 1,000 shares by Salomon in this offering.

institutional investors with allocations higher than Mr. Ebbers, and once again he was the highest recipient among Salomon's retail customers.

Again, affiliation with WorldCom made a difference. Thus, in a memorandum from the PWM Group sent to ECM's Syndicate Desk on September 24, 1997 indicating interests of PWM clients requested to be allocated from the Institutional Pot, the following are noted: "Don Sturm – Owns 13,000,000 WCOM"; "Jim Crowe – Past President WCOM/MFS"; and "Bernie Ebbers – Chairman WCOM."

A comparison of Mr. Ebbers' allocation to those of other PWM Group clients demonstrates his special treatment:

Nextlink IPO

PWM Client	Shares Allocated
Bernard Ebbers	200,000
Customer 1	150,000
Customer 2	125,000
Customer 3	89,500
Customer 4	75,000
Customer 5	50,000
James Crowe	50,000
Customer 7	27,500
Customer 8	25,000
Customer 9	19,500

Even when compared to the four institutional investors who received a greater numbers of shares in the final allocation, it is again clear that Mr. Ebbers was treated more favorably on a percentage basis in terms of shares allocated compared to indications of interest than all but two of the institutions:

Name	Percent of Request Granted	Allocation	Indication of Interest
Putnam	33.1%	350,000	1,056,000
Fidelity	32.9%	400,000	1,216,000
Bernard Ebbers	20%	200,000	1,000,000
Alliance	17.0%	225,000	1,320,000
Capital Research	14%	210,000	1,500,000

When Mr. Ebbers' allocation is compared to a larger group of all institutional investors who sought one million or more shares, it becomes clear that Mr. Ebbers received a far greater percentage allocation than most institutional investors. Indeed, only Fidelity and Putnam received a greater percentage allocation. See Appendix 4.

Mr. Ebbers held his Nextlink IPO shares for approximately a year, eventually selling them for a profit of over \$1.8 million on an initial investment of \$3.4 million – a better than 50 percent return.

e. The Metromedia Fiber Network IPO Allocation to Mr. Ebbers

On October 28, 1997, one month after the Nextlink IPO and with no intervening activity in his Salomon brokerage account, Salomon allocated 100,000 shares to Mr. Ebbers on the MFN IPO. Once again, Mr. Ebbers received the largest individual share allocation, and this time his allocation exceeded all but 18 institutional investors. Further, when Mr. Ebbers' allocation is compared to all institutional investors who sought 500,000 or more shares (Mr. Ebbers sought 500,000 shares), Mr. Ebbers received a higher percentage of his indications of interest than all but 12 institutional investors, again showing more favorable treatment than the vast majority of Institutional Pot customers. See Appendix 5.

The comparison of Mr. Ebberts' allocation to those of other PWM clients is as follows:

MFN IPO

PWM Client	Shares Allocated
Bernard Ebberts	100,000
Customer 1	60,000
Customer 2	45,000
Customer 3	25,000
Customer 4	12,500
Customer 5	11,000
Customer 6	10,000
Customer 7	10,000
Customer 8	10,000
Customer 9	10,000
Customer 10	10,000

Within five months of the allocation, Mr. Ebberts sold approximately 25,000 of his MFN shares for a profit of approximately \$400,000. One year after the allocation, he sold his remaining MFN shares for a profit of over \$4.1 million. Mr. Ebberts' initial MFN investment was \$1.6 million. His overall \$4.5 million profit represents more than a 280 percent return.

f. Other 1996-1997 Salomon IPO Allocations to Mr. Ebberts

Mr. Ebberts received other IPO share allocations during the same 1996-97 time period. Although smaller in size, these allocations are notable because Mr. Ebberts disposed of his shares from each IPO within two weeks or less.

<u>Issuer</u>	<u>Date</u>	<u>Shares Allocated to Mr. Ebbers</u>	<u>Share-Weighted Average Holding Period in Days</u>	<u>Profit</u>
Tag Heuer Int'l	9/26/96	5,000	5	\$2,250
TV Azteca	8/15/97	1,000	0	937
Box Hill Systems	9/16/97	5,000	6	23,125
China Mobile	10/16/97	2,000	1	(8,000)
Teligent	11/21/97	30,000	13	76,563

g. Summary of Salomon's IPO Allocations to Mr. Ebbers and Investment Banking Activity for WorldCom in 1996 and 1997

In total, Mr. Ebbers received 837,286 IPO and secondary offering shares from Salomon in 1996 and 1997, which he sold for gross profits of almost \$11 million. During the same period, Salomon was engaged by WorldCom for significant investment banking business, resulting in fees of over \$65 million. The following chronology summarizes the interrelationship between Salomon's largest IPO and secondary offering allocations to Mr. Ebbers and its WorldCom investment banking engagements during this time period:

- June 10, 1996. Salomon first allocates IPO shares to Mr. Ebbers – 200,000 shares in the McLeod IPO. He realizes profits of \$2,155,000.
- August 14, 1996. Salomon is engaged for the first time by WorldCom on the Company's acquisition of MFS, receiving fees of \$7,500,000.
- November 15, 1996. Salomon allocates 89,286 shares to Mr. Ebbers in the McLeod Secondary Offering. He realizes profits of \$390,172.
- March 18, 1997. Salomon is engaged by WorldCom on its issuance and sale of \$2 billion in senior notes, receiving fees of \$8,330,600.
- May 15, 1997. Salomon is engaged by WorldCom on its exchange offering for MFS Bonds, receiving fees of approximately \$1,500,000.
- June 23, 1997. Salomon allocates 205,000 shares to Mr. Ebbers in the Qwest IPO. He realizes profits of \$1,957,475.
- September 26, 1997. Salomon allocates 200,000 shares to Mr. Ebbers on the Nextlink IPO. He realizes profits of \$1,829,869.

- September 29, 1997. Salomon is engaged by WorldCom on the MCI transaction, receiving fees of more than \$48 million, including fees from a related investment-grade debt offering.
- October 26, 1997. Salomon allocates 100,000 shares to Mr. Ebbers in the MFN IPO. He realizes profits of \$4,558,711.

3. Salomon's Pre-SSB Merger IPO Allocations Aroused Concern From Smith Barney

In September 1997, Salomon announced its intention to merge with Smith Barney (then a subsidiary of Travelers Group, Inc.). The merger became effective on November 28, 1997. Contemporaneous documentary evidence shows that Smith Barney analyzed, and was concerned with, Salomon's pre-merger IPO allocations.

Contemporaneous documents show that senior Smith Barney management was concerned about Salomon's pre-merger IPO allocations to PWM Group clients. Handwritten notes, apparently reflecting discussions between senior management of the two firms, show that the issues discussed included "spinning," "flipping," "no name accounts," "special agreements" and a limit on allocation size to individuals. None of the persons we interviewed were able to identify the author of the notes.

However, there can be no doubt that SSB wanted to address potentially illegal spinning. Thus, on the day that the merger became effective, November 28, 1997, SSB issued a memorandum on "Syndicate Guidelines for Initial Public Offerings." The memorandum stated, among other things, that "in light of recent publicity concerning possible improper syndicate allocation practices elsewhere in the industry,"¹⁶⁰ basic principles relating to IPO allocations were being recirculated. One of those was: "[S]hares may not be allocated to an executive of a corporate client or prospect as a quid pro quo for receiving

¹⁶⁰ A November 13, 1997, Wall Street Journal article reported that the SEC and NASD had commenced an investigation of spinning practices of numerous investment banks.

investment banking or other business from his or her corporate employer.” Salomon had no such policy.

Messrs. Olson and Trautenberg had their own discussions with senior management of the two firms at the time of the merger and agreed to stay on with the merged firm. Their ability to allocate IPO shares was specifically addressed in their written agreement with the new firm. The agreement provided that “[a]llocations for the PWM Group will be done by the Syndicate Department in accordance with firm policy” and that the PWM Group “will place an order into the Institutional Pot when directed to do so by the Syndicate Department.” It was also agreed that the PWM Group would be treated as a separate branch and that it would generally be among the top 5 SSB branches in terms of IPO shares available to be allocated to its clients. Another significant limitation was placed on the PWM Group’s IPO allocation authority: the merged firm adopted an unwritten “guideline” that 25,000 shares was the maximum number of shares to be allocated to any individual customer.

Four days after the PWM Group agreed to terms with SSB, a March 27, 1998 memorandum was circulated to SSB Branch Managers, Operation Managers and Syndicate Desk employees that specifically addressed flipping¹⁶¹ and spinning:

We believe it is appropriate to allocate syndicate stock to “investors” rather than “flippers,” i.e., accounts that show a pattern of purchasing a new issue securities for the purpose of quickly selling the hot issues for a profit.

* * * * *

The fact that an individual has in the past, or has the ability in the future, to bring to Salomon Smith Barney investment banking, asset management, or other business because of a fiduciary role (e.g., as CEO of a corporation) cannot be a factor in determining allocation to the individual’s personal accounts or

¹⁶¹ The memorandum defines flipping as “selling stock within 10 days after offering.”

related accounts. A client should neither receive an advantage nor be disadvantaged because the client is able to bring investment banking, asset management, or other type of business to our Firm based on his or her position with a particular entity.

4. Mr. Ebbers Continued to Receive Lucrative IPO Share Allocations After the Salomon/Smith Barney Merger

After the merger, the size of the IPO allocations to Mr. Ebbers decreased dramatically, both in absolute terms and in proportion to other PWM Group clients. This was due to the increased number of retail brokers at the merged firm and also apparently to the new “guideline” issued by SSB. Nonetheless, Mr. Ebbers still received preferential treatment on many of the IPO’s over other PWM clients, notwithstanding the fact that he continued to conduct no SSB brokerage business except to buy and sell IPO’s. See Appendix 6.

As detailed in the following chart, in 1998-2000, Mr. Ebbers received shares in 12 IPO’s and continued to receive favorable treatment compared to most other PWM clients.

1998-2000 SSB IPO Share Allocations to Mr. Ebbers				
Issuer	Trade Date	Shares Allocated	Total Gain (Loss)	Ebbers' Ranking Compared to PWM Group Clients
Earthshell Corp.	03/23/98	12,500	(\$73,945)	4 th
Rhythms Netconnections	04/06/99	10,000 ¹⁶²	\$66,900	1st (tied with 1 other)
Juno Online Services	05/25/99	10,000	(\$6,662)	2 nd
Juniper Networks, Inc.	06/24/99	5,000	\$860,125	N/A ¹⁶³
Focal Comm.	07/27/99	5,000	\$100,700	3rd (tied with 2 others)
Williams Comm.	10/01/99	35,000	(\$804,405)	3rd (tied with 2 others)
Radio Unica	10/18/99	4,000	\$8,010	23 rd
Chartered Semi-conductor	10/29/99	5,000	\$291,250	3rd (tied with 1 other)
UPS	11/09/99	2,000	\$17,625	3rd (tied with 1 other)
KPN Qwest	11/09/99	20,000	\$371,926	2 nd
Tycom LTD	07/26/00	7,500	\$32,813	5 th
Signal Soft	08/02/00	5,000	\$59,094	4th

E. Mr. Ebbers Was Not a “Best Customer” of Salomon or SSB

SSB told Congress in August 2002 that Mr. Ebbers and the other WorldCom officers and Directors receiving IPO shares were some of the “best” retail customers of Salomon and SSB, and therefore appropriate recipients of their IPO allocations:

¹⁶² The Examiner is aware that David Chacon, a former employee in the PWM Group, has alleged that Mr. Ebbers actually was allocated 350,000 shares from this IPO. The Examiner has not found any evidence to support this allegation.

¹⁶³ It appears from SSB documents that Mr. Ebbers' shares came from Juniper's DSP.

[T]he WorldCom officers and directors [that received IPO allocations] were very substantial retail clients of SSB with large retail accounts.

* * *

SSB, like most firms, has traditionally allocated IPO shares to provide the most effective distribution of the issuers' shares while giving preference – where consistent with effective distribution – to the firm's best customers. Various factors enter into allocation decisions, including the customer's investment objectives, the customer's level of interest in the IPO, past IPO participation, the size of the customer's portfolio and net worth, and the level of personal business that the customer generates or may potentially generate in the future.

* * *

The IPO allocations to the WorldCom officers and directors at issue were reasonable since these were high net worth individuals and substantial retail clients. Indeed these retail accounts would put them in approximately the top one percent of SSB's 3.5 million households with individual clients.

* * *

The WorldCom officers and directors at issue were among SSB's best individual customers; in fact their individual accounts put them in approximately the top 1 percent of SSB retail clients.

Based on the facts already discussed and others enumerated below, the Examiner rejects this explanation and concludes that Mr. Ebbers did not fit any definition of "best customer." This reinforces the conclusion that Mr. Ebbers received his IPO shares due to his WorldCom connection and his ability to direct WorldCom investment banking business as he chose.

1. Mr. Ebbers Was Not Even a "Customer" of Salomon at the Time of His Extraordinary McLeod IPO Allocation

As noted before, Mr. Ebbers did not have a brokerage account with Salomon prior to June 1996, when he was allocated 200,000 shares in the McLeod IPO. In fact, Mr. Ebbers opened his account with Salomon to receive these IPO shares. Thus, Mr. Ebbers clearly was not a "best customer" at the time of the McLeod IPO.

When asked how they first came to know Mr. Ebbers, Messrs. Olson and Trautenberg advised the Examiner that, some time in early 1996, they “cold called” Mr. Ebbers and set up a meeting in Jackson, Mississippi. They advised that they subsequently met with Mr. Ebbers in Jackson and made a “pitch” to have Mr. Ebbers open a Salomon brokerage account. The standard PWM Group “pitch” to potential clients included possible access to IPO allocations. At the conclusion of the meeting, Mr. Ebbers is said to have agreed to open such an account and to have referred the PWM brokers to his personal financial advisor, Mr. Lewis.

There is no evidence that, subsequent to the meeting in early 1996, Mr. Olson or Mr. Trautenberg had any contact with Mr. Ebbers or Mr. Lewis before the McLeod IPO. Further, as previously noted, Messrs. Olson and Trautenberg have no recollection of having any role in the McLeod IPO allocation to Mr. Ebbers. Thus, while the Examiner does not doubt that Messrs. Olson and Trautenberg met with Mr. Ebbers in early 1996, Mr. Ebbers had not become a PWM client before the McLeod IPO.

2. Mr. Ebbers Never Became a Best Customer of Salomon or SSB

Mr. Ebbers was never a “best” Salomon or SSB customer who would expect to receive massive IPO allocations because of his retail brokerage business. Indeed, Mr. Ebbers (i) carried out no brokerage business in his Salomon and SSB accounts, other than buying and disposing of IPO or secondary offering shares, (ii) was not a long-term holder of the allocated shares and even engaged in “flipping” on a number of occasions, and (iii) did much more personal brokerage activity with other firms. Thus, it is likely that Salomon/SSB’s generosity to Mr. Ebbers was motivated by factors other than Mr. Ebbers’ status as a retail brokerage client, such as to curry favor with Mr. Ebbers because of his control over the award of WorldCom’s vast investment banking business.

a. Mr. Ebbers Carried Out No Non-IPO Brokerage Business in His Salomon/SSB Accounts

Aside from buying and selling his IPO and secondary offering shares, Mr. Ebbers did no trading in his Salomon brokerage accounts. Indeed, at one point, Mr. Trautenberg complained to Mr. Olson about Mr. Ebbers' lack of retail brokerage activity, questioning his partner's ability to convert Mr. Ebbers from a client who was "primarily partaking in deal [i.e. IPO] stock" into a client who would "bring in significant assets."¹⁶⁴ Furthermore, a Citibank analysis of Mr. Ebbers' financial condition prepared as of July 27, 2000, disclosed that Mr. Ebbers held only IPO shares (or money market shares after sales of IPO shares) in his SSB account and held all of his WorldCom and non-IPO securities either personally or in accounts at other firms. Accordingly, Mr. Ebbers could not be deemed a "best" brokerage customer of Salomon or SSB based on the level of personal brokerage business that he conducted.

Counsel for CGM has asserted that Mr. Ebbers' year-end account balances placed him in the top 1-2 percent of Salomon/SSB retail accounts between 1996 and 1999. The Examiner has been furnished with statistics to support this claim. However, the statistics for 1996 and 1997 include Smith Barney customers, even though the Salomon-Smith Barney merger did not occur until the end of 1997. The Examiner can see no basis for including Smith Barney's customers in a comparative analysis of Mr. Ebbers' status as a Salomon customer in 1996 and 1997.

¹⁶⁴ Messrs. Olson and Trautenberg sought to justify the IPO allocations to Mr. Ebbers on the basis that they knew that he had vast WorldCom stock holdings and that they hoped eventually to persuade Mr. Ebbers to deposit most of those assets with Salomon/SSB. There is no evidence that Mr. Ebbers ever moved in the direction of fulfilling this "game plan." Accordingly, the Examiner cannot account on this basis for the continued favoritism showed to Mr. Ebbers in IPO allocations absent some other more persuasive explanation, such as his control of WorldCom investment banking business.

The Examiner received one document from SSB, that does appear to present a basis for comparison. Thus, the Examiner reviewed a report prepared by Salomon's internal auditors in January 1998. Included in the report is the following information: "As of July 31, 1997, PWM had responsibility for approximately 260 accounts (140 active accounts), which had approximately \$1.9 billion in total assets held at Salomon. . . ." Thus, using the 260 total accounts, PWM's customers apparently had an average balance of approximately \$7.3 million at that time. Using only the 140 active accounts, the average balance would be approximately \$13.6 million. The balance in Mr. Ebbers' account as of July 31, 1997 was \$1,867,500, well under the average for PWM customers on either basis. Furthermore, Mr. Ebbers' average account balance (as of month end) over the period from June 1996 to July 31, 1997, was approximately \$3.5 million. Accordingly, on all bases, Mr. Ebbers was less than an "average" Salomon retail customer as of July 31, 1997, but he nevertheless received the highest allocations among retail clients.

b. Mr. Ebbers Was Not a Long-Term Holder of His IPO Shares

Mr. Ebbers generally was not a long-term holder of his IPO shares and often sold them within days after he purchased them. For example, he sold all of his 200,000 McLeod IPO shares within four months after buying them. In the Qwest IPO, he engaged in "flipping," by selling 140,000 of his 205,000 shares as soon as he paid for them. Similarly, in the Juniper IPO, he sold 4,000 of his 5,000 shares the same day he bought them.

The witnesses interviewed by the Examiner agreed that long-term investors were desired by Salomon and SSB for IPO's and that a history of "flipping" IPO shares was a negative factor in determining future IPO allocations. Thus, based on Mr. Ebbers' penchant

for selling his IPO shares shortly after purchasing them, he failed to qualify as a best customer based on the criterion of acceptable past IPO participation.

CGM through counsel has urged that the “share-weighted” average period for which Mr. Ebbers held his Salomon/SSB IPO shares was 219 days. The Examiner does not accept this analysis. This formula fails to highlight the multiple instances when Mr. Ebbers “flipped” all or a portion of his IPO shares. For example, on five of those nine IPO’s, his share weighted average holding period was 13 days or less; on Qwest it was 21 days and on McLeod it was 124 days.

c. Mr. Ebbers Held Most of His Assets and Conducted All of His Retail Trading at Firms Other Than Salomon/SSB

Based upon a review of Mr. Ebbers’ account statements from Salomon/SSB and other firms, it is clear that Mr. Ebbers had far more assets in his accounts at other firms than he did in his Salomon/SSB accounts. Similarly, an analysis of Mr. Ebbers’ trading activity also shows that Mr. Ebbers did all of his non-IPO trading at firms other than Salomon or SSB. Thus, approximately 99 percent of his trading at other firms, both in terms of shares traded and dollars invested, did not involve IPO shares. Accordingly, while Salomon/SSB handsomely rewarded Mr. Ebbers with IPO’s, Mr. Ebbers was investing most of his liquid assets with other firms.

The Examiner has partial records of Mr. Ebbers’ accounts at PaineWebber, Morgan Keegan, Bank of America, Goldman Sachs and Jesup & Lamont. These records show the following, regarding the size of Mr. Ebbers’ high and low month-end balances in those accounts compared to Mr. Ebbers’ SSB accounts, during the period when he was receiving IPO’s from Salomon and SSB:

<u>Firm</u>	<u>Mr. Ebbers’ Account Statements</u> ¹⁶⁵	<u>Low Month-End Balance</u>	<u>High Month-End Balance</u>
PaineWebber	August 1996 - August 2000	\$ 60,369,226	\$ 188,105,853
Morgan Keegan	August 1996 - August 2000	\$ 10,237,945	\$ 58,079,047
Bank of America	June 1999 - August 2000	\$ \$2,048,568	\$ 8,314,892
Jesup & Lamont	November 1997 - August 2000	\$ 556,200	\$ 8,600,405
Goldman Sachs	May 1999 – August 2000	\$ 1,000,547	\$ 1,929,810
Salomon/SSB	June 1996- August 2000	\$ 1,589,223	\$ 11,769,147

d. Conclusion

In sum, Mr. Ebbers did not qualify as a Salomon/SSB best customer. Mr. Ebbers’ “small” amount of activity in his Salomon/SSB account, combined with his penchant for “flipping” and his large portfolio and trading activity with other firms, support the conclusion that Mr. Ebbers was not a “best customer” of Salomon/SSB, and that some other factor must have led to his remarkably large IPO allocations. Given the extraordinary size and questionable circumstances surrounding these allocations, together with their timing, it is reasonable to conclude that they were intended to, and did, reward his decision on hiring and continuing to hire Salomon/SSB as WorldCom’s lead investment banker.

¹⁶⁵ The Examiner was not provided Mr. Ebbers’ month-end balances for the following accounts during the relevant time period and therefore these balances were not considered in the above-chart: SSB (November 1999); PaineWebber (October 1996, January and June-November 1997); and Jesup & Lamont (January, February, May, June, July, October, November 1998, and April, May and October 1999).

F. SSB's Extraordinary Financial Assistance to Mr. Ebbers in 2000-2002

The SSB IPO allocations to Mr. Ebbers ended in August 2000. However, a new sort of SSB financial favor to Mr. Ebbers began shortly thereafter. Thus, in October 2000 and thereafter, in response to requests from Mr. Ebbers for help to avoid WorldCom stock sales due to margin calls from Mr. Ebbers' lenders, SSB provided unprecedented financial assistance to Mr. Ebbers.

The evidence supports the conclusion that the loan assistance, guarantees and other financial assistance by SSB to Mr. Ebbers in 2000-2002 were made for the purpose of gaining and/or keeping WorldCom corporate business and not because of Mr. Ebbers' status as a SSB brokerage client. Thus, SSB engaged in conduct that constituted another form of "spinning," a means of obtaining and/or keeping corporate business as a result of personal financial favors provided to corporate executives. The evidence also supports the conclusion that Mr. Ebbers allocated WorldCom work to SSB in return for these favors.

1. Background to Mr. Ebbers' Financial Assistance Requests

In the 1990's, with technology stocks surging in value, Mr. Ebbers became extraordinarily wealthy. Most of that wealth consisted of the WorldCom stock that he owned.

As he became wealthier, Mr. Ebbers invested in properties that ranged far beyond WorldCom. These included a purchase of a Canadian ranch for approximately \$57 million, a Georgia shipyard valued at approximately \$15 million, and approximately 600,000 acres of timberland in Mississippi and Alabama.

Mr. Ebbers did not finance his diverse personal investments by selling his WorldCom stock. Rather, it was widely known that Mr. Ebbers did not wish to sell any of his WorldCom stock, and he frequently discouraged sales of WorldCom stock by other

WorldCom personnel. Accordingly, to finance his non-WorldCom pursuits, Mr. Ebbers generally obtained the cash needed through loans secured by his WorldCom stock. As of the start of 2000, with WorldCom's stock selling for approximately \$53 per share, Mr. Ebbers' WorldCom stock had a value in excess of \$1 billion and he had a reported net worth of approximately \$1.3 billion, with outstanding notes and margin loans payable totaling approximately \$279 million. Thus, it appears that there was sufficient stock value available as collateral for his borrowings.

In late July 2000, Citibank performed a review of Mr. Ebbers' financial condition to determine whether to approve a credit line of up to \$17 million to finance his purchase of a trucking company. The review revealed a drastic decrease in Mr. Ebbers' assets and an increase in his liabilities since the end of 1999. With WorldCom's stock price falling more than \$13 in the first seven months of 2000, Mr. Ebbers' net worth was cut almost in half, to an estimated \$658 million. His margin debt at the time, secured by WorldCom stock and other securities, was approximately \$378 million, with loans outstanding at various banks and broker/dealers, including approximately \$203.9 million at Bank of America, \$47.2 million at PaineWebber, \$12.5 million at Morgan Keegan, and \$51 million at Citibank.¹⁶⁶

By September 2000, Mr. Ebbers' financial status had continued to decline along with WorldCom's faltering stock price, which, by September 6, had dropped to approximately \$33. One hundred percent of Mr. Ebbers' WorldCom stock, which then had a market value

¹⁶⁶ Citibank, an SSB affiliate, made this loan to Mr. Ebbers in 1999. The initial loan was approximately \$63 million. Mr. Olson, the PWM Group broker who then handled Mr. Ebbers' SSB account, teamed with a banker at Citibank to arrange for this loan, which was used to refinance Mr. Ebbers' Canadian ranch. The loan appears to have been made on commercially reasonable terms. It was secured initially by sufficient WorldCom shares to maintain a loan-to-stock value ("LTV") ratio of at least 70 percent. Mr. Ebbers was subject to a margin call (i.e., he needed to post additional security) if the LTV ratio exceeded 75 percent and Citibank had the right to sell the WorldCom stock if the LTV ratio exceeded 82 percent.

of approximately \$611 million, was pledged as collateral to secure his outstanding bank loans.

2. Mr. Ebbers' Need for SSB Assistance

Many of the loans to Mr. Ebbers had his WorldCom stock as collateral. Mr. Ebbers was required to post additional security if the value of the WorldCom stock securing the loans dropped below a specified value. If he did not, the lender had the right to sell WorldCom stock securing the loan to pay down the loan and restore the specified LTV ratio. The dramatic drop in WorldCom's stock price in 2000 resulted in substantial margin calls by Mr. Ebbers' lenders. If Mr. Ebbers did not cover the margin calls with additional collateral, he faced the prospect of having to sell significant amounts of his WorldCom stock.

As reported in the Second Interim Report, Mr. Ebbers first turned to WorldCom for assistance to meet these margin calls without selling any of his WorldCom stock. Thus, at a WorldCom Compensation Committee meeting held September 6, 2000, the Committee approved a request by Mr. Ebbers for a \$50 million loan, and also granted him a \$10 million cash bonus. This loan was provided in specific response to a Bank of America margin call Mr. Ebbers was facing at the time. Second Interim Report, Appendix 8.

The \$50 million WorldCom loan and \$10 million cash bonus were not sufficient to satisfy the demands of Mr. Ebbers' lenders, given the continued decline of WorldCom's stock price. Rather, as WorldCom's stock price continued to fall in September 2000, Mr. Ebbers faced additional margin calls. In late September 2000, Mr. Ebbers sought further help from WorldCom but the Chairman of the WorldCom Compensation Committee turned down a second loan request from Mr. Ebbers. As a result, Mr. Ebbers engaged in a forward sale of 3 million WorldCom shares on September 28, 2000 to meet a margin call from Bank of America.

The September 28, 2000 forward sale was apparently reported in the media on October 4, 2000. Possibly as a result of the reports of Mr. Ebberts' forward sale, WorldCom's stock price dropped from \$29.56 at opening on October 4 to \$25.94 by close on October 5, and continued to fall in October 2000. Thus, during October 2000, Mr. Ebberts faced additional margin calls from all his lenders, including an additional \$22 million margin call from Bank of America and a \$3.5 million margin call from Citibank. Mr. Ebberts then sought financial assistance from SSB.

3. October 2000: SSB Provides Extraordinary and Unprecedented Financial Assistance to Mr. Ebberts

In response to Mr. Ebberts' request, SSB provided extraordinary and unprecedented financial assistance to Mr. Ebberts. SSB persuaded Citibank not to sell any of Mr. Ebberts' pledged stock and to take over Mr. Ebberts' Morgan Keegan loan. In return, SSB guaranteed Citibank that it would suffer no losses on the combined Citibank/Morgan Keegan loan, which was approximately \$53 million. In addition, SSB offered the same sort of assistance to Mr. Ebberts on his PaineWebber loan, which would have been approximately an additional \$49 million, but Mr. Ebberts ultimately did not require that assistance.

SSB's assistance to Mr. Ebberts was apparently unprecedented. SSB personnel confirmed that, to their knowledge, similar assistance has never been provided to any other brokerage client.¹⁶⁷ The assistance was not casually provided. Rather, it required the involvement of high-level SSB executives, including at least SSB's CEO, head of investment banking, co-heads of Global Equities, Vice Chairman of the Global Private Client Group,

¹⁶⁷ An investment banker on the WorldCom account informed the Examiner that he was "surprised" in 2000 at SSB's assistance to Mr. Ebberts because he could not think of any other circumstance where SSB entered into such an arrangement.

senior Credit and Risk Management personnel, Senior Executive Vice President and Director of Private Client Sales and Marketing Group and Mr. Grubman.

The SSB assistance to Mr. Ebbers began with two phone calls in early October to Mr. Trautenberg, by then Mr. Ebbers' PWM Group broker. One call was from Mr. Lewis, Mr. Ebbers' personal financial advisor. Mr. Lewis reported to Mr. Trautenberg that Mr. Ebbers was facing approximately \$31 million in margin calls from his lenders, including a \$3.5 million margin call from Citibank, and he asked Mr. Trautenberg if SSB could help Mr. Ebbers. At approximately the same time, Mr. Trautenberg received a similar call from a banker at Citibank, who reported to Mr. Trautenberg on Mr. Ebbers' margin loan difficulties and asked whether SSB was willing to assist Mr. Ebbers.

Mr. Trautenberg immediately sought to mobilize high level SSB support to assist Mr. Ebbers. Thus, on October 6, 2000, Mr. Trautenberg sent a "High Importance" e-mail to senior SSB management seeking support for SSB assistance for Mr. Ebbers. Among other things, he recommended:

Arrange a meeting with either [Vice Chairman of the Global Private Client Group] or [SSB Chairman and CEO] and other senior members of Institutional Equities, Credit, and Investment Banking to immediately and to aggressively pursue a comprehensive short-term strategy that gets Bernie Ebbers out of his current liquidity predicament. That means being like BofA (Nationsbank is the predecessor relationship) and working with Bernie quickly and committing to lending decisions in a streamlined fashion.

Getting together with Bernie at the top levels of the Broker/ Dealer -- Retail and Institutional -- with the support of Jack Grubman and show him we want to be and will be his go to relationship now while it is rocky and for a long time in the future.

Mr. Trautenberg recognized from the outset that such assistance could not be provided to Mr. Ebbers without high-level support within SSB. Thus, he wrote in the same e-mail:

I cannot do this without top support at SSB. The inertia is too great at PBG [Citibank Private Bank] to get them to move quickly and there is always concern there if things blowup [sic] that the P&L gets destroyed. This is the time to act with alacrity. This should be our relationship and I want to get this done in the right way so we don't have to read anymore about a pre-filed EMS trade at a competitor for WCOM for Bernie.

While Mr. Trautenberg was urging SSB senior management to provide assistance to Mr. Ebbers, Citibank personnel were similarly considering means to assist Mr. Ebbers. Thus, an October 14, 2000 memorandum by Citibank executives noted that Mr. Ebbers had borrowed \$331 million against his WorldCom shares from various lenders and had open margin calls of \$31 million, including a \$3.5 million margin call by Citibank. The memorandum went on to state:

[a]n institutional concern has been expressed given the high profile/quality of Ebbers as a Citigroup client both individually and as CEO of WCOM. The client has asked Citigroup to evaluate his financial situation and propose a loan structure that would give him some “breathing room.”

(emphasis supplied.) The memorandum went on to point out:

Ebbers borrows from the Private Bank (PBG), has invested personally to a small degree with SSB, uses Citigroup Investments to finance personal timberland purchases, and has indirect relationships with the Citibank GRB and SSB's Investment Bank through WCOM.

(emphasis supplied.) The memorandum concluded by recommending, among other things, the following:

[R]efinance [Mr. Ebbers' loans from] Paine Webber and Morgan Keegan. This will provide immediate margin call relief to Citibank and the client and will allow for further slippage in WCOM to \$21/share. We would be responsive to the client needs, yet would be offering a solution proportionate to our relatively good credit position and our strong institutional relationship.

Subsequent to October 14, 2000, SSB financial assistance for Mr. Ebbers rapidly came to be approved. On October 17, Mr. Trautenberg sent another High Importance e-mail to senior SSB personnel:

We need to have a conference on Bernie Ebbers first thing in the morning along with Jack Grubman and maybe either Scott Miller or Eduardo Mestre and David Bushnell. We are at a critical stage for Bernie Ebbers and need to speak prior to the Private Bank selling him out through SSB.

It appears that Citibank was reluctant to provide assistance to Mr. Ebbers that exposed it to any new risk.¹⁶⁸ Accordingly, as of October 17, 2000, there was a significant possibility that Citibank would sell some of Mr. Ebbers' stock to satisfy its margin call. SSB personnel, who maintained close relations with Mr. Ebbers and knew of his strong aversion to sales of WorldCom stock and who were also well aware of the adverse effect such a sale would have on WorldCom's stock price, took action to avoid this result.

Senior SSB personnel reached agreement on how to provide financial relief to Mr. Ebbers. Thus, on October 18, an internal memorandum was circulated setting forth an increase in and restructuring of Mr. Ebbers' debt. The memorandum was approved on behalf of SSB by a member of its Executive Committee. The purpose and background of the memorandum were set forth in pertinent part as follows:

The purpose of this memorandum is to: 1) approve a new \$11,151,753. . . credit facility to refinance margin debt currently held at Morgan Keegan ("MOKE"); 2) approve a new \$49MM credit facility to refinance margin debt currently held at Paine Webber ("PW"); 3) restructure Ebbers' facilities to eliminate the existing "advance rate", "top-up", and "sell-out" language and substitute a "sell out" level at a WCOM market value of \$52.059M (\$17.50/share x 2,974,783 shares) for a portion of Ebbers' exposure -- \$52.876M (\$41.724M existing plus \$11.152M from MOKE). . . ; 4) set a sell-out threshold on the refinanced PW exposure of approximately \$20/share (79% LTV). . . .

¹⁶⁸ For example, the same October 14, 2000 memorandum referred to above stated:

Decline client request to quickly advance funds against the Canadian ranch property. Under the current circumstances, this is not a credit the Private Bank would undertake. BofA has much more incentive to provide loan value against the property than Citigroup given its poor margin position. However, should SSMB wish to assume the credit risk, the PBG could act as its underwriting and booking utility.

In the wake of margin call activity with the client given the recent decline in WCOM stock price, the client has asked us to refinance his loans at MOKE and PW in order to cure his mandatory margin calls The following proposal was developed by SSB, principally D. Trautenberg, R. Case, and J. Elmlinger, with senior relationship involvement by M. Carpenter and E. Mestre, and by the PBG.

SSB's credit support for Ebbers was summarized as follows:

Salomon Smith Barney Holdings, Inc. has agreed to provide credit support to the Citibank Private Bank (Citicorp USA, Inc.) with:

- 1) A \$10MM continuing guaranty for the client's obligations related to the PBG's existing margin loans and the new \$11.152M margin loan which will be booked with the refinancing of the MOKE debt.
- 2) A guaranty of a sell-out price of \$14.41/share to the PBG against the \$52.876M of debt. This guaranty will encompass all execution/liquidation risk associated with the sale of the collateral. This guaranty effectively gives the PBG an absolute put of the WCOM shares for \$42.876M, or \$52,876M less the aforementioned \$10MM guaranty.
- 3) A guaranty of a sell-out price of \$20/share (80% LTV) against the \$49MM of debt currently at PW. The sell-out would be effected through the client's irrevocable obligations to enter into either a) a forward sale of the shares (at a pre-determined price level with pre-executed dox.), or b) through a Rule 144k sale by a non-affiliate pledgee. NOTE: *Neither this credit support, nor the client's agreement to irrevocably sell the shares, has been committed. Consequently, this memorandum seeks approval for the \$49MM refinancing conditionally, upon terms and conditions satisfactory to [relevant Citibank officers].* (emphasis in the original).

Thus, SSB was prepared to guarantee both the combined Citibank/Morgan Keegan loans of \$52.8 million and the PaineWebber loan of \$49 million, a total in excess of \$100 million. Ultimately, Mr. Ebbers decided not to ask Citibank/SSB to refinance his PaineWebber loan.

On October 20, Salomon Smith Barney Holdings ("SSBH") and Citicorp USA executed an agreement memorializing SSB's assistance on behalf of Mr. Ebbers on the

Citibank/Morgan Keegan loans. The agreement noted that as of October 20, Mr. Ebbers owed the Bank \$53,015,976, apparently the total of Mr. Ebbers' debt to both Citibank and Morgan Keegan, which was secured by 2,974,783 shares of Mr. Ebbers' WorldCom stock.

In pertinent part, the agreement provided as follows:

This letter will set forth our agreement regarding the Obligations. For and in consideration of the forbearance of CUSA in liquidation of the Collateral [Mr. Ebbers' WorldCom stock] and CUSA's refinancing of \$11,151,753 of Mr. Ebbers margin debt to Morgan Keegan on the date hereof, Salomon Smith Barney Holdings, Inc. ("SSBH") and CUSA agree as follows:

- 1) SSBH hereby (a) guarantees payment of the Debtors' Obligations to CUSA as described in Paragraph 3 below and (b) agrees to allocate \$10MM (and any additional amounts which may be required in the future) of an account it maintains with Citibank, N.A. for 23A purposes (the "Account") in support of its guaranty (the "Guarantee Deposit").
- 2) Under the terms of the Indebtedness, CUSA may sell the Collateral if the market price of the Collateral is at any time less than \$52,058,702.50. If the market price drops below this level and CUSA decides to sell, it will so instruct SSBH. SSBH will control the liquidation of the Collateral.
- 3) Upon the sale of the Collateral by SSBH or its agent, SSBH guarantees to pay CUSA an amount equal to the greater of (i) the net proceeds from the sale of the Collateral plus \$10 Million but not more than the amount of the Obligations of the Debtors to CUSA on the date of such payment or (ii) \$53,015,976 if the net proceeds from the sale of the Collateral are less than \$43,015,976 (i.e., \$14.4602 per share). CUSA shall be entitled to direct Citibank, N.A. to deliver to it from the Account, all or the applicable portion of, the Guarantee Deposit in payment of all or a portion, as the case may be, of the amount due from SSBH to CUSA hereunder.
- 4) SSBH will complete the sale of the Collateral no later than six months from its receipt of CUSA's instructions to sell the Collateral.

SSB, by agreeing to guarantee that Citibank would not be at risk, assumed the risk of a further drop in the price of WorldCom's stock. This was not an insignificant risk, since Smith Barney Asset Management as of September 30, 2000 was reported to have controlled

over 45 million shares of WorldCom stock and was reported to be the 4th largest holder among all institutions. Accordingly, SSB added to its multi-million dollar incentive to have WorldCom's stock price remain high. Also, at this very time, SSB investment bankers were advising WorldCom whether and how to implement two Tracker stocks, whose very purpose was to attempt to boost the value of WorldCom's stock. See Chapter IX, *infra*.

The Examiner makes a number of observations about the financial assistance provided by SSB to Mr. Ebbers. First, as previously noted, the assistance was unprecedented. SSB personnel stated that such assistance has never been provided to any other SSB brokerage client. To underscore the unprecedented nature of this assistance, the assistance required approvals at the highest levels of SSB.

Second, while it is difficult to assess the risk assumed by SSB in providing this financial assistance, it is clear that SSB did assume some degree of risk. A number of persons sought to minimize the risk that SSB faced in the guarantee provided (\$52 million) and the PaineWebber guarantee offered but ultimately not accepted (\$49 million), stating that SSB was protected because it had the right to sell Mr. Ebbers' stock at certain thresholds. However, there were certain restrictions on SSB's ability to sell Mr. Ebbers' shares, at least in a way that was preferable. Thus, in a November 15, 2000 e-mail, it was explained that Mr. Ebbers was "VERY sensitive about how a sale would be portrayed [sic] in the [public] filing, in that he would want it to appear as a voluntary sale." Another SSB e-mail noted that Citibank/SSB's "ability to accommodate [Mr. Ebbers] here is subject to the opinion of the WCOM CFO, who determines whether we are in a window that would allow the client to sell shares voluntarily." Further, as the course of this assistance proved, SSB was extraordinarily

reluctant to sell any of Mr. Ebberts' stock and did not do so until after Mr. Ebberts was removed as WorldCom's CEO.

Indeed, senior SSB management accepted an unsecured exposure of up to \$10 million before selling any of Mr. Ebberts' stock, underscoring that this was no normal commercial transaction. Thus, in a September 20, 2001 e-mail to senior SSB personnel, Mr. Trautenberg recounted:

Both Institutional Equities and Investment Banking have gone on record stopping out the Private Bank against any losses on its loan to Bernie. Internally, separate and distinct from the Private Bank, both IED and IBD initially decided to go to as low as \$10 million unsecured with Bernie before selling any of this stock. This was an internal decision only and was not communicated to the client (either verbally or in writing).¹⁶⁹

(emphasis supplied.) This assumption of a \$10 million risk on Mr. Ebberts' behalf appears to be unprecedented for a SSB brokerage client.¹⁷⁰

Third, Mr. Ebberts' connection to WorldCom was expressly cited by SSB personnel as a reason to provide the financial assistance. Thus, in advocating takeover of the PaineWebber loan to senior SSB management, Mr. Trautenberg stated in an October 23, 2000 email:

This individual is associated with the number one fee generating client [i.e., WorldCom] of the [SSB Investment] Bank as well as institutional Fixed Income/Equities. In addition, Retail does have WorldCom's stock option exercise program.

(emphasis supplied.) The conclusion is again unmistakable: SSB provided personal financial assistance to Mr. Ebberts as a means of enhancing the probability that SSB would

¹⁶⁹ Other contemporaneous SSB documents reveal that Mr. Ebberts knew about and discussed with SSB its willingness to go \$10 million unsecured. For example, in a September 5, 2001 e-mail, a Citibank officer expressed to his colleagues that "[i]n June Trautenberg and I made a margin call on the client, but the client advised that he believed he could have up to \$10MM of unsecured exposure and wanted to discuss the matter with Mestre."

¹⁷⁰ In a normal brokerage account situation, a broker generally extends loans on margin, i.e., with sufficient securities in the account to cover the loan amount.

keep a preferred position in receipt of WorldCom business, including investment banking and stock option business, and also as a means of avoiding sales of Mr. Ebbers' stock, which would adversely affect WorldCom's stock price.

Further, as of October 2000 and thereafter, SSB had reason to be concerned about the maintenance of its preferred investment banking position with WorldCom. First, in August 2000, WorldCom engaged SSB as its financial advisor on its possible merger with Intermedia. The Intermedia transaction had an extraordinarily expedited schedule, with SSB starting work on the evening of August 30, 2000, with knowledge that the deal needed to close by 5 P.M. on September 1. In mid-afternoon on August 31, SSB informed Mr. Ebbers that it was withdrawing from the representation because SSB had previously been engaged by a competitor, Global Crossing, to pursue a similar transaction. Second Interim Report at 53. Several persons reported to the Examiner that Mr. Ebbers was extremely unhappy about the SSB conflict and its withdrawal.¹⁷¹

Second, with regard to the Tracker stocks, WorldCom engaged J.P. Morgan Securities, in addition to SSB, as financial advisors.

Third, J.P. Morgan acted as deal manager on a \$2 billion private debt offering in December 2000.

Fourth, SSB's concerns about its preferred relationship with WorldCom were manifest in 2001. In April and May 2001, when WorldCom was planning its \$11.9 billion debt offering, SSB sought to be the sole lead book runner on the offering. SSB investment bankers had Mr. Grubman personally call Mr. Ebbers and Mr. Sullivan to seek such a

¹⁷¹ WorldCom personnel subsequently reminded SSB personnel about the Global Crossing conflict. Thus, in a December 15, 2000 e-mail to a SSB fixed income investment banker, Mr. Sullivan stated that in 2001, WorldCom would consider "larger term refinancings" He then added: "Hopefully, your boss won't have a Global Crossing conflict."

coveted position. Ultimately, that effort failed and SSB ended up as co-manager with J.P. Morgan. In a contemporaneous e-mail to Mr. Sullivan, WorldCom's Treasurer reported that Mr. Mestre had called her to express gratitude for at least being awarded the co-manager role on the deal, and to say that he understood that "SSB had been on the outs with WorldCom over the past year and he was glad that this deal seems to indicate that [WorldCom] had regained confidence in [SSB]."

Moreover, in fall 2001, Citibank, a large consumer of WorldCom services, owed WorldCom approximately \$9.5 million for services, some of which were significantly overdue. Mr. Sullivan made clear to SSB bankers that SSB's status as WorldCom's preferred investment banker was in jeopardy. Thus, in an October 12, 2001 e-mail, Mr. Sullivan advised the SSB investment banker: "There is no need to come see us next week on October 18 if all your accounts are not completely current with us by Monday October 15." When the late payments continued, Mr. Sullivan sent a further e-mail to the SSB banker on November 29, 2001: "I will not recommend or support SSB for any work – treasury, M&A, etc. – if this is not absolutely zero before year-end."

4. SSB Continued to Provide Financial Assistance to Mr. Ebbers after October 2000

Notwithstanding the fact that SSB's hold on WorldCom's investment banking work seemed to be in jeopardy during 2000-2001, SSB's financial assistance to Mr. Ebbers continued. Indeed, in certain respects, the financial assistance became even greater after October 2000.

a. SSB Declined to Sell Mr. Ebbers' Stock in November 2000

The first example of additional financial assistance provided to Mr. Ebbers after October 2000 was SSB's decision in November 2000 not to sell any of Mr. Ebbers'

WorldCom stock, even after the stock price fell sharply in early November. The situation was as follows.

On October 26, 2000, WorldCom announced third-quarter 2000 earnings that failed to meet analysts' projections. Then, on November 1, 2000, WorldCom announced revised financial guidance, lowering future predicted earnings per share. As a result, WorldCom's stock price dropped further, reaching \$16.94 on November 8, 2000. The drop breached the \$17.50 margin call level of the restructured Citibank loan. Accordingly, on November 8, 2000, Citibank instructed SSB to sell the WorldCom stock that secured Mr. Ebbers' indebtedness. SSB was not obligated to sell the stock on Citibank's instruction but, if it did not, SSB would be responsible to Citibank for any eventual shortfall between the value of the collateral and the loan balance.

At this point if not earlier, SSB effectively took full responsibility for Mr. Ebbers' loan with Citibank and the possible sale of the collateral. SSB elected not to sell Mr. Ebbers' stock as of November 8, 2000. Instead, on November 9, 2000, Mr. Trautenberg informed senior SSB management that he proposed to hold off any sale unless WorldCom shares fell below \$16 per share.¹⁷² However, SSB was more lenient than Mr. Trautenberg proposed, deciding not to sell Mr. Ebbers' shares until the stock fell to the \$15.50 level. Indeed, SSB still did not sell even when the share price fell below \$15.50 on November 13.

On November 10, 2000, Mr. Trautenberg informed senior SSB management that the risk faced by SSB as guarantor on the restructured Citibank loan to Mr. Ebbers was greater than previously believed. SSB had been informed previously by Citibank that it had a negative pledge on Mr. Ebbers' Canadian ranch, meaning that the ranch, valued at greater

¹⁷² It is not clear how the \$16 per share threshold was determined. Mr. Trautenberg recalled that he was not the person who decided on that number, but he could not recall who made the decision. The Examiner believes that one or more members of senior SSB management must have determined the \$16 share threshold.

than \$50 million, could serve as additional security on the restructured Citibank loan. Contemporaneous documents indicate that Mr. Ebbers had told Mr. Grubman the same thing. On November 9, 2000, however, SSB learned that Citibank did not have a negative pledge and that Bank of America had a first lien on all of Mr. Ebbers' unencumbered assets, including the ranch. Even with this new information, SSB still did not sell any of Mr. Ebbers' collateral.

The threshold for sale of Mr. Ebbers' collateral became a moving target. Thus, in a November 13, 2000 e-mail, Mr. Trautenberg advised senior SSB management that SSB Institutional Equities had instructed Mr. Trautenberg to sell one million shares of Mr. Ebbers' collateral, out of the total of 2,974,738 shares then held by Citibank as collateral, if the stock price reached \$14.75. It appears that Executive Committee members set the \$14.75 price, underscoring the high-level attention being given to the relationship with Mr. Ebbers.

However, even the \$14.75 trigger price was disregarded, and as WorldCom's stock eventually fell to the point where SSB was exposed to a \$6.9 million loss, SSB still did not sell the stock. Thus, a November 22, 2000 e-mail to senior SSB management summarizing Mr. Ebbers' situation, stated as follows:

The loan balance is \$50,015mm, against 2,974,783 shares. Bernie made a \$3mm cash payment in our favor on 11/14 to buy some time. He is also in the process of providing us with liens on physical assets as follows: a condo in Beaver Creek on the market for \$1.5mm, and a yacht offered for \$8mm. We have not ascribed exact loan value to these physical assets, preferring to look to them to assist in covering any unsecured exposure remaining in the event we ultimately have to liquidate the stock.

The current breakeven on the margin position is \$16.81 per share. We go \$10mm unsecured at \$13.45/share.

Because the stock traded as low as \$14.50 earlier today (\$6.9mm unsecured exposure), we felt we needed to be prepared to take action. David

Trautenberg and I spoke to Mark Lewis in Bernie's office requesting \$5mm of additional cash. We indicated that if such funds were provided, we would be comfortable for now down to \$13.75. Otherwise the stock was getting perilously close to a sell point.

The Examiner concludes that SSB's forbearance from selling any of Mr. Ebbbers' collateral in November 2000 and its willingness to be exposed to up to \$10 million of losses were again prompted by its desire not to take any action that might harm SSB's relations with WorldCom. This conclusion is supported by a November 21, 2000 e-mail from a Citibank executive to various Citibank and SSB personnel, in which he summarized Mr. Ebbbers' financial problems and margin loan situation with SSB, and stated:

On the strength of the corporate finance relationship between SSB and WCOM, SSB effectively guaranteed the Private Bank's exposure, and has elected not to enforce the margin call provisions or the demand feature of our loan documents.

(emphasis supplied.)

Also, a December 1, 2000 memorandum from Citibank to senior SSB executives, including its CEO, demonstrated the sensitivity to Mr. Ebbbers' corporate position. The memorandum recapped the Citibank loan restructuring afforded to Mr. Ebbbers in fall 2000 and the pressures experienced by WorldCom stock price declines. In closing, the author stated: "Given the sensitivity of the relationships involved, we are likely facing a longer-term work-out scenario until the WCOM stock price recovers."

A further reason to believe that SSB provided assistance to Mr. Ebbbers to gain and/or keep WorldCom business for SSB or its affiliated companies is reflected in developments early in 2001. On January 26, 2001, Mr. Ebbbers and his financial advisors met with Citibank and SSB representatives to discuss his financial situation. At this meeting, Mr. Ebbbers indicated that because of his displeasure at the way he had been treated by Bank of

America¹⁷³ and because of the favorable treatment he had received from Citibank and SSB, he was considering replacing Bank of America with Citibank for WorldCom's corporate banking. A January 31 memorandum by the Citibank executive handling Mr. Ebbers' Citibank loan summarized this portion of the meeting and stated:

[Bank of America's] demands on Ebbers has [sic] apparently weakened their overall relationship with WCOM. Ebbers appears open to considering Citibank as lead bank for his company's corporate banking relationship. Citigroup currently only has a secondary relationship with WCOM; and

* * *

Our efforts to 'weather the storm' with Ebbers during WCOM's price volatility have apparently paid off, as he is looking to expand our relationship [Bank of America's] demands (mandatory paydowns of \$75MM in 2001 and demand of a \$150MM WCOM guaranty) have damaged what was once a solid relationship.

The Examiner has been informed by Company personnel that after January 2001 WorldCom did not utilize Citibank for more of its corporate banking. Regardless, it appears clear that Mr. Ebbers expressed his willingness to do so in return for the personal financial favors extended to him by Citibank and SSB.

b. Further SSB Financial Assistance to Mr. Ebbers in 2001-2002

By June 2001, WorldCom's stock price had again fallen to the point where Mr. Ebbers was facing margin calls on his various loans, including his Citibank loan. For example, as of June 25, 2001, Mr. Ebbers' LTV ratio on this loan was approximately 98 percent, far exceeding the 75 percent LTV ratio required by the Citibank loan documents.

Responding to this situation, Mr. Trautenberg contacted Mr. Lewis, Mr. Ebbers' financial advisor, and asked that Mr. Ebbers pay down the loan by \$7.5 million. Mr. Ebbers

¹⁷³ The displeasure with Bank of America appears to have stemmed from Mr. Ebbers' forward sale of 3 million WorldCom shares in late September 2000 to meet a Bank of America margin call, the subsequent Bank of America insistence that it get a lien on Mr. Ebbers' previously unencumbered assets and Bank of America's further insistence that WorldCom guarantee a portion of Mr. Ebbers' indebtedness to Bank of America.

did not agree to make a \$7.5 million payment.¹⁷⁴ Instead, Mr. Ebbers spoke with Mr. Trautenberg and Mr. Trautenberg then advised senior SSB personnel:

This morning we spoke to [sic] Bernie. He would like to speak with Eduardo [Mestre, chairman of SSB Investment Banking] prior to discussing with SSB curative steps on his loan. We asked Bernie for 7.5 million and he would like to discuss if the Firm is still willing to go unsecured.

Thus, Mr. Ebbers requested further financial assistance from SSB through its investment banking division. Once again, SSB complied. It took almost two months before Mr. Ebbers and Mr. Mestre conferred. During this period, the LTV ratio on Mr. Ebbers' Citibank loan reached as high as 102 percent. In addition, there appears to have been indecision and concern at SSB and Citibank whether to continue SSB's \$10 million exposure on Mr. Ebbers' loan. In a July 2001 e-mail, Mr. Trautenberg wrote to Mr. Mestre stating:

We are again at over 98% LTV. I am praying that you have spoken to Bernie. I could use some color here as the Citibank Private Bank Credit people are extremely concerned. We just need an agreed upon course of action if SSB is still inclined to work things out and go naked on \$10mm or some other amount.

The next month, on August 26, 2001, Mr. Trautenberg e-mailed SSB's co-heads of Global Investment Banking and copied other senior SSB executives, stating:

Currently Bernie is a little over 100% Loan to Value, meaning if we sold him out today he would owe SSB monies.

Prior to the current market environment beginning this Summer, internally the firm had decided to go approximately \$10 million exposed to Bernie on his Margin Loan. That would now be a stock price of approximately \$10.75 cents. At this point, \$10.75, Bernie would owe the Firm \$10 million.

Where is SSB in its willingness to go unsecured with Bernie? Is it still \$10 million to be shared equally between Equities and IBD?

Is there a price point at which we are going to sell Bernie out? If yes, what is that price?

¹⁷⁴ Mr. Ebbers agreed to send a \$600,000 payment, which was a small fraction of the \$7.5 million requested.

Rather than sell Bernie out, do we “force” him into a variable forward trade? That is if this trade is even economically feasible.

What should be my objectives if I visit with Bernie on September 12th in Jackson?

We have given the Private Bank a guarantee that they are not subject to any loss on this loan. So we control this completely.

In a September 5, 2001 e-mail, a Citibank executive wrote to other Citibank executives, summarizing the communications between SSB and Citibank regarding Mr. Ebberts’ loan:

[T]oday I participated in a conference call with Eduardo Mestre and Bob Morse, co-heads of the I-Bank, Bob Case, David Bushnell, and David Trautenberg.

In June, Trautenberg and I made a margin call on the client, but the client advised that he believed he could have up to \$10MM of unsecured exposure and wanted to discuss the matter with Mestre. As a senior SSB person put it, there’s been “radio silence” from the I-Bank, despite quite a number of attempts by us to obtain clarity on how to handle the margin call.

Today the I-Bank acknowledged that it hadn’t contacted the client but would do so promptly. The I-Bank will likely take the position with the client that the loan dox. [sic] don’t speak to the \$10MM unsecured figure and that “the world has changed”. At the current price level, or perhaps at \$12/sh. (\$4MM loss level) add’l collateral or support will be required.

With exposure of \$41.2MM, we’re right at a 100% ltv today.

We will await Mestre’s debriefing from the client call, and Trautenberg and I will likely visit the client on 9/12.

The Citi Private Bank is still protected by SSB Holdings. Moreover, I believe if any loss is incurred, it would be absorbed by the I-Bank and Institutional Equities, as opposed to SSB Private Client.

Finally, shortly after the September 11, 2001 attacks, Messrs. Ebberts and Mestre spoke and SSB and Mr. Ebberts worked out a new agreement. Thus, in mid-September 2001, Mr. Mestre brokered an unwritten “gentleman’s agreement” between Mr. Ebberts and SSB, whereby the value of Mr. Ebberts’ stock securing the loan was permitted to reach 100 percent

LTV before any margin payment was required, which was far more lenient than the Citibank loan documents permitted. Thus, in a September 17, 2001 e-mail, Mr. Trautenberg stated:

Last week Eduardo Mestre confirmed with the client that he will always be no worse than 100% LTV. In other words, Bernie has agreed not [to] have negative equity outstanding in his account. I have confirmed with Mark Lewis, the client's advisor, this understanding with the client. Currently, Mark Lewis has agreed to wire in \$3,000,000 of principal and \$500,000 to pay the interest accrued to date. The total wire into Citibank will be for \$3.5 million.

Mr. Mestre acknowledged to the Examiner that he had never been involved in an agreement of this nature during his 26-year tenure with Salomon and SSB.

Through the rest of 2001 and until his departure from WorldCom at the end of April 2002, Mr. Ebbers was permitted to have a 100 percent LTV ratio. As Mr. Ebbers' financial fortunes continued to decline in February 2002, Citibank executives reminded SSB that it had a lien on Mr. Ebbers' Vail, Colorado townhouse, which was under contract to be sold for over \$1.12 million. On February 28, 2002, Mr. Ebbers' investment advisor (Mr. Lewis) requested that SSB release the lien and allow the sale proceeds to be paid to Mr. Ebbers, rather than to Citibank. Mr. Trautenberg took this request to Mr. Mestre, and Mr. Mestre and other SSB senior executives agreed to this release, thereby allowing Mr. Ebbers to keep the sale proceeds.

Mr. Ebbers continued his margin payments to SSB until he resigned from WorldCom on April 29, 2002. At that point, the outstanding balance on his SSB-guaranteed loan was approximately \$10 million. On the day after Mr. Ebbers' resignation, Mr. Trautenberg commented in an e-mail to his financial assistant and Citibank executives, "Delta Force. Time to get locked and loaded," referring to potentially selling out Mr. Ebbers' stock. SSB, in fact, sold out Mr. Ebbers' stock a few days later, on May 3, 2002. After this sale, SSB suffered an eventual loss of approximately \$1.7 million on the loan.

5. Concluding Observations

Like Salomon's and SSB's awards of lucrative IPO and secondary offering allocations to Mr. Ebbers, SSB's significant financial assistance to Mr. Ebbers beginning in October 2000 and continuing until May 2002 is an example of its willingness to award personal financial advantage to Mr. Ebbers in return for Mr. Ebbers' award of WorldCom corporate business to SSB.

G. WorldCom's Relationship with Mr. Grubman

1. The First Interim Report

In the First Interim Report, the Examiner noted the following allegations made by public officials and members of the media pertaining to WorldCom and its relations with securities analysts:

- Mr. Grubman combined forces with corporate executives, like Mr. Sullivan, to project inflated prospects for WorldCom's fortunes, resulting in bloated stock valuations (First Interim Report at 82); and
- Salomon/SSB secured WorldCom engagements, at least in part, because Mr. Grubman gave WorldCom's stock unduly favorable ratings (*id.* at 87).

The Examiner stated that he did not plan to address general issues relating to the independence of securities analysts, but that he intended to investigate the following:

- Whether an unhealthy relationship developed between WorldCom and the analysts who covered its stock, particularly Mr. Grubman (*id.* at 88);
- Whether Mr. Grubman may have combined with corporate insiders to exaggerate WorldCom's future financial strength (*id.* at 82). Specifically, the Examiner intended to investigate whether Mr. Grubman in good faith simply got it wrong or whether he had other motivations for enthusiastically recommending WorldCom's stock well into 2002 (*id.* at 97).

The Examiner noted that, based on his limited review to that point, the following facts had emerged:

- WorldCom’s former Management and former Directors paid close attention to the views expressed by Wall Street’s securities analysts, carefully tracked their stated expectations for the Company’s stock prices and recognized the significance of maintaining Wall Street’s confidence (id. at 83);
- Mr. Grubman’s behavior created at least the appearance of impropriety in that he seemed to have departed from the role of an independent securities analyst. On this point, the Examiner found evidence that Mr. Grubman:
 - repeatedly gave WorldCom his highest rating and enthusiastically urged investors to buy the stock, even as the Company’s share price was plummeting (id. at 89-97);
 - played an advisory role to the Company – including attending at least four WorldCom Board meetings and counseling in advance of analyst conference calls (id. at 98); and
 - may have played a role in the allocation of valuable IPO’s to Mr. Ebbers (id. at 98-99).

2. The Examiner’s Conclusions

Mr. Grubman published a prodigious quantity of reports about WorldCom over the years, virtually all of it highly favorable.¹⁷⁵ Given Mr. Grubman’s status as one of the best known and most respected Telecom analysts, one must assume that his reports had a role in investor support for WorldCom stock for many years.¹⁷⁶ The Examiner has discovered no data that suggest that Mr. Grubman did not believe what he stated about WorldCom. However, the close relationship he had with WorldCom may have clouded his objectivity, giving him significant motivation to maintain a positive outlook on WorldCom and removing him from being a truly “independent” analyst of the Company.

¹⁷⁵ The Examiner has examined Mr. Grubman’s analyst reports as compared to those of other analysts. In terms of ratings (see Appendix 7) and earnings per share estimates (see Appendix 8), the Examiner has determined that Mr. Grubman was generally consistent with other analysts. However, with respect to target price (see Appendix 9) and rhetoric, Mr. Grubman was generally more bullish than other analysts.

¹⁷⁶ It should also be noted that SSB had a significant position in WorldCom stock, both in its proprietary accounts and in accounts that it managed for clients. Thus, there was a large financial incentive to SSB to maintain the price of WorldCom stock.

H. Potential Causes of Action Relating to SSB's Spinning Activities with Mr. Ebbers

1. Introduction

As reported in Parts C-F of this Chapter, Salomon/SSB engaged in conduct intended to persuade Mr. Ebbers to direct WorldCom's investment banking business to Salomon/SSB in exchange for providing personal financial favors to Mr. Ebbers. The Examiner concludes that the evidence described previously is sufficient to support claims against: (1) Mr. Ebbers for breaches of his duties of loyalty and good faith to WorldCom; and (2) Salomon/SSB for aiding and abetting Mr. Ebbers' breaches of these fiduciary duties. The Examiner summarizes below the claims that the Company should consider and possible defenses.

2. Legal Standards

a. Fiduciary Duties of Loyalty and Good Faith

The legal standards governing liability for breaches of fiduciary duties by a corporate officer are discussed in the Corporate Governance Appendix. See Appendix A. Those standards are summarized here.¹⁷⁷

The duties of loyalty and good faith "mandate [that] the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer, or controlling shareholder and not shared by the stockholders generally."¹⁷⁸ A corporate officer breaches these fiduciary duties by using his corporate position to further his private interests at the expense of the corporation.¹⁷⁹ For example, an officer or director

¹⁷⁷ The Examiner believes that a court would apply Georgia law to these breach of fiduciary duty claims based upon the internal affairs doctrine, which generally requires application of the law of the state of incorporation (in this case Georgia) to breach of fiduciary duty claims, as discussed in more detail in Appendix A, § A. See also BBS Norwalk One, Inc. v. Raccolta, Inc., 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999).

¹⁷⁸ Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

¹⁷⁹ Id. at 361; In re Trim-Lean Meat Products, Inc., 4 B.R. 243, 246 (Bankr. D. Del. 1980).

breaches these fiduciary duties by accepting a bribe to influence his conduct.¹⁸⁰ A principal may be entitled to return of compensation paid to an agent who breaches the duties of loyalty or good faith, even if there is no showing of damages to the corporation.¹⁸¹

In addition, an officer breaches these fiduciary duties by usurping a corporate opportunity. Under Georgia law, courts apply a

two step process for determining the ultimate question of when liability for wrongful appropriation of a business opportunity should be imposed. "In order to impose liability for an official's appropriation of a business opportunity, a court must resolve two inquiries. First, a court must determine whether the appropriated opportunity was in fact a business opportunity rightfully belonging to the corporation. If a court finds that the business opportunity was not a corporate opportunity, the directors or officers who pursued the opportunity for personal benefit are immune from liability. However, if the court finds that the business opportunity was a bona fide corporate opportunity, the court must determine whether the corporate official violated a fiduciary duty in appropriating that opportunity. If, however, the opportunity is found to be a corporate one, liability should not be imposed upon the acquiring officer if the evidence establishes that his acquisition did not violate his fiduciary duties of loyalty, good faith, and fair dealing toward the corporation."¹⁸²

As one Georgia court explained:

Different jurisdictions have different tests to determine whether a business opportunity constitutes a corporate as opposed to a private

¹⁸⁰ See Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 N.Y.U.L. Rev. 1045, 1053 n.19 (1991); see also Curiale v. Capolino, 883 F. Supp. 941, 948 (S.D.N.Y. 1995) (public official breaches duty of loyalty by accepting a bribe).

¹⁸¹ See, e.g., Royal Carbo Corp. v. Flameguard, Inc., 645 N.Y.S.2d 18, 19-20 (N.Y. App. Div. 1996) (affirming forfeiture of fees paid during period of disloyalty); Riggs Inv. Mgmt. Corp. v. Columbia Partners, L.L.C., 966 F. Supp. 1250, 1266 (D.D.C. 1997) (principal entitled to return of compensation paid to former CEO during period that CEO breached duty of loyalty); Restatement (Second) of Agency § 469 (1958) ("An agent is entitled to no compensation for conduct which is disobedient or which is a breach of his duty of loyalty; if such conduct constitutes a willful and deliberate breach of his contract of service, he is not entitled to compensation even for properly performed services for which no compensation is apportioned.").

¹⁸² Southeast Consultants, Inc. v. McCrary Egg's Corp., 273 S.E.2d 112, 117 (Ga. 1980); accord In re Digex Inc. Shareholders Litig., 789 A.2d 1176, 1188 (Del. Ch. 2000) ("If there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, [and that opportunity] is . . . in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation . . .").

opportunity; however, it has been stated by one commentator that "[u]nder any test, a corporate opportunity exists when a proposed activity is reasonably incident to the corporation's present or prospective business and is one in which the corporation has the capacity to engage."¹⁸³

Furthermore, even if an "opportunity[] is not one which is essential or desirable for [the] corporation to embrace, being an opportunity in which it has no actual or expectant interest," an officer cannot use "the corporation's resources in order to acquire the business opportunity."¹⁸⁴ In that situation, corporate resources have secured a personal benefit to an officer, which benefit the corporation was entitled to due to the expenditure of its resources.¹⁸⁵

¹⁸³ Phoenix Airline Servs., Inc. v. Metro Airlines, Inc., 390 S.E.2d 219, 223 (Ga. Ct. App. 1989) (applying Delaware law), *rev'd on other grounds*, 397 S.E.2d 699 (Ga. 1990). See William Meade Fletcher, et al. *Fletcher Cyclopedia of the Law of Private Corporations* § 861.1 at 285.6 (1986 ed.).

¹⁸⁴ Phoenix Airline Servs., Inc., 390 S.E.2d at 223; see Goth v. Loft, Inc., 5 A.2d 503, 510-11 (Del. 1939) (affirming lower court's decision that company president was estopped to deny that he usurped a corporate opportunity when he utilized the company's resources to secure a personal benefit for himself); see also Equity Corp. v. Milton, 221 A.2d 494, 497 (Del. 1966) ("A corollary of the Goth rule is that when a business opportunity comes to a corporate officer, which because of the nature of the opportunity, is not one which is essential or desirable for his corporation to embrace ..., the officer is entitled to treat the business opportunity as his own ..., provided the officer has not wrongfully embarked the corporation's resources in order to acquire the business opportunity."); Fletcher Cyc. of Corps., § 861.1 at 285.87 (1986) (stating same principle).

While Georgia does not have a case directly on point, in Southeast Consultants, Inc. v. McCrary Egg's Corp., 273 S.E.2d 112 (Ga. 1980), the Georgia Supreme Court affirmed a decision holding that a corporate officer had usurped a corporate opportunity. Although the opportunity fell within the corporation's "line of business," one of the key facts that the Georgia Supreme Court relied upon was that the opportunity had been "born, incubated and nourished ... at the [corporation's] expense." *Id.* at 118. This emphasis on the improper utilization of corporate resources, as well as the citations to the seminal Delaware case of Goth v. Loft, Inc., 5 A.2d 503 (Del. 1939), suggests that the Georgia Supreme Court may be favorably disposed toward the legal principle that an officer usurps a corporate opportunity through the improper utilization of corporate resources even where the opportunity does not fall within the corporation's line of business.

¹⁸⁵ See Phoenix Airline Servs., Inc., 390 S.E.2d at 223 ("where the officer has utilized the resources of the corporation to acquire the opportunity, he is estopped from asserting that the corporation had no interest in it"); cf. Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 815 (Miss. 1956) ("If officers or directors make a personal profit through the use of corporate assets, they must account for it to the stockholders, and it is immaterial that their dealings may not have caused a loss or been harmful to the corporation; the test of liability is whether they unjustly gained enrichment.") (quoting 3 Fletcher Cyclopedia of Corps., § 884 (1986 ed.)).

b. Aiding and Abetting the Breach of a Fiduciary Duty¹⁸⁶

To establish a claim for aiding and abetting the breach of a fiduciary duty, the plaintiff must prove the breach of a fiduciary duty by another and that the defendant knowingly induced or participated in the breach.¹⁸⁷ It is not always essential that damages be proven, such as in an action to recover fees charged for a wrongdoer's services to prevent the wrongdoer from profiting.¹⁸⁸ A party who aids and abets a corporate officer's breaches of fiduciary duties is jointly and severally liable with the officer.¹⁸⁹ In addition, the party who

¹⁸⁶ A split of authority exists on the appropriate choice-of-law rules applicable to a claim of aiding and abetting a breach of fiduciary duties. See Appendix A, § E.2. One line of cases follows the internal affairs doctrine and applies the law of the state of incorporation. See Lou v. Belzberg, 728 F. Supp. 1010, 1023 (S.D.N.Y. 1990). Another line of cases follows the most significant contacts test and applies the law of the jurisdiction having the most significant factual contacts with the aiding and abetting claim. See Solow v. Stone, 994 F. Supp. 173, 177 (S.D.N.Y. 1998); Granite Partners L.P. v. Bear Stearns & Co., 17 F. Supp. 2d 275, 306 & n.16 (S.D.N.Y. 1998). This second line of cases appears to be the more prevalent line of authority.

In this case, both Mississippi and New York have significant contacts with the spinning claims. Although not free from doubt, the Examiner believes that the most significant contacts analysis is most likely to be applied, meaning that New York or Mississippi law is most likely to apply to any aiding and abetting claims.

¹⁸⁷ See Wight v. BankAmerica Corp., 219 F.3d 79, 91 (2d Cir. 2000); Whitney v. Citibank, N.A., 782 F.2d 1106, 1115 (2d Cir. 1986); In re Trump Hotels Shareholder Derivative Litig., No. 96 Civ. 7820 DAB, 2000 WL 1371317 (S.D.N.Y. Sept. 21, 2000); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ct. Ch. 1972). See also Appendix A, § E.

¹⁸⁸ See, e.g., Continental Mgmt., Inc. v. United States, 527 F.2d 613, 616 (Ct. Cl. 1975); City of Findlay v. Pertz, 66 F. 427 (6th Cir. 1896); Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 770-71 (Miss. 1956). There are also cases holding that damages are an element of a claim for aiding and abetting a breach of a fiduciary duty. See, e.g., Whitney v. Citibank, N.A., 782 F.2d 1106, 1115 (2d Cir. 1986); Gilbert v. El Paso Co., 490 A.2d 1050, 1057 (Del. Ct. Ch. 1984). Thus, the choice of law decision on an aiding and abetting claim could be critical to ultimate liability issues.

¹⁸⁹ See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 172-73 (Del. 2002); Ga. Code Ann. § 51-12-30. See also Time Warner Ent. Co. v. Six Flags Over Georgia LLC, 537 S.E.2d 397, 408 (Ga. Ct. App. 2000), vacated on other grounds, 534 U.S. 801 (2001), opinion reinstated in part, 563 S.E.2d 178 (Ga. Ct. App. 2002); Jackson v. Smith, 254 U.S. 586, 589 (1921) ("Since he did pursue it and profits resulted the law made him accountable to the trust estate for all the profits obtained by him and those who were associated with him in the matter, although the estate may not have been injured thereby. And others who knowingly join a fiduciary in such an enterprise likewise become jointly and severally liable with him for such profits. Wilson and Smith are therefore jointly and severally liable for all profits resulting from the purchase; the former although he had no relation to the estate; the latter, without regard to the fact that he was also counsel for the receiver.") (citations omitted); Irving Trust Co. v. Deutsch, 73 F.2d 121, 125 (2d Cir. 1934); United States v. Kenealy, 646 F.2d 699, 705-06 (1st Cir. 1981); In re Albion Disposal, Inc., 152 B.R. 794, 824-25 (W.D.N.Y. 1993); Miller v. Steinbach, 268 F. Supp. 255, 281 (S.D.N.Y. 1967).

aids and abets any breaches may be required to disgorge any fees paid to it by the corporation.¹⁹⁰

3. Potential Claims Against Mr. Ebbers and SSB

a. Mr. Ebbers Breached His Fiduciary Duties of Loyalty and Good Faith to WorldCom and Possibly Usurped a WorldCom Corporate Opportunity

(i) Breach of Duties of Loyalty and Good Faith

Prior to June 1996, Mr. Ebbers was not a Salomon client. Similarly, Salomon, prior to August 1996, had not been engaged to perform investment banking work for WorldCom. Beginning in June 1996, however, Salomon/SSB provided lucrative IPO and secondary offering allocations to Mr. Ebbers, from which Mr. Ebbers earned over \$12 million in profits. SSB also provided Mr. Ebbers in 2000-2002 with other significant financial assistance. During this period, Mr. Ebbers, in turn, directed over \$100 million in investment banking business to Salomon/SSB.

The Examiner believes that the most reasonable inference that a finder of fact could draw from this evidence is that Salomon/SSB provided these allocations and other favorable financial assistance to Mr. Ebbers to secure and keep WorldCom's investment banking business. In effect, Salomon/SSB gave Mr. Ebbers millions of dollars of personal financial favors, and, in return, he directed over \$100 million of WorldCom's investment banking business to SSB. Mr. Ebbers had not utilized Salomon/SSB's investment banking services until he began receiving the lucrative IPO allocations and then shortly after receipt of these favors began steering virtually all of WorldCom's investment banking business to

¹⁹⁰ See Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 828-29 (Miss. 1956); see also Cont'l Mgmt., Inc. v. United States, 527 F.2d 613, 616 (Ct. Cl. 1975) ("courts have declared that victimized principals may obtain non-statutory remedies against outsiders who have knowingly participated in or induced an agent's breach of duty"); City of Findlay v. Pertz, 66 F. 427 (6th Cir. 1896) (city voided contract with third party that was obtained by bribing city official).

Salomon/SSB. Based upon this timing and the nature and amount of the favors from SSB, the Examiner believes that strong circumstantial evidence exists of a quid pro quo between Mr. Ebbers and Salomon/SSB in which Mr. Ebbers received these inducements from Salomon/SSB in return for directing WorldCom's investment banking business to Salomon/SSB. Because the evidence indicates that Mr. Ebbers based the decision on where to steer investment banking business on his own personal financial interests rather than the best interests of WorldCom, the Examiner concludes that the Company could pursue claims that Mr. Ebbers breached his duties of loyalty and good faith.¹⁹¹

(ii) Possible Usurpation of a Corporate Opportunity

There also is sufficient evidence for a fact finder to conclude that Mr. Ebbers usurped a WorldCom corporate opportunity by accepting these lucrative financial favors in exchange for providing SSB with WorldCom's investment banking business. The Examiner recognizes that the purchase of IPO and secondary offering shares and the acceptance of loan assistance were not activities that fell within WorldCom's regular line of business. However, Mr. Ebbers was able to realize substantial profit and other financial gain, using the WorldCom relationship with Salomon/SSB to acquire these personal financial favors. He did so by directing WorldCom's investment banking business to SSB in return for the SSB financial inducements. Consequently, a fact finder could find that these benefits belonged to WorldCom and that Mr. Ebbers usurped a corporate opportunity by utilizing WorldCom's resources to further his personal business interests. This would constitute a breach of the duties of loyalty and good faith.

¹⁹¹ The Examiner further observes that Mr. Ebbers may have breached his fiduciary duties by seeking and accepting financial favors from a WorldCom vendor of corporate services even if no quid pro quo were established.

The Examiner feels that a corporate opportunity claim, while sustainable on the facts and Georgia precedents, is not as strong as the other claims against Mr. Ebbers related to the Salomon/SSB financial favors. However, since the same facts which support the other claims would similarly support this claim, the Examiner recommends that this claim be considered by the Company if other claims are pursued against Mr. Ebbers.

b. Salomon/SSB Aided and Abetted Mr. Ebbers' Breaches of His Fiduciary Duties of Loyalty and Good Faith

As discussed above, the Examiner concludes that Mr. Ebbers breached his fiduciary duties of loyalty and good faith to WorldCom. Mr. Ebbers' breach is sufficient to establish the first element of an aiding and abetting claim against SSB.

Substantial evidence indicates that Salomon/SSB knowingly induced and participated in Mr. Ebbers' breaches of his duties of loyalty and good faith through the practice of spinning. Spinning enabled Salomon/SSB to provide substantial financial benefits to Mr. Ebbers in the form of lucrative IPO allocations and other banking favors in exchange for WorldCom's substantial investment banking business.

The Examiner concludes that such facts as are summarized in this Chapter are sufficient to support a claim that Salomon/SSB knowingly induced and participated in Mr. Ebbers' breach of his fiduciary duties to WorldCom and, consequently, that Salomon/SSB aided and abetted Mr. Ebbers' misconduct.

4. WorldCom's Possible Damages

The Examiner sought to determine whether WorldCom suffered damages as a result of Mr. Ebbers' fiduciary duty breaches. For example, the Examiner sought to determine whether WorldCom could have negotiated for lower investment banking fees if Mr. Ebbers had declined the Salomon/SSB financial favors. The Examiner found no persuasive evidence

to support that proposition. Indeed, some evidence suggests that WorldCom succeeded in negotiating for lower investment banking fees despite Mr. Ebberts' breaches. For example, SSB initially sought a \$7.5 million fee for its services as WorldCom's financial advisor on the Tracker stocks but eventually settled for a \$3.5 million fee. Similarly, the Examiner identified no evidence that suggests that Salomon/SSB failed to perform services for WorldCom in a competent manner.

Notwithstanding the lack of evidence of damages, a principal typically can recover compensation and fees paid to the disloyal agent and profits made by that agent. In addition, one who aids and abets the breach of a fiduciary duty is jointly and severally liable for the fees and profits. See Appendix A, § J. Accordingly, the Examiner believes that WorldCom could seek to recover the compensation paid to Mr. Ebberts during his period of disloyalty, as well as the profits he made from the IPO allocations. The Examiner also believes that WorldCom could seek to recover fees that WorldCom paid to Salomon/SSB for the investment banking services.

a. Mr. Ebberts

Under well-established legal principles, an agent who breaches a fiduciary duty to his principal forfeits compensation during the period of the breach.¹⁹² The Examiner believes that the Company could contend that Mr. Ebberts began breaching his fiduciary duties to WorldCom in connection with the MFS transaction in 1996, shortly after he first received the McLeod IPO allocation from Salomon. Mr. Ebberts last received an IPO allocation from SSB in August 2000 but he received other SSB financial favors until May 2002. WorldCom

¹⁹² See, e.g., E.H. Crump Co. v. Millar, 391 S.E.2d 775, 776 (Ga. Ct. App. 1990); O.C.G.A. § 10-6-31 ("an agent who shall have discharged his duty shall be entitled to his commission and all necessary expenses incurred about the business of his principal. If he shall have violated his engagement, he shall be entitled to no commission."); Short v. Columbus Rubber & Gasket Co., Inc., 535 So. 2d 61, 68 (Miss. 1988); accord Restatement (Second) of Agency § 469.

continued to award SSB investment banking business well into 2002. Accordingly, the Examiner concludes the Company could contend that Mr. Ebbers breached his fiduciary duties of loyalty and good faith over the 1996-2002 period and recommends that WorldCom consider claims against him seeking the forfeiture of all compensation that he earned during that period, as well as any financial benefits he received from Salomon/SSB in the same period.

In addition, a fiduciary who usurps a corporate opportunity is also required to forfeit profits from his usurpation of the corporate opportunity. The Examiner recommends that WorldCom consider claims requiring Mr. Ebbers to pay WorldCom the more than \$12 million in gross profits that he earned from the favorable IPO allocations that SSB provided to him. See Appendix A, § J.

b. SSB

One who aids and abets the breach of a fiduciary duty generally is liable jointly and severally with the party who breached that duty.¹⁹³ Thus, SSB, along with Mr. Ebbers, may be liable for the same damages and other remedies as Mr. Ebbers.

In addition, the Company could seek to require SSB to forfeit all or a portion of the approximately \$106 million in investment banking fees paid to it. Principles of equity may prohibit SSB from profiting as a result of its course of misconduct.¹⁹⁴ Thus, the Examiner

¹⁹³ See Appendix A, § J.5; see also O.C.G.A. § 51-12-30; Jackson v. Smith, 254 U.S. 586, 589 (1921); Irving Trust Co. v. Deutsch, 73 F.2d 121, 125 (2d Cir. 1934); United States v. Kenealy, 646 F.2d 699, 705-06 (1st Cir. 1981); Miller v. Steinbach, 268 F. Supp. 255, 281 (S.D.N.Y. 1967); cf. In re Albion Disposal, Inc., 152 B.R. 794, 824-25 (Bankr. W.D.N.Y. 1993) (that others who participate in another's breach of fiduciary duty are jointly and severally liable is a "theme [that] recurs throughout the cases of high authority").

¹⁹⁴ See Crites, Inc. v. Prudential Ins. Co., 322 U.S. 408, 414 (1944) ("Any profits that might have resulted from a breach of these high standards, including the profits of others who knowingly joined him in pursuing an illegal course of action, would have to be disgorged and applied to the estate."); Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 819-24 (Miss. 1956) (third party who assisted corporate officer in breaching fiduciary duty "comes clearly within the universally accepted rule that one who participates with a fiduciary in a breach of his duties, with knowledge that he is violating his obligations, is liable for the profits received,

recommends that WorldCom consider disgorgement claims against SSB seeking some or all of the \$106 million that SSB earned from its investment banking business with WorldCom. See Appendix A § J.5.¹⁹⁵

5. Defenses

a. Fact-Based Defense

The Examiner has set forth in earlier portions of this Chapter his conclusion that the financial inducements provided by Salomon/SSB to Mr. Ebbers were, at least in part, for the purpose of obtaining investment banking business and that they were successful. The Examiner must acknowledge, however, that this conclusion is based on circumstantial evidence. There are no “smoking guns” and present and former Salomon/SSB personnel have denied that they engaged in spinning.

The Examiner believes that a fact finder ultimately is likely to reach conclusions consistent with those reached by the Examiner in this Third and Final Report. However, the Examiner must observe that such an outcome is not free from doubt.

b. Mr. Ebbers

Mr. Ebbers may assert as a defense the release that he received from WorldCom in the April 2002 Separation Agreement, which purports to release Mr. Ebbers from liability to

thereby from the corporation.”); Continental Mgmt., Inc. v. United States, 527 F.2d 613, 616 (Ct. Cl. 1975) (“courts have declared that victimized principals may obtain non-statutory remedies against outsiders who have knowingly participated in or induced an agent’s breach of duty”); City of Findlay v. Pertz, 66 F. 427 (6th Cir. 1896) (city voided contract with third party that was obtained by bribing city official). While the Examiner is not aware of any reported decisions addressing whether a third party who provides financial favors to a corporate officer for the purpose of obtaining corporate business must forfeit fees earned as a result of this conduct, the Examiner believes that principles of equity support such a result.

¹⁹⁵ Cases such as Crites and Knox Glass support the disgorgement and return to WorldCom of all of Salomon/SSB’s fees and profits from its investment banking activities. Nevertheless, given the equitable nature of this remedy, the Examiner recognizes the potential appropriateness of a lesser remedy that would involve the return to WorldCom of some but not necessarily all of the Salomon/SSB fees, particularly because the Examiner has discovered no evidence to suggest that Salomon/SSB failed to perform the investment banking services in accord with applicable standards of professionalism or that Salomon/SSB charged unreasonable fees for these services.

WorldCom outside of his loan obligations. The release, however, contains several exceptions pursuant to which Mr. Ebbers retains liability, including for “fraud, willful misconduct, gross negligence, or criminal acts.” These exceptions may apply and, at a minimum, a genuine issue of material fact appears to exist on this issue. Furthermore, in light of Mr. Ebbers’ apparent breach of the Separation Agreement by failing to pay the \$25 million due on April 29, 2003, good cause may exist to set aside the release altogether.¹⁹⁶ Indeed, on April 30, 2003, the Company advised Mr. Ebbers that he was in default under the \$408 million Promissory Note executed in connection with the Separation Agreement and demanded full payment thereof. Further, the Company has requested the Bankruptcy Court to reject the Separation Agreement. See Section VIII.B.1.c, infra.

c. SSB

(i) Standing and In Pari Delicto

As discussed in Appendix B addressing standing and in pari delicto, SSB may cite agency principles as a possible defense to a claim for aiding and abetting a breach of a fiduciary duty under the doctrine of imputation.¹⁹⁷ Where an outside party aids and abets the breach of a fiduciary duty by a corporate agent, the imputation of the agent’s misconduct to the corporation may, under certain circumstances, preclude the corporation from successfully

¹⁹⁶ Neither the exculpatory clause nor the indemnification provisions in WorldCom’s Articles of Incorporation provide a defense to Mr. Ebbers against these spinning claims. Both provisions specifically exclude the receipt of improper benefits, such as those that Mr. Ebbers received from Salomon/SSB, from their protections. Further, these provisions explicitly protect WorldCom Directors, but not WorldCom officers, and Mr. Ebbers made the investment banking decisions in his capacity as WorldCom’s CEO, not in his capacity as a Director. See Appendix A, §§ G & H.

¹⁹⁷ If Mississippi law applies to these claims, Salomon/SSB may not be able to avail itself of imputation defenses, such as standing and in pari delicto, because the Mississippi courts have not applied these defenses against corporations seeking to recover damages from third-party wrongdoers who acted in concert with corporate principals and the Mississippi Supreme Court has implied that it may not impute the misconduct of a fiduciary to the corporation. See Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799 (Miss. 1956). See also Appendix B, § D.

bringing an aiding and abetting claim.¹⁹⁸ In the bankruptcy context, the imputation of a corporate agent's misconduct to a corporation may preclude aiding and abetting claims under two separate legal theories: (1) lack of standing (under the theory that the claim actually belongs to the creditors of the bankrupt corporation rather than to the corporation that participated in the wrongdoing); or, alternatively, (2) the affirmative defense of in pari delicto (under the theory that the corporation, through its agent, is equally culpable for the wrongdoing).¹⁹⁹ See Appendix B, § A.

Whether treated as a standing issue or as an affirmative defense, there are two recognized exceptions to the imputation doctrine: (1) the “adverse interest” exception, applicable where corporate agents acted adversely to the interests of the corporation, in such a manner that they “have totally abandoned the principal’s interest;”²⁰⁰ and (2) the “innocent decision maker” exception, applicable where there existed within the corporation an officer or director who could have prevented the wrongdoing had he or she been aware of such misconduct.²⁰¹

¹⁹⁸ Wight, 219 F.3d at 86; In re Bennett Funding Group, Inc., 336 F.3d 94, 99-100 (2d Cir. 2003).

¹⁹⁹ See Bennett Funding Group, 336 F.3d at 99-100 (bankruptcy trustee, who stands in the shoes of debtor corporation, has no standing to pursue claims against third parties who joined with third party in defrauding creditors); Official Comm. of the Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand LLP, 322 F.3d 147, 156 (2d Cir. 2003) (concluding that the in pari delicto defense prevented a corporation from pursuing claims against certain third parties).

²⁰⁰ In re Bennett Funding Group, Inc., 336 F.3d 94, 100 (2d Cir. 2003) (the act of the agent will not be charged to the corporation if the agent is actually “committing a fraud for his own benefit”); Wight, 219 F.3d at 87 (allegations that bank was adversely dominated by corrupt management who acted in their own interest and not in the interest of the bank were sufficient at the pleading stage to trigger the adverse interest exception); In re CBI Holding Co., 247 B.R. 341, 365 (Bankr. S.D.N.Y. 2000).

²⁰¹ Bennett Funding Group, 336 F.3d at 101 (exception applies where there existed an innocent decision maker who had the power to correct or stop the fraud had he known of it); Securities Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999) (exception did not apply where complaint failed to allege existence of an innocent decision maker who could have stopped the unlawful conduct). Stated alternatively, this exception requires that “all relevant decision makers” must be involved in the fraud for the imputation to occur. See Bennett Funding Group, 336 F.3d at 101.

WorldCom may seek to argue against the imputation defense based on the adverse interest exception. WorldCom can argue that Mr. Ebbers acted solely in his own interest and not in the interest of WorldCom, when he accepted the financial favors from Salomon/SSB while providing Salomon/SSB with WorldCom's investment banking business. WorldCom also can argue that this conduct disadvantaged WorldCom because it usurped business opportunities provided by Salomon/SSB and, at a minimum, because Mr. Ebbers utilized WorldCom's resources to pay Salomon/SSB's investment banking fees in return for their providing him the IPO allocations. In response, a court may find the IPO allocations and other financial favors provided to Mr. Ebbers did not constitute a misappropriation of WorldCom corporate opportunities or that WorldCom's payment of investment banking fees did not disadvantage WorldCom because the Company received bona fide investment banking services from Salomon/SSB. In that case, WorldCom would not have been disadvantaged by Mr. Ebbers' conduct, thus supporting SSB's defense. Accordingly, the Examiner believes that it is a close question whether WorldCom can establish the adverse interest exception, although there may be sufficient issues of fact to preclude dismissal of the claim as a matter of law.

The Examiner believes that SSB would have a more difficult time establishing the imputation defense due to the innocent decision maker exception. The Examiner has uncovered no evidence that Mr. Ebbers informed the WorldCom Board of the Salomon/SSB financial inducements. While the Examiner has criticized the WorldCom Board in this and his earlier Reports, the Directors, to their credit, acted aggressively to uncover the accounting fraud upon being notified of it by WorldCom's Internal Auditing Department in June 2002. Further, even before the discovery of the fraud, the Directors forced Mr. Ebbers to resign as

WorldCom's CEO due to the Company's declining financial situation and Mr. Ebbers' conduct regarding the WorldCom loans and guaranty. SSB's spinning practices with Mr. Ebbers possibly amounted to corporate bribery, and the Examiner believes it is quite likely that the WorldCom Board would have taken measures against Mr. Ebbers' conduct had it possessed a clear picture of the SSB inducements and their amount.²⁰²

Accordingly, the "innocent decision maker" exception may apply against an imputation defense. In any event, genuine issues of material fact appear to exist regarding the applicability of this exception, which would likely preclude the dismissal of the SSB claims as a matter of law based on an imputation defense.

(ii) No Damages to WorldCom from SSB's Investment Banking Services

SSB might also argue that it performed its investment banking services in accord with reasonable business practices and that WorldCom has suffered no damages in connection with its spinning activities. SSB will likely point out that the Examiner has not determined that any of the transactions in which SSB provided investment banking services were unreasonable, criticized any of SSB's fees and services as excessive, or alleged that SSB's work fell below industry standards.²⁰³

²⁰² The Examiner recognizes that certain WorldCom Directors received IPO allocations during the relevant period, making it a closer question whether they would have questioned the enormous allocations made to Mr. Ebbers at the same time that he was awarding investment banking business to Salomon/SSB.

²⁰³ SSB may prevail on this defense if a court applies New York law because New York appears to require damages as an essential element of an aiding and abetting claim. See King v. George Schonberg & Co., 650 N.Y.S.2d 107, 108 (N.Y.A.D. 1996); Shearson Lehman Bros., Inc. v. Bagley, 614 N.Y.S.2d 5, 6 (N.Y.A.D. 1994); S&K Sales Co. v. Nike, Inc., 816 F.2d 843, 847-48 (2d Cir. 1987)(applying New York law). Still, this conclusion is not free from doubt since none of the cases applying New York law addresses the circumstances in this case where a third-party wrongdoer benefits from a corporate fiduciary's breach of duty, but that breach of duty does not actually damage the company. Under these unique circumstances, a court applying New York law may still require disgorgement on equitable grounds to prevent a wrongdoer like SSB from profiting from its misconduct. See, e.g., Jackson v. Smith, 254 U.S. 586, 589 (1921) ("Since he did pursue it and profits resulted the law made him accountable to the trust estate for all the profits obtained by him and those who were associated with him in the matter, although the estate may not have been injured thereby. And others who knowingly join a fiduciary in such an enterprise likewise become jointly and severally liable for all profits

Nevertheless, these factors do not provide a complete defense to these equitable claims. Under applicable law, the remedies for aiding and abetting a breach of fiduciary duty in the context of spinning may include, among other things, the return of fees paid for the services and the value of any wrongful inducements paid in the spinning. As noted above, SSB would also be jointly and severally liable for any monies owed to WorldCom by Mr. Ebbers as the result of the various breaches of his fiduciary duties.

resulting from the purchase; the former although he had no relation to the estate; the latter, without regard to the fact that he was also counsel for the receiver.”) (citations omitted); Crites, Inc. v. Prudential Ins. Co., 322 U.S. 408, 414 (1944) (“Any profits that might have resulted from a breach of these high standards, including the profits of others who knowingly joined him in pursuing an illegal course of action, would have to be disgorged and applied to the estate.”); Curtis v. George J. Meyer Malt & Grain Corp., 6 F.R.D. 444, 448 (W.D.N.Y. 1947) (citing Crites for this proposition).

VI. MR. EBBERS' LOANS AND GUARANTY

A. Introduction and Summary

1. First and Second Interim Reports

The Examiner has previously reported at length about WorldCom's massive loans and guaranty to and on behalf of Mr. Ebbers and the lack of any meaningful due diligence by the WorldCom Board or its Compensation Committee pertaining to those transactions. First Interim Report at 71-81; Second Interim Report at 109-39. The sequence of WorldCom's financial assistance to Mr. Ebbers can be summarized briefly:

September 6, 2000	\$50 million loan approved by the Compensation Committee.
October 27, 2000	\$25 million loan approved by the Compensation Committee. \$75 million guaranty to Bank of America entered into by the Compensation Committee on Mr. Ebbers' behalf. Total loans and guaranty were \$150 million.
November 13, 2000	The Compensation Committee extends guaranty to Bank of America to \$100 million. Total loans and guaranty were \$175 million.
November 16, 2000	WorldCom's Board ratifies the prior loans and guaranty.
December 27, 2000	\$25 million loan approved by the Compensation Committee. Total loans and guaranty were \$200 million.
January 30, 2001	The Compensation Committee extends guaranty to Bank of America to \$150 million, plus additional payments related to margin calls on the WorldCom stock securing Mr. Ebbers' debt. Total loans and guaranty were \$250 million.
March 1, 2001	WorldCom Board ratifies the prior loans and guaranty.

January 25, 2002	\$65 million loan approved by the Compensation Committee. The Compensation Committee also agrees to modification and reaffirmation of its guaranty to Bank of America. Total loans and guaranty were \$315 million.
April 29, 2002	WorldCom converts Mr. Ebberts' loans from demand notes to a five-year \$408 million term loan, at an initial interest rate of 2.3 percent. ²⁰⁴

See Second Interim Report, Appendix 8.

In his First and Second Interim Reports, the Examiner identified several troublesome issues with the loans and guaranty. WorldCom made the loans at interest rates far below a normal commercial rate.²⁰⁵ Further, the Examiner in the Second Interim Report observed:

- The Compensation Committee and the Board of Directors failed to conduct meaningful due diligence prior to issuing or ratifying the loans and providing or extending the guaranty.
- The Compensation Committee and the Board of Directors failed to document properly the loans and guaranty before advancing funds to Mr. Ebberts.
- The Compensation Committee and the Board of Directors failed to monitor Mr. Ebberts' financial situation and his ability to repay the loans and the guaranty, even though the value of his WorldCom stock declined steadily throughout the period.

²⁰⁴ The \$408 million reflected \$198.7 million paid by WorldCom to Bank of America pursuant to the guaranty, \$36.5 million to support financing to a third party on Mr. Ebberts' behalf, \$165 million lent to Mr. Ebberts, and accrued interest.

²⁰⁵ The interest rate applicable to the \$408.2 million consolidated promissory note Mr. Ebberts signed in April 2002 was equal to the "Eurodollar rate applicable to each one-month Interest Period commencing on the date hereof [April 29, 2002] plus the Applicable Margin during the corresponding period applicable to Eurodollar Rate Borrowings by the Lender . . ." At that time, the applicable interest rate was 2.32 percent. Mr. Ebberts' previous promissory notes, as well as the guaranty, reflected a similar interest rate based on WorldCom's prior Eurodollar credit facility. Over the course of the time during which WorldCom extended loans and its guaranty on behalf of Mr. Ebberts, lenders charged him and his related entities an interest rate that was as much as two percent greater than that charged by WorldCom. While the Examiner has not performed a detailed analysis of what interest rates would have been available to a similarly situated borrower, the Examiner has confirmed that, as of April 29, 2002, the Prime Rate was 4.75 percent and the interest rate paid on a 5-year Treasury note was 4.56 percent. Thus, WorldCom's loans and guaranty saved Mr. Ebberts millions of dollars in interest payments, assuming he could have obtained the loans from commercial lenders.

- The Compensation Committee and the Board of Directors failed to investigate whether creditors possessed prior perfected security interests in Mr. Ebbers' assets before approving and/or ratifying the loans and guaranty.
- The Compensation Committee and the Board of Directors failed to establish procedures to ensure that Mr. Ebbers used the loan proceeds to satisfy his margin calls until the Fall of 2001, by which time Mr. Ebbers had used significant amounts of the loan proceeds to prop up his personal investments.²⁰⁶
- The Compensation Committee and the Board of Directors failed to take meaningful steps to perfect any security interests in assets held by Mr. Ebbers until February 2002, after his debt to WorldCom had reached approximately \$400 million.

Second Interim Report at 114-15.

2. Summary of Conclusions

The Examiner concludes that Mr. Ebbers, two members of the WorldCom Compensation Committee (Messrs. Bobbitt and Kellett), and the remaining WorldCom Directors violated certain of their fiduciary duties in connection with the loans and guaranty to Mr. Ebbers. The Examiner also concludes that Mr. Ebbers breached the separation agreement that he entered with WorldCom on April 29, 2002 (the "Separation Agreement").

a. Liability of Mr. Ebbers

The Examiner concludes that Mr. Ebbers did not breach any fiduciary duties in seeking loans from WorldCom in September and October 2000 in an effort to avoid selling WorldCom stock to meet margin calls. The Examiner agrees as a general proposition that the market potentially could have reacted negatively to large sales of WorldCom stock by

²⁰⁶ Indeed, by the Fall of 2001, Mr. Ebbers had utilized more than \$27 million of the loan proceeds to prop up his personal investments instead of meeting margin calls or paying off the rest of his bank debt. See Second Interim Report at 115, 135.

WorldCom's CEO, causing a further decline in WorldCom's stock price and thus injuring WorldCom shareholders.²⁰⁷

However, the Examiner faults Mr. Ebbers in three respects, all of which support the conclusion that Mr. Ebbers breached his duty of loyalty by placing his personal interests ahead of WorldCom's interests. First, Mr. Ebbers should not have accepted loans at a non-commercial interest rate. This low interest rate represented a direct subsidy to Mr. Ebbers. WorldCom could have utilized this money for other corporate opportunities, such as paying off higher interest debt of the Company -- a conclusion also reached by the Corporate Monitor -- or investing in infrastructure or more secure financial instruments bearing higher rates of interest.

Second, by early November 2000, Mr. Ebbers knew or should have known that the precariousness of his financial status rendered it unlikely that he could repay the loans and guaranty from the Company. Mr. Ebbers breached his duty of loyalty by requesting additional loans and guaranty extensions after this time and by failing to disclose his true financial status to the Compensation Committee and the Board. He compounded this breach in early 2002 by providing the Compensation Committee with documents purporting to show assets sufficient to secure the loans made to him. Those documents made inaccurate and misleading misrepresentations about Mr. Ebbers' net worth, purporting to show that he possessed sufficient assets to provide full collateral for his WorldCom obligations when, in fact, he lacked sufficient unencumbered assets to do so.

²⁰⁷ One could argue that Mr. Ebbers breached his duty of loyalty to WorldCom by investing heavily in outside business pursuits secured by his WorldCom stock. In doing so, he arguably put his personal business interests before those of the Company, placing WorldCom shareholders at risk if he needed to sell large blocks of stock to repay the loans.

Third, Mr. Ebbers breached the terms of the April 29, 2002 Separation Agreement. This Agreement converted Mr. Ebbers' loans from demand loans to a five-year term loan, documented by a \$408 million promissory note. Pursuant to the Agreement, Mr. Ebbers should have made the first payment of \$25 million under the promissory note on April 29, 2003.²⁰⁸ Mr. Ebbers failed to make the first required payment, placing him in breach of the Separation Agreement and making all remaining payments immediately due and payable pursuant to the Agreement.²⁰⁹ The Company notified Mr. Ebbers on April 30, 2003 that he was in default and that the full loan amounts were due to be paid immediately.

b. Liability Messrs. Bobbitt and Kellett

The Examiner concludes that two members of the Compensation Committee, Stiles Kellett and Max Bobbitt, breached their fiduciary duties of care and loyalty in the manner in which they approved and administered the loans made to Mr. Ebbers.²¹⁰ The failures summarized in Section A.1 of this Chapter and in Section VI of the Second Interim Report describe those multiple lapses, all of which involved the conduct of Messrs. Kellett and Bobbitt. In sum, Messrs. Bobbitt and Kellett breached their fiduciary duties of care and loyalty by virtue of: (1) their approval of massive financial favors for Mr. Ebbers without careful consideration whether those favors were in WorldCom's best interest; (2) their lack of

²⁰⁸ The remaining payments under the note were due on April 29, 2004 (\$25 million), April 29, 2005 (\$75 million), April 29, 2006 (\$100 million) and April 29, 2007 (all remaining principal).

²⁰⁹ Mr. Ebbers appears to have breached the Separation Agreement even earlier, in October 2002, in failing to remit certain collateral to WorldCom.

²¹⁰ During the relevant period, Gordon Macklin served as a member of the Compensation Committee, but he played a very limited role in matters pertaining to Mr. Ebbers' loans. Accordingly, the Examiner does not conclude that he breached any duties in his Compensation Committee role, although, as discussed below, the Examiner concludes otherwise pertaining to Mr. Macklin's role on the WorldCom Board with respect to the loans. Laurence Tucker also served as a member of the Compensation Committee until October 2000, at which time he resigned as a Director. After his resignation, he remained an Advisory Director, attending Board and Compensation Committee meetings. Mr. Tucker, like Mr. Macklin, played a very small role in Mr. Ebbers' loans. Further, the Examiner concludes that, as an Advisory Director, Mr. Tucker probably owed no fiduciary duties to WorldCom. Accordingly, the Examiner recommends no claims against Mr. Tucker relating to the loans.

due diligence in overseeing the loan approval process, investigating Mr. Ebbers' financial situation, and obtaining sufficient collateral to protect the Company in the event of default; and (3) their failure to inform the remaining Directors about what they did know regarding Mr. Ebbers' troubled financial situation.²¹¹ They further breached their duties of care and loyalty by providing Mr. Ebbers with a highly-favorable interest rate, at WorldCom's expense.²¹²

(i) The Initial Loan Decisions

The Examiner concludes that the approval of the loans and guaranty transactions by Messrs. Bobbitt and Kellett in September and October 2000 represented reasonable business decisions, with the exception of the below-market interest rate that they granted to Mr. Ebbers. The Examiner bases this conclusion on a number of factors. First, Mr. Ebbers' claim that he would repay the initial loans and security in the short-term was not unreasonable. At the time of these transactions, Mr. Ebbers' assets appeared sufficient to cover his debt, although barely. Second, a letter from Bank of America, dated November 9, 2000, which disclosed Mr. Ebbers' precarious financial situation, had not yet been sent to Messrs. Kellett and Bobbitt. Third, Messrs. Kellett and Bobbitt had yet to attend meetings with a Bank of America senior vice president in early November 2000, at which time she detailed and underscored the serious problems with Mr. Ebbers' finances. Fourth, because

²¹¹ See Pereira v. Cogan, 294 B.R. 449, 528-30 (S.D.N.Y. 2003) (holding that board members breached fiduciary duties of loyalty and care by ratifying excessive compensation paid to the CEO and recognizing that "Cogan's self-interest, the close relationships of the Board members to Cogan, and the complete lack of any exercise of diligence in the performance of the Board's duties further suggest that a breach of the duty of loyalty exists".) See also Appendix A, §§ C.2 and D.

²¹² These highly favorable loan transactions to Mr. Ebbers also call into question Mr. Kellett's ability to have made impartial decisions on the loans, given his close personal and financial ties to Mr. Ebbers. In particular, Mr. Ebbers invested several million dollars in a company called Virtual Bank in which Mr. Kellett served on the Board and had a significant financial interest. Mr. Ebbers also provided Mr. Kellett with a highly favorable airplane lease shortly before Mr. Ebbers began seeking loans from WorldCom.

Mr. Ebberts' forward sale of WorldCom stock in late September 2000 appeared to trigger a substantial drop in the price of WorldCom stock, it appears that the Compensation Committee reasonably feared that additional sales of WorldCom stock by Mr. Ebberts would further erode the price of the Company's stock. Accordingly, the Examiner does not believe that the approval of these initial loans and guaranty provides a basis for any claims, except for the below-market interest rate given to Mr. Ebberts.

(ii) A Flawed Process of Loan Approval

The Examiner further concludes, however, that although reasonable, the initial loans and guaranty resulted from a flawed process that foreshadowed future problems. It would be difficult to defend the process utilized by Messrs. Bobbitt and Kellett in granting the \$50 million loan to Mr. Ebberts on September 6, 2000. Messrs. Bobbitt and Kellett may well have approved this loan in good faith and with the honest conviction that they acted in WorldCom's best interests. However, they certainly did not grant this loan on an informed basis. Messrs. Bobbitt and Kellett approved this initial loan based on Mr. Ebberts' five-minute meeting with Mr. Kellett, without reviewing any documentation concerning his margin calls, without performing any due diligence, without considering Mr. Ebberts' ability to repay the loan, and without exploring other options. They did not consult with the full Board, which was meeting the next day, or with any financial or legal experts concerning the advisability of this loan, and this failure continued with the subsequent loans and guaranty.

(iii) Breaches of Fiduciary Duty

The Examiner concludes that Messrs. Kellett and Bobbitt first breached their fiduciary duties of care and loyalty on September 6, 2000, when they approved the initial loan at a non-commercial interest rate. This initial breach was compounded thereafter when they approved further loans and extended the guaranty to and on behalf of Mr. Ebberts

beginning in November of 2000. The Examiner acknowledges that Messrs. Kellett and Bobbitt sought to gather some limited financial information through discussions with Mr. Ebberts and by meeting with Bank of America and obtaining data from the officer handling Mr. Ebberts' Bank of America loans. However, they failed to consider sufficiently the information that Bank of America provided through the documents it produced and discussions that highlighted Mr. Ebberts' serious financial troubles. They also failed to obtain more detailed credit and other financial information from Bank of America, even though Mr. Ebberts had signed a written authorization giving them permission to do so. Further, they failed to inform the other WorldCom Directors about what Bank of America had told them concerning Mr. Ebberts' troubled financial situation.

In addition, Messrs. Bobbitt and Kellett failed to require Mr. Ebberts to provide them with detailed financial information, did not perform due diligence to ensure that Mr. Ebberts had sufficient assets to cover his growing debt to WorldCom, did not obtain collateral to provide security ensuring repayment, and continued to provide him with an unreasonably low interest rate. In approving these loans, Messrs. Bobbitt and Kellett appear to have clung to the hope that somehow Mr. Ebberts' WorldCom stock, which had been steadily declining in value throughout 2000 and was pledged to other lenders, would provide sufficient security to protect WorldCom from financial loss. In fact, from early-to-mid-November 2000 onward, the evidence indicates that Mr. Ebberts could not repay his WorldCom loans due to his many other liabilities and the pledge of his assets to secure other loans. If Messrs. Kellett and Bobbitt had conducted the appropriate due diligence, they would have become aware of Mr. Ebberts' extreme financial difficulties and should have questioned whether it was in the Company's best interest to make further loans or guaranty extensions. Unfortunately, they

did not do so. As a result, the Company effectively replaced Bank of America as Mr. Ebberts' primary lender for his personal business interests.

c. Liability of Remaining Directors

The Examiner concludes that the remaining members of the WorldCom Board who did not serve on the Compensation Committee also breached their fiduciary duties of loyalty and care.²¹³ Most of these Directors did not learn about the loans and guaranty until the November 16, 2000 quarterly Board meeting, by which time the loans amounted to \$75 million and the guaranty totaled \$100 million.²¹⁴ At this time, Messrs. Bobbitt and Kellett made a brief presentation to the Board about the loans and guaranty, which they justified as reasonable steps to ensure that Mr. Ebberts not sell WorldCom stock to meet his margin calls and other debt obligations. Based upon this justification, the Directors then ratified the actions taken by the Compensation Committee.

The Examiner does not fault the Directors for such ratification, except as it pertains to the non-commercial interest rate. However, the Directors' passivity at this meeting troubles the Examiner. Not one Director asked any questions about the loans or guaranty, such as the terms of the loans, the applicable interest rate, and the collateral securing repayment. None of the Directors sought detailed financial information from Mr. Ebberts. Moreover, none of the Directors questioned the passage of over two months between the approval of the first loan and the Board learning about it.²¹⁵

²¹³ While the Examiner recommends excluding Mr. Macklin from potential claims arising out of the Compensation Committee's actions, Mr. Macklin is included among the Directors the Examiner believes breached duties to the Company based upon actions and inaction by the full Board.

²¹⁴ Mr. Sullivan knew of the loans prior to November 16 and, in fact, probably learned of the first loan soon after it was granted.

²¹⁵ A number of Directors advised the Examiner that they were surprised on November 16, 2000 to learn that the Compensation Committee had provided the loans and guaranty without first informing the full Board. None

The Examiner recognizes that directors generally may rely upon a committee of the Board if they reasonably believe that the committee merits confidence. See Appendix A, § D.1. The Examiner believes a close question exists whether, as of November 16, 2000, WorldCom's Directors had a basis to have confidence in Messrs. Kellett and Bobbitt, given their failure to provide data about the loans and guaranty before November 16, 2000. Nevertheless, the Examiner recommends that no claims be pursued to contest the Board's ratification of these transactions, which appears to have been a reasonable business judgment based on the facts and circumstances detailed above.²¹⁶

The Board, however, can be criticized for ratifying the extremely low interest rate provided to Mr. Ebbers. It was a breach of the Directors' duty of care to have failed to inquire about the terms of the loans and possibly a breach of their duties of loyalty and care to have ratified the loans at such low rates to the detriment of WorldCom, which could have used the proceeds to reduce its existing higher-interest rate debt.

Subsequent to November 16, 2000, however, when the Compensation Committee approved an additional \$25 million additional loan to Mr. Ebbers in December 2000 and an increase in the guaranty to at least \$150 million in January 2001 -- actions that the Board apparently ratified without meaningful discussion on March 1, 2001 -- the Examiner concludes that the Directors should have lacked confidence in Messrs. Kellett and Bobbitt and that the Directors breached their fiduciary duties of care and loyalty by failing to become

of the Directors, however, questioned this at a Board meeting or proposed guidelines for any further loans to Mr. Ebbers.

²¹⁶ The Examiner also does not fault the Board's ratification, on November 16, 2000, of the \$25 million guaranty extension, which the Compensation Committee approved on November 13, 2000. However, the Examiner faults Messrs. Bobbitt and Kellett for this guaranty extension, because by that time sufficient red flags existed from Bank of America about Mr. Ebbers' precarious financial position. Yet, they ignored the red flags Bank of America communicated to them and failed to advise the Board about them.

adequately informed about the loans and guaranty, and all related details.²¹⁷ The Examiner reaches the same conclusion that the Directors breached their fiduciary duty of care respecting all subsequent loans to and guaranty extensions on behalf of Mr. Ebbers for the same reasons described above.

B. Discussion of Potential Causes of Action

1. Mr. Ebbers

a. Legal Standards

As an officer and Director of WorldCom, Mr. Ebbers owed fiduciary duties of loyalty and good faith to the Company.²¹⁸ To fulfill these duties, Mr. Ebbers needed to place the best interests of WorldCom and its shareholders before his own personal interests. These fiduciary duties also prohibited him from entering into transactions with WorldCom that involved self-dealing or the usurpation of WorldCom's corporate opportunities, unless he obtained the requisite approval of the Company's independent Directors or could establish the "entire fairness" of such transactions.²¹⁹

b. Mr. Ebbers Breached His Fiduciary Duties of Loyalty and Good Faith in Connection with the WorldCom Loans

By September 2000, Mr. Ebbers had incurred massive debt, secured by his WorldCom stock, in financing his personal investments. As the value of the Company's

²¹⁷ See Pereira v. Cogan, 294 B.R. 449, 528-30 (S.D.N.Y. 2003) (holding that board members breached their fiduciary duties of loyalty and care by ratifying excessive compensation paid to executives). The March 1, 2001 ratification of the additional loan and guaranty extension without any due diligence is all the more difficult to understand since by that point in time, a WorldCom shareholder had threatened legal action pertaining to the loans.

²¹⁸ See In re Munford, Inc., 98 F.3d 604, 611 (11th Cir. 1996) (applying Georgia law), cert. denied, 522 U.S. 1068 (1998); In re Intercat, Inc., 247 B.R. 911, 923 (S.D. Ga. 2000) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Georgia law will apply to the breach of fiduciary duty claims against Mr. Ebbers and the former Directors. See Appendix A, § A.

²¹⁹ See Ga. Code Ann. §§ 14-2-831; 14-2-861; 14-2-862; Quinn v. Cardiovascular Physicians, P.C., 254 Ga. 216, 218, 326 S.E.2d 460 (Ga. 1985). See also Appendix A, §§ C.3 and F.

stock plummeted in 2000, Mr. Ebberts' lenders made margin calls that required him to provide additional security for the loans. He then placed his own interests ahead of WorldCom and its shareholders when he accepted a below-market interest rate on the September 6, 2000 loan, as well as the later loans, that effectively subsidized his personal business interests at a cost to WorldCom.²²⁰

By early-to-mid-November 2000, and certainly thereafter, however, Mr. Ebberts knew of his dire financial circumstances. He most likely knew that he could not repay the WorldCom loans, given that other lenders possessed security interests in the vast majority of his personal assets. The Examiner lacked access to Mr. Ebberts and his financial advisor, Mark Lewis, and thus could not determine with certainty exactly when Mr. Ebberts first learned of his likely insolvency. However, based upon the documents that the Examiner has obtained, as well as an interview with the Bank of America senior vice president who served as Mr. Ebberts' personal banker, the Examiner believes that Mr. Ebberts most likely realized, no later than early November 2000, that his debt greatly exceeded his liquid assets and that it may also have exceeded his total assets.

The Examiner also concludes that Mr. Ebberts likely knew at this time that he could not repay additional loans from WorldCom or provide adequate security not pledged to other lenders for such loans. Yet, Mr. Ebberts never disclosed his financial situation to Messrs. Bobbitt and Kellett or the Board, and, instead, sought additional loans and guaranty extensions from WorldCom.

²²⁰ The Examiner does not conclude that Mr. Ebberts breached a duty to WorldCom by using his WorldCom stock holdings to secure his personal investments, although this is a close question. The Examiner also does not conclude that Mr. Ebberts breached any duties in seeking the September 6, 2000 loan and the October 27, 2000 loan and guaranty (if the transactions had been at commercially reasonable rates), because: (1) it probably served the best interests of WorldCom for the CEO not to sell large amounts of WorldCom stock to repay margin debt; and (2) the full picture of Mr. Ebberts' troubled finances would not emerge until early-to-mid-November 2000.

To fulfill his duties of loyalty and good faith to WorldCom, Mr. Ebbers should neither have requested nor accepted special terms on any loans from the Company, absent full disclosure about his finances so that the Compensation Committee and the Board could make an informed decision whether further loans and guaranty extensions were in the Company's best interest. He failed to do so.

Mr. Ebbers then compounded the extent to which he favored his personal interests over WorldCom's best interests in several additional ways. Mr. Ebbers failed to assist, and, indeed, appears to have hampered, starting in the Fall of 2001, the Compensation Committee's efforts to collateralize his WorldCom loans. He not only failed to give the Compensation Committee information concerning his finances and business interests, but he also failed to provide the Committee with accurate financial statements and valuations of his non-stock assets, including his Canadian ranch, timber holdings, and shipyard and yacht-building businesses. Instead, he submitted documentation substantially overstating the value of those assets. Mr. Ebbers also permitted WorldCom to disclose publicly, in a Form 8-K that the Company filed on February 7, 2002, and in proxy materials that the Company issued in the Spring of 2002, that his assets were sufficient to cover his debt obligations to the Company -- a statement that he must have known to be inaccurate.

For the foregoing reasons, the Examiner concludes that sufficient evidence exists to support a cause of action against Mr. Ebbers for breach of his duties of loyalty and good faith to WorldCom in connection with his personal loans from WorldCom.

c. Mr. Ebbers Breached the Separation Agreement

The Directors' final accommodation to Mr. Ebbers with respect to his personal debt occurred in late April, 2002, after the Board of Directors requested his resignation as CEO of the Company. On April 29, 2002, as part of his Separation Agreement with WorldCom,

Mr. Ebbers executed a Promissory Note that converted his cumulative debt to the Company – approximately \$408 million -- from demand notes to a five-year term loan, the first \$25 million payment of which became due on April 29, 2003. Mr. Ebbers received the same favorable interest rate on the Promissory Note that he had benefited from in his previous notes to the Company.²²¹ The Separation Agreement granted Mr. Ebbers pension benefits of \$1.5 million per year for his lifetime, \$750,000 per year to his spouse for her lifetime after his death, medical and life insurance benefits, and certain other benefits.

The Examiner concludes that Mr. Ebbers most likely knew, at the time that he entered into the Separation Agreement and signed the Promissory Note, that he could not make timely payments under the Promissory Note and that, as a consequence, the Separation Agreement did not serve the best interests of WorldCom's shareholders. Yet, he failed to disclose to the Board the depth of his financial troubles or the unlikelihood that he could ever repay these debts.

In light of Mr. Ebbers' dire financial circumstances, it was no surprise that he defaulted on the Separation Agreement and Promissory Note by failing on April 29, 2003 to make the first payment due thereunder. Apparently, because the Separation Agreement provided no benefit to WorldCom's bankruptcy estate, the Company filed a Rejection Notice with the Bankruptcy Court on September 30, 2003 in the event that the Bankruptcy Court were to determine the Separation Agreement was an "executory contract" rather than a contract that had been previously terminated as a result of breaches by Mr. Ebbers.

²²¹ WorldCom's Corporate Monitor estimated that, even if Mr. Ebbers made all principal payments on the loan, this interest subsidy likely has a net present value of at least \$79 million. Mr. Breeden based this figure on the assumption that WorldCom's average interest subsidy is 6 percent per annum and that an 8 percent discount rate applies. He has also noted that the likely cost to WorldCom of this subsidy actually is much higher as a result of principal risk and other factors.

Based on the plain language of the Separation Agreement, the Examiner concludes that Mr. Ebbers has breached the Agreement by failing to pay the Company the \$25 million first payment. As a result of Mr. Ebbers' default, the Company has, among other things, accelerated all of Mr. Ebbers' payment obligations so that his total loan obligations immediately became due and terminated Mr. Ebbers' multi-million dollar annual severance package and other benefits. The Examiner recommends that WorldCom continue to consider all potential remedies under the Separation Agreement and Promissory Note.

d. Defenses

(i) The Board of Directors' Approval of the Loans and Guaranty

Mr. Ebbers may seek to avail himself of the Georgia Corporation Code's safe harbor provisions for "conflicting-interest transactions" by asserting that the independent Directors' ratification of the loans and guaranty protects him from liability for breaches of his fiduciary duties.²²² The Examiner believes that this defense likely would not succeed for several reasons. First, Mr. Ebbers failed to meet the "required disclosure" mandated by Section 14-2-861 of the Georgia Code, which serves as a condition precedent to this defense. The "required disclosure" element of Section 14-2-861 requires the person engaging in a conflicting interest transaction to disclose the material facts and circumstances relating to the transaction.²²³ Mr. Ebbers failed to do this. In particular, he failed to inform the Compensation Committee of his progressively deteriorating financial condition, he provided false information that vastly overstated his financial condition, and he resisted providing

²²² See Appendix A, § C.3 for a discussion the law pertaining to conflicting interest transactions.

²²³ See Dunaway v. Parker, 453 S.E. 2d 43, 49 (Ct. App. Ga. 1994) ("Required disclosure' means disclosure by the director who has a conflicting interest of ... all facts known to him respecting the subject matter of the transaction that an ordinarily prudent person would reasonably believe to be material to a judgment as to whether or not to proceed with the transaction.")

sufficient collateral to secure the loans. Accordingly, the Examiner does not believe that this safe harbor applies.

Second, for Mr. Ebbers to avail himself of the safe harbor for conflicting interest transactions, he must prove the fairness of the loans. Specifically, he must show the fairness of the process by which the Compensation Committee approved the loans and guaranty and the fairness of the interest rate on the loans. Ga. Code Ann. § 14-2-861(b). However, as noted above, the Examiner concludes that the loan-approval process was deeply flawed and that the low interest on the loans was not fair. Therefore, the Examiner does not believe that Mr. Ebbers could establish the fairness of these loans.²²⁴

(ii) The Release in Mr. Ebbers' Separation Agreement

The Separation Agreement releases Mr. Ebbers from any claims that the Company may have against him, with the exception of claims for breaching the Separation Agreement or the Promissory Note or claims “in connection with any fraud, willful misconduct, gross negligence or criminal act.” Thus, on its face, the Separation Agreement does not preclude the Company from pursuing claims for Mr. Ebbers' breach of its terms and conditions.

Further, Mr. Ebbers' breach of the Separation Agreement may result in setting aside the entire release. The language of the release and other provisions of the Separation Agreement are ambiguous whether satisfaction of the Separation Agreement's terms and conditions represents a condition precedent to the release. Resolution of this ambiguity

²²⁴ Even assuming that Mr. Ebbers could meet the conflicting interest transaction safe harbor requirements, the loan transactions would lose the protections of this safe harbor because the members of the Compensation Committee breached their fiduciary duties to WorldCom in connection with these transactions by failing to comply with their obligations, as directors and committee members, to act “[w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances.” Ga. Code Ann. § 14-2-830. In order for the actions of Directors (including committee members) to be effective under Section 14-2-862, such actions must be taken in accordance with the requirements of Section 14-2-830(a). Ga. Code Ann. § 14-2-830 and Comment to same.

likely will turn upon the parties' intent, and a fact finder will probably have to resolve this issue in any related litigation.

Moreover, the many fiduciary duty claims that the Company may pursue against Mr. Ebbers may fall within the "fraud, willful misconduct, gross negligence or criminal act" exceptions to the release. Mr. Ebbers accepted hundreds of millions of dollars in loans from WorldCom and violated duties in other respects as well, such as accepting financial favors from SSB and wrongfully committing WorldCom to the amended Intermedia merger. In the Examiner's view, Mr. Ebbers' actions may rise to the level of gross negligence and perhaps even willful misconduct. At a minimum, a genuine issue of material fact exists regarding Mr. Ebbers' actions that should preclude a defense based on the release from prevailing as a matter of law.²²⁵

2. Messrs. Bobbitt and Kellett

a. Legal Standards

Messrs. Bobbitt and Kellett, as the members of the Compensation Committee responsible for approving and overseeing the loans, owed fiduciary duties of care, good faith, and loyalty in fulfilling their responsibilities to WorldCom.²²⁶ To fulfill these duties, they must have acted on an informed basis, in good faith, and with the genuine conviction that their actions served the Company's best interests. See Appendix A, §§ C and D. Seeking the advice of experts, including Company officers and employees, legal counsel, public

²²⁵ See Callaway v. Ryckley, 404 S.E.2d 650, 651 (Ga. App. 1991), rev'd on other grounds, 412 S.E.2d 826 (Ga. 1992); DaCosta v. Technico Constr. Corp., 344 N.Y.S.2d 967, 969-70 (N.Y. Cir. Ct. 1973); cf. In re WorldCom, 02 Civ. 3288 (Hon. D. Cote) (S.D.N.Y. December 1, 2003) ("Among the ways fraudulent intent, or scienter, may be pleaded is through facts that constitute strong circumstantial evidence of recklessness," including "allegations that a defendant had access to information contradicting her public statements . . .").

²²⁶ See Boddy v. Theiling, 199 S.E.2d 379, 382 (Ga. Ct. App. 1973); In re Munford, Inc., 98 F.3d 604, 611 (11th Cir. 1996) (applying Georgia law), cert. denied, 522 U.S. 1068 (1998); Pereira v. Cogan, 294 B.R. 449, 528-30 (S.D.N.Y. 2003). See also Appendix A, § C.2.

accountants and other consultants, provides one indicia that they satisfied their duty of care. Id., § D.1. In addition, Messrs. Bobbitt and Kellett also must demonstrate that they informed themselves of all material information reasonably available to them with respect to the loan transactions at issue. Thus, they may breach their duty of care to WorldCom through inaction, as well as through action. Id., § D. This duty of care, moreover, required them to use the amount of care that a prudent person would use under similar circumstances. Id. § B. Similarly, Messrs. Bobbitt and Kellett may have breached their duty of loyalty by essentially abdicating their duties in the face of a dominant executive.²²⁷ The Examiner concludes that Messrs. Bobbitt's and Kellett's duties of care and loyalty to the Company required them to provide the entire Board of Directors with sufficient information concerning the loans and guaranty to enable the Board to take informed action when asked to ratify the loans and guaranty.

If Messrs. Bobbitt and Kellett can establish that they met these standards in fulfilling their duties of care and loyalty to WorldCom, then they may avail themselves of the protections of the business judgment rule, which shields directors from liability when they make business decisions in a thoughtful and informed manner. If they cannot meet this burden, then they will have to demonstrate the fairness of the transactions at issue, which is an exacting burden. See Appendix A, § F.1 and 2. As set forth below, the Examiner believes that Messrs. Kellett and Bobbitt breached their fiduciary duties of care and loyalty to WorldCom regarding the loan and guaranty transactions and that they cannot meet their burden of showing the entire fairness of the Ebberts' loan transactions.

²²⁷ See Pereira v. Cogan, 294 B.R. 449, 528(S.D.N.Y. 2003) (citations omitted).

b. Messrs. Bobbitt and Kellett Breached Their Duties of Care and Loyalty by Providing Mr. Ebbers with a Highly-Favorable Interest Rate

The Compensation Committee extended a very favorable interest rate on the initial \$50 million loan to Mr. Ebbers and on every loan thereafter. WorldCom's Corporate Monitor has described this interest rate as a direct subsidy to Mr. Ebbers because it was lower than the marginal interest rate on the Company's most expensive debt -- debt that the Company presumably could have paid down instead of loaning funds to Mr. Ebbers. The Examiner concurs with Mr. Breeden.

The Examiner recognizes that many corporations made loans to senior executives during 2000 and 2001. The Examiner cannot accept, however, the practice of making loans to Mr. Ebbers at an extraordinarily favorable interest rate, thereby providing a substantial subsidy to him and effectively wasting a WorldCom corporate opportunity to retire some of the Company's higher-interest debt. Accordingly, the Examiner concludes that Messrs. Kellett and Bobbitt breached their duties of care and loyalty to WorldCom by providing him with such a favorable interest rate.

c. Messrs. Bobbitt and Kellett Breached Their Duties of Care and Loyalty in Approving the Loans and the Increases in the Bank of America Guaranty After the October 27, 2000 Transaction

(i) The November 13, 2000 Extension of the Guaranty

The Examiner does not believe that the Compensation Committee's approval of the post-October 27, 2000 loans and expanded guaranty represented reasonable business decisions. The Examiner has previously concluded that the Compensation Committee's decision on November 13, 2000 to increase WorldCom's guaranty to Bank of America from

\$75 million to \$100 million was “unjustified and without rational basis.” Second Interim Report at 127.

Following Bank of America’s November 9, 2000 letter and Messrs. Kellett’s and Bobbitt’s meetings with Bank executives during this time period, they knew at least the outlines of Mr. Ebbers’ serious financial troubles.²²⁸ They failed, however, to request additional information available from the Bank that would have provided substantially more details about Mr. Ebbers’ troubled finances.²²⁹ Instead, as Mr. Bobbitt admitted during his interview with the Examiner, they “relied on Mr. Ebbers’ word” about his financial status. Moreover, Messrs. Bobbitt and Kellett failed to provide the entire WorldCom Board of Directors with the information that they did know concerning Mr. Ebbers’ precarious financial situation or Bank of America’s concerns about his mounting debt.²³⁰

²²⁸ Although Mr. Bobbitt did not recall receiving the November 9 Bank of America letter, Mr. Ebbers’ personal banker at Bank of America credibly advised the Examiner that she sent this letter to both Messrs. Kellett and Bobbitt. This letter discussed the deteriorating value of Mr. Ebbers’ timber assets (one of his largest personal assets other than his WorldCom stock). Mr. Ebbers’ personal banker at Bank of America also confirmed that during this time period, she periodically informed Mr. Bobbitt and, on occasion, Mr. Kellett of the Bank’s growing concerns about Mr. Ebbers’ highly-leveraged, illiquid, and increasingly unstable financial situation. Based on this and other evidence, the Examiner concludes that, by early-to-mid-November 2000, Messrs. Bobbitt and Kellett possessed sufficient information about Mr. Ebbers’ precarious financial situation to raise a red flag warning against additional loans.

²²⁹ Mr. Ebbers authorized Bank of America to provide the Compensation Committee with the Bank’s information concerning his finances, and Mr. Ebbers’ personal banker told the Examiner that she would have shared the vast majority of her internal documents with the Compensation Committee had it requested the materials. Second Interim Report at 126.

²³⁰ During their interviews, Messrs. Bobbitt and Kellett characterized Mr. Ebbers’ problems as primarily liquidity and cashflow problems rather than an insolvency problem, and this is how they characterized Mr. Ebbers’ financial situation to the WorldCom Directors. Indeed, the November 16, 2000 WorldCom Board minutes describe the loan’s purpose as being to avoid forced sales of Mr. Ebbers’ WorldCom stock, highlighting the concern with liquidity rather than solvency. Further, Mr. Bobbitt presented financial information provided by Mr. Ebbers, purportedly showing his substantial net worth, to some of the Directors at a WorldCom Board meeting. Mr. Bobbitt recalled doing this at the November 15, 2001 Board meeting, but the cursory Board minutes from this meeting do not mention this. Moreover, both Messrs. Bobbitt and Kellett approved public disclosure language, in February 2002, representing that Mr. Ebbers possessed sufficient collateral to satisfy WorldCom’s obligations, which further highlights their failure to disclose what Bank of America had told them about Mr. Ebbers’ dire financial circumstances. Indeed, even after Mr. Ebbers’ resignation, in May 2002, Mr. Bobbitt resisted taking this disclosure language out of WorldCom’s public filings even though outside counsel expressed doubts about the sufficiency of Mr. Ebbers’ collateral to cover the WorldCom obligations.

If Messrs. Kellett and Bobbitt had informed the WorldCom Board about Mr. Ebberts' financial problems, the Board may have -- and any reasonable Board would have -- limited the loan and guaranty amounts made available to Mr. Ebberts and/or required substantial collateral from Mr. Ebberts as a condition of any further loans or guaranty extensions. Yet, Messrs. Bobbitt and Kellett failed to do so, which resulted in Mr. Ebberts receiving several hundred million dollars in additional loans beginning with the \$25 million guaranty extension on November 13, 2000.

As noted, it should have been evident by early November 2000 that Mr. Ebberts' debt outstripped the value of his WorldCom stock and that Mr. Ebberts' financial situation had seriously deteriorated. The minutes of the Compensation Committee's November 13, 2000 meeting, however, do not indicate that any Committee members performed any due diligence, obtained the views of any financial or legal experts on the guaranty, or even debated the advisability of raising the guaranty. Accordingly, the Examiner concludes that Messrs. Bobbitt and Kellett breached their duties of care and loyalty by failing to conduct adequate due diligence respecting the November 13th guaranty extension, by approving this transaction without a rational basis and by failing to inform the entire Board about what they knew about Mr. Ebberts' financial situation at the November 16th quarterly Board meeting.

**(ii) The December 27, 2000 and January 30, 2001
Additions to the Loan and Guaranty**

By mid-November 2000, Messrs. Bobbitt and Kellett had received sufficient red flags to alert them to WorldCom's substantial risk and bad-debt exposure in lending additional sums to Mr. Ebberts. Notwithstanding, on December 27, 2000, the Compensation Committee approved an additional \$25 million loan to Mr. Ebberts, and on January 30, 2001, the Compensation Committee agreed to raise WorldCom's guaranty to Bank of America to

\$150 million. By this time, Messrs. Bobbitt and Kellett had received further briefings from Bank of America on Mr. Ebberts' precarious financial condition, and it had become clear that WorldCom's loans to and guaranty on behalf of Mr. Ebberts were not short-term. Messrs. Bobbitt and Kellett, however, continued their pattern of neglecting due diligence, failing to inform the Board about the materially adverse information they had received concerning Mr. Ebberts' financial situation. Thus, they failed to explore alternatives to the proposed transactions and approved the additional loan and guaranty extension without thoughtful analysis or in-depth deliberations.

(iii) The January 25, 2002 Additional Loan and Modification of the Guaranty

The Examiner believes Messrs. Bobbitt and Kellett similarly breached their fiduciary duties, on January 25, 2002, by approving a further \$65 million loan to Mr. Ebberts and by modifying and reaffirming WorldCom's guaranty to Bank of America. They approved these transactions even though they knew that the value of Mr. Ebberts' WorldCom stock (which represented the main asset by which repayment might be possible) had steadily and dramatically deteriorated. The Compensation Committee minutes do not indicate that anyone on the Committee performed any due diligence or consulted with any financial or accounting experts before approving these transactions. Indeed, the Compensation Committee members interviewed by the Examiner could not even recall why they had approved this final loan.

The Examiner previously hypothesized that Messrs. Bobbitt and Kellett may have approved this last loan to induce Mr. Ebberts to provide collateral for his debt to the Company, which amounted to over \$300 million at that point. Second Interim Report at 129. If this was the rationale, the Examiner concludes that it does not provide a reasonable basis

upon which to loan Mr. Ebbers an additional \$65 million. Instead, expanding Mr. Ebbers' debt to WorldCom for this reason merely underscores Messrs. Bobbitt's and Kellett's earlier failures to protect WorldCom's interests on the loan transactions.

d. Messrs. Bobbitt and Kellett Breached Their Duties of Care and Loyalty by Failing to Obtain Accurate Financial Information or Sufficient Collateral from Mr. Ebbers

In February 2002, the Compensation Committee retained a private law firm to attempt to secure collateral from among Mr. Ebbers' personal assets to protect WorldCom from unsecured risk on Mr. Ebbers' loans. Prior to this time, Mr. Borghardt had taken a few steps to obtain collateral from among Mr. Ebbers' personal assets. Mr. Ebbers fiercely resisted these efforts. Indeed, Mr. Ebbers went so far as to criticize Mr. Borghardt in harsh terms, placing this in-house counsel in an untenable position in dealing with the CEO.

To relieve Mr. Borghardt from this predicament, the Compensation Committee retained outside counsel to secure collateral from Mr. Ebbers.²³¹ The outside law firm also met with considerable obstacles and resistance from Mr. Ebbers. Messrs. Kellett and Bobbitt knew of this resistance and knew that Mr. Ebbers had been "stonewalling" and not cooperating with the outside law firm.

Based upon a shareholder derivative lawsuit filed in 2001 regarding the loans,²³² as well as the growing amount of the loans, Messrs. Bobbitt and Kellett should have exercised heightened due diligence in the loan-approval process, including conducting a detailed

²³¹ Mr. Bobbitt acknowledged that retaining outside counsel to secure collateral from Mr. Ebbers represented an effort "to protect" Mr. Borghardt from Mr. Ebbers' criticisms for not protecting his interests in connection with the loans. Also, an e-mail, dated March 12, 2002, from outside counsel to Mr. Borghardt indicated that Messrs. Bobbitt and Kellett had directed him to keep Mr. Borghardt "out of the direct line of fire on matters involving Mr. Ebbers."

²³² As reported in the March 1, 2001 Board minutes, a shareholder threatened to bring a lawsuit and demanded that WorldCom protect the shareholders' interests regarding the Ebbers' loans and guaranty. In particular, the shareholder alleged that the loans to Mr. Ebbers usurped a corporate opportunity and wasted WorldCom's assets.

analysis of Mr. Ebberts' ability to repay the loans. Instead, as Mr. Bobbitt admitted, they "relied on Mr. Ebberts' word" and accepted, in March 2002, an out-of-date and unaudited personal financial statement that did not comply with GAAP. See Second Interim Report at 131. The valuations of Mr. Ebberts' non-stock assets -- including the Canadian ranch, his timber concerns, and the shipyard and yacht-building business -- that he presented to the Compensation Committee represented little more than "guesstimates" and were quite inflated. Id. at 133-34.

In addition to this obviously flawed personal financial statement, other red flags should have alerted Messrs. Bobbitt and Kellett of the need to conduct more due diligence, including: (1) the decision of Mr. Ebberts' accountants not to audit his personal financial statement; (2) WorldCom's in-house lawyers' concern about the accuracy of the valuations supplied by Mr. Ebberts in connection with an SEC inquiry regarding WorldCom in early 2002; and (3) the refusal of Mr. Ebberts' personal attorney to verify the accuracy of this financial information to WorldCom's outside counsel. See Second Interim Report at 131. Notwithstanding these red flags, Messrs. Bobbitt and Kellett never sought an independent appraisal of Mr. Ebberts' financial condition.

In the first half of April 2002, the Compensation Committee and its outside counsel finally obtained some collateral with respect to Mr. Ebberts' loans. Thus, on April 2, 2002, Mr. Ebberts entered into a letter agreement with WorldCom in which he pledged to the Company a subordinated security interest in his Company stock and security interests in certain of his personal businesses, including Joshua Holdings and other timber concerns, the Canadian Ranch, and his shipyard and yacht-building business. At the Board of Directors' quarterly meeting on April 3, 2002, Mr. Bobbitt reported that Mr. Ebberts had entered into an

agreement with WorldCom that provided for “the full collateralization of the Company’s loan to him.” This was not, in fact, the case as WorldCom was not fully collateralized.²³³ By making this representation without conducting the appropriate due diligence, and without having fully informed the Board about what he did know of Mr. Ebberts’ troubled financial situation, Mr. Bobbitt breached his duty of care and loyalty. By remaining silent in the face of this misrepresentation, Mr. Kellett’s similarly breached his fiduciary duties of care and loyalty.

e. Additional Failures Respecting the Loans to Mr. Ebberts

In addition to the facts cited above, other facts underscore that Messrs. Bobbitt and Kellett disregarded their fiduciary duties to WorldCom regarding Mr. Ebberts’ loan transactions. The Examiner details these additional failures in his Second Interim Report (at pp. 115, 134-36), and they are merely summarized here. In particular, these facts, among others, support the Examiner’s conclusion that Messrs. Bobbitt and Kellett breached their fiduciary duties by failing to:

- establish procedures to ensure that Mr. Ebberts used the proceeds from his Company loans solely to meet his margin calls and debt payments;
- halt Mr. Ebberts’ use of over \$27 million from these loans to prop up his personal business interests instead of paying off debt; and
- document WorldCom’s loans to Mr. Ebberts promptly after WorldCom made them.

²³³ As of late February/early March 2002, Mr. Ebberts owed WorldCom approximately \$377 million based upon the loans and guaranty. Second Interim Report at 130. At this time, his assets included: (1) his WorldCom stock, primarily pledged to others, valued around \$135 million; (2) his timber farm worth less than \$31 million (65% of which was already encumbered); (3) his shipyard and yacht sales business worth substantially less than the \$41 million indicated on the personal financial statement he provided to WorldCom and sold for less than \$10 million in 2003; and (4) the Canadian ranch, sold in late May 2003 for \$68.5 million. Second Interim Report at 111. Thus, looking at the value of these assets in the most favorable light to Mr. Ebberts at this time, his loans from WorldCom were under-collateralized by over \$100 million.

For all of the foregoing reasons, the Examiner concludes that sufficient evidence exists to support claims against Messrs. Bobbitt and Kellett for breaches of their fiduciary duties.

f. Defenses

(i) The Business Judgment Rule

The Examiner believes the facts surrounding the Compensation Committee's approvals of WorldCom's loans to and guaranty on behalf of Mr. Ebbers strongly suggest that Messrs. Bobbitt and Kellett cannot avail themselves of the protections of the business judgment rule. These protections extend only to directors and officers who can show that they fulfilled their fiduciary duties by acting on an informed basis, in good faith, and with the genuine conviction that they acted in the best interests of the Company. As part of these duties, they also must monitor potential Company losses and act to prevent them. See Appendix A, § F.

As detailed above, numerous problems existed with the handling of Mr. Ebbers' loans by Messrs. Bobbitt and Kellett. Consequently, the Examiner believes that Messrs. Bobbitt and Kellett cannot avail themselves of the business judgment rule with respect to the loans and guaranty extensions made to Mr. Ebbers after October 27, 2000 because, at a minimum, they failed to act on an informed basis and with due care to monitor and avoid potential losses.²³⁴

The Examiner also believes that Messrs. Bobbitt and Kellett cannot avail themselves of the "entire fairness" safe harbor either. See Appendix A, § F.2. To establish entire fairness, Messrs. Bobbitt and Kellett would have to prove the fairness of the loan-approval

²³⁴ At a minimum, a genuine issue of material fact exists regarding whether Mr. Ebbers' loans and guaranty extensions represented informed decisions by the Compensation Committee within the protections of the business judgment rule.

process and the fairness of the loan interest rates.²³⁵ The Examiner believes that they cannot meet this burden. The Compensation Committee did not establish or follow systematic procedures in approving Mr. Ebberts' loans and guaranty. Further, the terms and conditions of the loans were hardly fair to WorldCom, since Mr. Ebberts received a below-market interest rate that has been characterized by the Corporate Monitor as a \$79 million subsidy. This situation parallels that of Pereira v. Cogan, in which a federal bankruptcy court, applying Delaware law, determined that loans to the corporation's CEO were not entirely fair:

There was no process in place for the loans to be approved and, in fact, the officers and directors for the most part could only determine the existence of the loans by reading the daily cash reports. At no time did any of the Defendants attempt to (1) set up a procedure by which loans would be approved; (2) seek to insure that Cogan had put up collateral or was otherwise able to pay back the loans; (3) investigate the loans to insure that they were fair to the company; or (4) even discuss whether such measures should be put into place. As a result, there was not fair process.

The Defendants have also failed to establish fair price. The terms of the loans were set by Cogan, rather than Trace, at extremely favorable rates to him. Thus, all the Defendants are liable for the Cogan loans.²³⁶

The same criticisms apply with equal force to the handling of Mr. Ebberts' loans, which also lacked adequate procedures, collateral, investigation, deliberation, and fair terms.

(ii) The Exculpatory Clause in WorldCom's Articles of Incorporation

The exculpatory clause in WorldCom's Articles of Incorporation protects Directors from liability to WorldCom and its shareholders for breaches of their fiduciary duties, except in cases of: (1) misappropriation of WorldCom's business opportunities; (2) acts or omissions that involve intentional misconduct or knowing violations of the law; (3) the

²³⁵ See Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); Appendix A. § F.2.

²³⁶ 294 B.R. at 537.

receipt of improper personal benefits from a transaction; and (4) liability associated with unlawful distributions. Messrs. Bobbitt and Kellett may argue that the exculpatory clause bars claims against them for breach of their fiduciary duties.

At a minimum, the Examiner believes that issues of material fact exist regarding the exceptions to the exculpatory clause and that consequently Messrs. Bobbitt and Kellett would not prevail as a matter of law on this defense. Instead, a fact finder likely would need to resolve whether the misconduct surrounding the loans falls within the applicable exceptions.

In particular, the Examiner believes that Messrs. Bobbitt's and Kellett's mishandling of the loans may be sufficiently reckless and egregious so as to amount to intentional misconduct -- one of the exceptions to the exculpatory clause.²³⁷ Moreover, in certain jurisdictions, a debtor-in-possession stands in the shoes of a trustee and represents the interests of its creditors. As a creditor representative, the debtor-in-possession may not be bound by the WorldCom exculpatory clause, which on its face applies just to the Company and its shareholders.²³⁸

(iii) Ratification of the Loans and Guaranty by the WorldCom Board

Messrs. Bobbitt and Kellett may contend that the Board's approval of the loans on November 16, 2000 and March 1, 2001, as well as its approval of the Separation Agreement in April 2002, ratified their decision to approve the loans and guaranty extensions. The

²³⁷ Cf. Lewis v. Duggan, 362 S.E.2d 73, 74 (1987) (in tort context, conscious indifference to consequences may amount to intentional misconduct); In re: Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795, 808 (7th Cir. 2001) (sustained and systematic failure to exercise oversight may be intentional where the director knew of legal violations and failed to take action to avert corporate losses); In re WorldCom, 02 Civ. 3288 (S.D.N.Y. December 1, 2003) (Hon. D. Cote) ("Among the ways fraudulent intent, or scienter, may be pleaded is through facts that constitute strong circumstantial evidence of recklessness."). In addition, the perks that Mr. Kellett received from Mr. Ebbers, which include Mr. Ebbers' agreement to lease a WorldCom jet to Mr. Kellett at nominal cost and Mr. Ebbers' investments in one of Mr. Kellett's personal business ventures, may constitute improper personal benefits that influenced Mr. Kellett's approval of the loans.

²³⁸ See Pereira v. Cogan, 2001 U.S. Dist. WL 243537 (S.D.N.Y. March 8, 2001); Ben Franklin Retail Stores, Inc. v. Kendig, 2000 U.S. Dist. WL 28266 (N.D. Ill. Jan. 12, 2000). See also Appendix A, § G.

November 16th and March 1st approvals, however, do not appear to protect Messrs. Bobbitt and Kellett. Effective ratification depends upon the Board possessing knowledge of “all relevant material facts before or at the time of ratification.”²³⁹ Messrs. Bobbitt and Kellett failed to provide the Board with sufficient information to allow the Directors to make an informed decision whether to ratify the loans.

As for approval of the Separation Agreement, this document represented an attempt to structure Mr. Ebbers' repayment obligations and there is no evidence that it constituted an endorsement of the prior loan and guaranty decisions made by the Compensation Committee. Further, ratification depends upon the sufficiency of the information provided to the Board “before or at the time of ratification.”²⁴⁰ At a minimum, a genuine issue of material fact exists about the sufficiency of the information that Messrs. Bobbitt and Kellett provided to the Board regarding Mr. Ebbers' loans. The Examiner believes a fact finder likely would need to resolve this issue.

(iv) The Indemnification Provision in the Articles of Incorporation

As discussed in Appendix A to this Report, Article Twelve of WorldCom's Articles of Incorporation is an indemnification provision applicable to the Company's Directors. The indemnification afforded by Article Twelve does not apply to a Director's liability “if [they] failed to act in a manner [they] believed in good faith to be in or not opposed to the best interests of the Corporation.” In other words, indemnification is unavailable in the event of a breach of a Director's fiduciary duties to WorldCom, particularly the duties of loyalty and

²³⁹ Synergy Worldwide, Inc. v. Long, Haymes, Carr, Inc., 44 F. Supp. 2d 1348, 1356 (N.D. Ga. 1998); see also Bresnahan v. Lighthouse Mission, Inc., 496 S.E.2d 351, 354 (Ga. App. 1998).

²⁴⁰ Synergy Worldwide, Inc. v. Long, Haymes, Carr, Inc., 44 F. Supp. 2d at 1356; see also Bresnahan v. Lighthouse Mission, Inc., 496 S.E.2d at 354.

good faith. As set forth above, the Examiner concludes that Messrs. Bobbitt and Kellett probably breached those fiduciary duties in connection with Mr. Ebberts' loans and guaranty and, therefore, are not entitled to indemnification.

Moreover, under Article Twelve, no indemnification exists "in the case of a proceeding by or in the right of the Corporation, in which [a director] was adjudged liable to the corporation, unless a court shall determine that the director is fairly and reasonably entitled to indemnification in view of all the circumstances" In light of this provision, Messrs. Bobbitt and Kellett most likely would not receive automatic indemnification at the beginning of any lawsuit brought by WorldCom. Rather, the issue of indemnification would have to await adjudication of WorldCom's claims against Messrs. Bobbitt and Kellett and, given the substantial evidence supporting the Company's claims, the Examiner believes it is unlikely that, "in view of all the circumstances," a court would find them entitled to indemnification.

3. Non-Compensation Committee Directors

a. Legal Standards

The members of the WorldCom Board who did not serve on the Compensation Committee had duties similar to those of the members of the Compensation Committee to act on an informed basis, in good faith, and with the genuine conviction that their actions served the Company's best interests. To satisfy their duty of care, these Directors also must demonstrate that they informed themselves of all material information reasonably available to them with respect to Mr. Ebberts' loans and guaranty. The Directors cannot insulate themselves from liability by failing to take an active role in managing the loans, particularly if they systematically failed to monitor or attempt to prevent potential losses.

b. The Directors Breached Their Duty of Care by Ratifying Mr. Ebbers' Loans and Guaranty Extensions After the November 16, 2000 Board Meeting Without Acting on an Informed Basis and Without Requiring Sufficient Collateral Securing the Loans and Guaranty

The Examiner does not criticize the Board's ultimate decision to ratify Mr. Ebbers' loans and guaranty at the November 16, 2000 quarterly meeting, except for the extraordinarily low interest rate. While the Examiner believes that the Board utilized a flawed loan-ratification process and should have asked more questions about the transaction and the failure to notify them earlier about the initial loans,²⁴¹ the Examiner primarily criticizes Messrs. Bobbitt and Kellett for failing to disclose to the Board their full knowledge about Mr. Ebbers' financial troubles at the November 16th meeting. Therefore, the Examiner does not believe the remaining Directors should be viewed as accountable for ratifying the loans and guaranty on November 16, 2000, except for the interest rate.

The Examiner concludes, however, that the Board members did breach their fiduciary duty of care on multiple occasions regarding the Ebbers' loan transactions taking place after November 16, 2000, by failing to: (1) conduct appropriate due diligence; (2) question Mr. Ebbers and the Compensation Committee about the loans; and (3) secure sufficient collateral protecting WorldCom's interests. While the Compensation Committee possessed the primary duty to perform these tasks, the Examiner believes that the other Directors also had a duty to oversee this process. See Ga. Code Ann. § 14-2-825(e). Instead of supervising

²⁴¹ On November 16, 2000, the Board members who did not serve on the Compensation Committee, other than Mr. Sullivan, learned for the first time that the Compensation Committee had approved \$75 million of loans to Mr. Ebbers and a \$100 million guaranty on his behalf. Messrs. Kellett, Bobbitt and Ebbers informed the full Board of the loans and guaranty in a brief presentation in which they explained that the loan transaction served the interests of WorldCom and its shareholders to avoid the CEO selling stock to meet margin calls. The Board received no written data concerning the loans and guaranty at this Board meeting. The Examiner criticizes the Board's passivity in the face of this information and the Directors' failure to demand relevant data about the loans and guaranty, such as the interest rate charged, the terms of the guaranty, and the existence of sufficient collateral.

the Compensation Committee, the Board abdicated this duty and merely rubber-stamped the loan transactions without any due diligence and after virtually no discussion regarding whether such loans and the guaranty were in WorldCom's best interest. Nor did the Board establish any procedures to supervise additional loans, establish guidelines for such loans, or even set forth notification procedures in the event of more loan requests. The Board should have been acutely aware of the need for loan notification procedures given that the Directors belatedly first learned about Mr. Ebberts' loans more than two months after the approval of the initial loan and the filing of a shareholder suit in 2001 to contest the loans and guaranty. Yet, the Directors continued to remain "out of the loop" because they established no notification procedures regarding the loans. For example, the Board first learned of the December 2000 loan and guaranty extension on March 1, 2001²⁴² and never even was asked to ratify the January 2002 loan of \$65 million and guaranty reaffirmation and modification.²⁴³

The Examiner is also troubled that no Director asked why the Compensation Committee approved the loans without first seeking Board approval. A number of Directors informed the Examiner that the loan transactions troubled them, and that they questioned the Compensation Committee's authority and judgment to enter these transactions without Board approval. Yet, no one raised any of these issues during a Board meeting. The Board's

²⁴² Indeed, on March 1, 2001, when the Board ratified the December loan and the January extension of the guaranty, the Board held an Executive Session in which the Directors discussed threatened shareholder litigation based upon the loans and guaranty. This potential litigation should have heightened their awareness that the loans and guaranty required significant scrutiny. Yet, neither the minutes of this meeting nor the Examiner's interviews of WorldCom's former Directors indicate that the Board questioned Messrs. Kellett and Bobbitt to ensure that the Compensation Committee acted on an informed basis. Moreover, the Special Committee the Board formed on March 1, 2001 to look into this potential litigation limited its inquiry to the merits of the lawsuit's allegations. Neither the Special Committee nor the Board as a whole made any further inquiries into the reasonableness of the loans themselves.

²⁴³ Nevertheless, the Examiner believes that the Directors should be held accountable for these transactions, under a breach of fiduciary duty theory, because they failed to establish any procedures, guidelines, or requirements for further loan transactions.

silence in the face of their admissions that the loans troubled them concerns the Examiner and represents yet another instance of the Board's unwarranted passivity.

To uphold their fiduciary duties, directors must question transactions that trouble them and, where appropriate, insist on modifications before approval. Yet, the WorldCom Board remained passive and accepted the cursory explanations provided by Messrs. Bobbitt and Kellett. The Directors never made such seemingly fundamental inquiries as: whether Mr. Ebbers had sufficient assets so that repayment of the loans was likely; whether WorldCom's loans were secured by collateral; and whether the loans carried a reasonable interest rate. In doing so, the Examiner concludes that the Directors breached their fiduciary duty of care. See, Appendix A, § D.2 (directors may violate the duty of care by failing to act).

c. Defenses

The Board members who did not serve on the Compensation Committee may seek to assert some of the same defenses as Messrs. Bobbitt and Kellett, such as the business judgment rule, the exculpatory clause, and the indemnification provision in the WorldCom articles of incorporation. For the reasons set forth previously, the Examiner believes that the Board likely will not prevail on any of these defenses and almost certainly will not succeed as a matter of law.

Those Directors who did not serve on the Compensation Committee also may argue that they are shielded from liability because they did not actually make Mr. Ebbers' loans or increase the Bank of America guaranty, but instead relied upon the Compensation Committee and merely ratified its actions. In furtherance of this argument, these Directors may attempt to rely upon Section 14-2-830 of the Georgia Code, which permits Directors "to rely on information, opinions, reports, or statements, including financial statements and other

financial data, if prepared or presented by: * * * (3) A committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.” See Appendix A, § D.1.

The Examiner finds that the Board could not reasonably believe that the Compensation Committee “merit[ed] confidence” regarding the loan transactions that took place after the November 16, 2000 Board meeting, at which they ratified the initial loan and guaranty transactions. Based on the facts and circumstances detailed above, the Board should have known that the Compensation Committee lacked due diligence and failed to obtain any collateral to protect WorldCom’s interests. Indeed, Directors interviewed by the Examiner admitted being troubled by the Compensation Committee’s handling of the loans, and this concern began as early as the November 16th Board meeting when they learned of the Compensation Committee’s failure to disclose the initial loan for over two months. Instead of believing that the Compensation Committee merited confidence, several Board members candidly informed the Examiner that they actually felt exactly the opposite. The Board, however, remained passive in the face of this troubling situation, thereby effectively abdicating its responsibilities. Accordingly, the Examiner does not believe that the defense of reasonable confidence in the Compensation Committee will prevail.²⁴⁴

4. Available Remedies

A variety of potential remedies exist. The Examiner recommends that WorldCom consider claims against Messrs. Ebberts, Bobbitt and Kellett and WorldCom’s other former Directors for disgorgement of the WorldCom compensation that they received earned during

²⁴⁴ See Pereira v. Cogan, 2001 U.S. Dist. WL 243537 (S.D.N.Y. 2001) (denying motion to dismiss and noting that “the Directors are not protected from liability [in making loans to senior executives, including a \$14 million loan to the CEO] for failing to exercise their duties as directors by admitting that they did not do so.”).

the period that they breached their fiduciary duties. See Appendix A, K.²⁴⁵ In addition, the Examiner recommends that WorldCom consider claims for recovery of compensatory damages proximately caused by any breaches of fiduciary duties. The compensatory damages would reflect, among other things: (1) the difference between a commercially reasonable interest rate and the highly-favorable interest rate charged to Mr. Ebbers for the loans; (2) the outstanding loan balance less the amounts attributable to the loans and guaranty prior to November 16, 2000;²⁴⁶ and (3) the interest due on this balance.²⁴⁷

In addition, pursuant to the Separation Agreement, WorldCom may: (1) seek accelerated payment from Mr. Ebbers of the full amount of the outstanding loans; (2) exercise its right to set off any amounts owed by Mr. Ebbers from any payments due to Mr. Ebbers from the Company; and (3) discontinue payment of his pension benefits.

²⁴⁵ For Mr. Ebbers, this disgorgement period should run from September 6, 2000, when he sought and received a \$50 million loan at an interest rate unfair to WorldCom to late April 2002 when he resigned as CEO. For Messrs. Bobbitt and Kellett this period would run for the same period. For the other Directors, the Examiner believes that the disgorgement period should run from November 16, 2000, when they ratified the loans at non-commercial interest rates, to late April 2002.

²⁴⁶ As noted above, the Examiner believes that Messrs. Bobbitt and Kellett reasonably approved the loan and guaranty transactions through the October 27, 2000 loan and that the Board reasonably ratified the loan transactions (but not the interest rate) and the guaranty prior to the November 16, 2000. Therefore, the Examiner believes that the amounts attributable to these business decisions should be subtracted from any outstanding loan balance that WorldCom seeks to recover from Messrs. Bobbitt, Kellett, and the remaining former Directors.

²⁴⁷ See *Davis v. Ben O'Callaghan Co.*, 227 S.E.2d 837, 841 (1976), rev'd in part, 232 S.E.2d 53 (1977); cf. *Holland v. Holland Heating & Air Conditioning, Inc.*, 423 S.E.2d 238 (1993).

VII. WORLDCom's FRAUD IN CONNECTION WITH ITS FINANCIAL STATEMENTS

A. Introduction and Summary of Findings

1. The Examiner's First and Second Interim Reports

In his First and Second Interim Reports, the Examiner discussed the manipulation of the Company's financial statements from the first quarter of 1999 through the first quarter of 2002 (the "relevant period"), as well as the corporate environment that fostered such accounting irregularities. The Examiner provided an overview of the irregularities and their effect on the Company's financial statements. However, the Examiner excluded many details pertaining to the accounting fraud for a number of reasons, including deference to the investigations and prosecutions by the Department of Justice and the SEC. Since the governmental investigations and prosecutions are still continuing at the time of issuance of this Third and Final Report, the Examiner has continued to limit his observations in this area.

The Examiner focused his preliminary conclusions in the First and Second Interim Reports primarily on the conduct and structure of WorldCom's Audit Committee and the Internal Audit Department and deficiencies that contributed to their failure to detect any aspect of the accounting fraud prior to June 2002. In summary, the Examiner reached preliminary conclusions in his First and Second Interim Reports that:

(1) During the relevant period, WorldCom manipulated its reported financial performance by improperly drawing down excess or other reserves into revenue or expenses to boost its earnings and meet stated expectations that the Company's revenues would grow by 12 to 15 percent year to year. When the reserves were exhausted, WorldCom took the brazen step of converting substantial portions of its line cost expenses into capital expenditures for property and equipment, thus boosting reported results by approximately \$3.8 billion.

(2) The accounting fraud has resulted in proposed restatements impacting the Company's EBITDA by about \$7.1 billion, including \$3.8 billion in improperly capitalized line costs and \$3.3 billion in improper accounting for releases of reserves and accounting for revenues and miscellaneous non-revenue items.

(3) WorldCom's accounting irregularities went undetected for at least three years due, in part, to substantial deficiencies in the Company's internal controls and systems of checks and balances on Management. Indeed, the members of the Audit Committee barely scratched beneath the surface of the accounting issues they reviewed, giving significant deference to CFO Scott Sullivan, based on his reputation and experience.

(4) There were numerous failures, inadequacies and breakdowns in the multi-layered system designed to protect the integrity of the WorldCom financial reporting systems, including the Audit Committee, the Internal Audit Department, the Company's internal controls, and the independent auditors. WorldCom did not have in place sufficient checks to detect the improper accounting machinations of the Company's Management.

(5) While the Audit Committee and the Internal Audit Department appear to have acted in good faith and took appropriate steps once the improper capitalization of line costs was detected, they had significant deficiencies in the scope of their operations. For example, the Internal Audit Department, which worked under the day-to-day supervision of the WorldCom CFO, focused primarily on operational issues and did not conduct audits impacting the Company's external reporting and financial statements. Rather than functioning as the Company's "internal controls" police, the Internal Audit Department used its limited resources to focus primarily on ways that the Company could control costs and improve its billing systems so that earnings could be maximized. There also was little meaningful coordination between the Internal Audit Department and the Company's external auditor.

In the Second Interim Report, the Examiner also made preliminary observations about the performance of Arthur Andersen, WorldCom's external auditor during the relevant period. These observations were not more definitive in large part because, as of June 2003, the Examiner had not yet had an opportunity to interview the Arthur Andersen personnel who worked on the WorldCom audits. The Examiner's preliminary observations in the Second Interim Report included the following:

(1) Arthur Andersen had internally designated WorldCom as a "maximum" risk client in 1999, 2000 and 2001. In each of those years, Arthur Andersen assessed as "significant" the risk of fraud due to WorldCom's aggressive

revenue and earnings targets and, in 1999, a “fair” risk of failure, error and/or fraud related to WorldCom’s ability to manage the financial reporting function.

(2) Arthur Andersen’s performance of its audits of WorldCom during the relevant period was possibly deficient, in light of the risks assessed, in a number of ways, including:

- a. The failure to perform substantive tests²⁴⁸ in a number of areas where such testing appeared warranted by Arthur Andersen’s assessments of the risks of error, fraud or failure.
- b. Acceptance of limitations placed by former WorldCom Management on the work of the audit team and its access to critical information and WorldCom personnel.
- c. Extensive reliance by the audit team upon the representations and the integrity of WorldCom’s former Management, instead of taking steps to confirm the representations made by Management.
- d. The failure to communicate requisite information to WorldCom’s Audit Committee, such as significant changes in WorldCom accounting policies, disagreements with Management, significant weaknesses in internal controls, and difficulties encountered during the audits.

2. The Examiner’s Further Investigation

Since issuance of the Second Interim Report, the Examiner has continued his investigation of fraud-related accounting issues, including the review of many additional documents that have been produced by WorldCom and third parties. Most important, the Examiner’s representatives interviewed some of the members of Arthur Andersen’s WorldCom engagement teams during the relevant period. Despite some troubling limitations on the cooperation received from these sources, the Examiner obtained sufficient information to be able to conclude his investigation and to make recommendations regarding certain of the persons and entities who may be responsible to WorldCom for damages.

²⁴⁸ Substantive tests consist of tests and analytical procedures performed by auditors of the details of transactions and account balances. Jerry D. Sullivan et al., Montgomery’s Auditing, 175 (10th ed. 1985).

3. Summary of Conclusions

Responsibility for WorldCom's accounting fraud can be laid at a number of doors, beginning with the former senior WorldCom executives and accounting employees who manipulated the Company's financial statements and who actively deceived the Company's external auditors and the investing public. WorldCom's proposed restatements of its financial statements demonstrate that the Company's impressive double-digit growth each quarter, and corresponding increase in stock price, were founded on accounting improprieties that, once revealed, eliminated the Company's ability to obtain necessary credit, and propelled the Company into bankruptcy.

The Examiner observes that given the magnitude of the WorldCom accounting fraud and the relative simplicity of the execution of some of its aspects, it is disappointing that the Company's gatekeepers failed to detect the fraud for so long. Certainly, those responsible for perpetrating the fraud took active measures to conceal the fraud and to circumvent the Company's internal controls and external auditor. Nonetheless, the failure for so long to detect any aspect of the fraud cannot simply be blamed on the deception. Rather, responsibility to ensure that the Company's financial statements were reasonable, fairly presented, and in accordance with Generally Accepted Accounting Principles ("GAAP") was shared by a number of individuals and entities including: (i) WorldCom's senior Management; (ii) its accounting and financial management professionals and officers, many of whom were certified public accountants ("CPAs"), charged with duties to refrain from acting fraudulently and to report any fraud that came to their attention; (iii) the Company's Audit Committee, which had a duty to oversee and to question the Company's accounting policies and independent accountants; (iv) the Company's Internal Audit Department, which was responsible for evaluating and proposing improvements to the Company's internal

controls; and, (v) Arthur Andersen, the external auditor, which had the responsibility to exercise professional skepticism in connection with its audits of the Company and “to perform the audit[s] to obtain reasonable assurance” that the Company’s financial statements were “free of material misstatement, whether caused by error or fraud.” See Statements on Auditing Standards, Statement on Auditing Standards (“SAS”) No. 1, AU § 110 (Responsibilities and Function of the Independent Auditor) (American Inst. Of Certified Pub. Accountants 1997); SAS No. 82, AU § 316.01 (Consideration of Fraud in a Financial Statement Audit). To varying degrees, each of these individuals or entities failed to perform its duties to WorldCom in this area.

a. Responsibility of Former WorldCom Officers and Employees

WorldCom’s financial statements were fraudulently manipulated from at least early 1999 until one aspect of the fraud was discovered in June 2002. Four individuals have already pled guilty to criminal charges that arose out of the Company’s improper capitalization of its line cost expenses: Controller David Myers; Director of General Accounting Buford “Buddy” Yates; and Betty Vinson and Troy Normand, two of Mr. Yates’ direct reports in the General Accounting group. In addition, federal prosecutors have brought criminal charges against Mr. Sullivan, who has pled not guilty and is awaiting trial at a now-unspecified date in April 2004 or later. Mr. Ebbers, Mr. Sullivan and the four former WorldCom employees who have pled guilty also were criminally charged by the State of Oklahoma for their role in the accounting fraud. Mr. Ebbers and Mr. Sullivan have pled not guilty to those charges.²⁴⁹

²⁴⁹ The charges against Mr. Ebbers were withdrawn by the State of Oklahoma on November 20, 2003, in apparent deference to the federal prosecution of Mr. Sullivan.

To the extent that these former officers or employees have pled guilty or are found guilty of criminal fraud in connection with the Company's financial statements, the Company has claims against these individuals grounded on their fraudulent acts and their breaches of their fiduciary duties of good faith and loyalty to the Company. Such claims are examined below in Section V.D.²⁵⁰

The Company may also wish to consider claims against other former officers and employees, based on their conduct and their involvement in the preparation and certification of the Company's financial statements. However, due to the pendency of ongoing investigations, as well as the lack of cooperation by certain individuals, including Mr. Ebbers, the Examiner is unable to reach definite conclusions whether claims are likely to exist against other former officers and employees. While the factual record in this area has not been fully developed, precedent suggests that claims against Mr. Ebbers and other former senior members of the Company's financial Management may be viable.

b. Responsibility of the Audit Committee and the Internal Audit Department

The Examiner reaffirms his preliminary conclusions in the Second Interim Report that the Company's Audit Committee and Internal Audit Department did not perform satisfactorily. But, while the Audit Committee and Internal Audit Department bear responsibility for failing to detect any aspect of the accounting fraud, such failures resulted primarily from the structure and scope of duties of the Internal Audit Department and the deference that the Audit Committee showed to the Company's former senior financial Management and the external auditor, rather than from any overt act or omission.

²⁵⁰ See also Appendix A for discussion of fiduciary duties.

Accordingly, based upon the facts and applicable law, the Examiner does not recommend that the Company consider any accounting-related claims against any former member of the WorldCom Audit Committee or any present or former employees of the Internal Audit Department. Indeed, in the end, the improper capitalization of line costs was eventually detected by employees of the Internal Audit Department and they and members of the Audit Committee acted appropriately to sound the alarm. A further explanation of why the Examiner does not believe that claims should be pursued against the Audit Committee or Internal Audit personnel is set forth in Section V.E.

c. Responsibility of Arthur Andersen

The Examiner concludes that the Company has claims against Arthur Andersen due to its responsibility for the failure to detect any aspect of the Company's accounting fraud. The Examiner did not find, however, evidence that Arthur Andersen participated in or had actual knowledge of the improper manipulation of the Company's financial statements. Further, Arthur Andersen was affirmatively deceived by WorldCom personnel in a number of significant ways designed to conceal the improprieties from Arthur Andersen.²⁵¹

Nonetheless, the Examiner concludes that a finder of fact would find that Arthur Andersen was negligent, committed professional malpractice and breached its agreements with the Company, in failing to conduct its audits in accordance with Generally Accepted Auditing Standards ("GAAS"). Accordingly, the Examiner believes that WorldCom has claims against Arthur Andersen and certain of its former personnel who worked on the WorldCom engagement in the relevant period, arising from their conduct related to

²⁵¹ As discussed more fully below, certain members of WorldCom's financial and accounting departments deceived Arthur Andersen in several ways. Several of these persons were not made available for interviews by the Examiner. The Examiner's conclusions on Arthur Andersen's conduct and culpability are based on the record available to the Examiner. These conclusions could change if additional information is developed that is inconsistent with the current record.

WorldCom. Such claims and the legal and factual bases that support them are described in Section V.F.8 below.

Arthur Andersen's conduct is measured by whether the auditors designed and implemented appropriate audit procedures in accordance with GAAS. Its conduct is also measured by GAAP, since Arthur Andersen opined in its reports to the Company and to its shareholders that the Company's financial statements during the relevant period "present fairly, in all material respects, the financial position of [the Company], and the results of their operations and their cash flows . . . in conformity with accounting principles generally accepted in the United States." See, e.g., Report of Independent Public Accountants, WorldCom, Inc. Form 10-K, March 24, 2000. Arthur Andersen represented that it had performed its audits in accordance with GAAS and that, accordingly, it had a "reasonable basis" for these unqualified audit opinions.

GAAS required that Arthur Andersen plan and perform its audits to obtain reasonable assurance that the WorldCom financial statements were free of material misstatement. Arthur Andersen represented that it had examined, "on a test basis, evidence supporting the amounts and disclosures in the financial statements," and evaluated the overall financial statement presentation, accounting principles used and significant estimates made by the Company's Management. Id.

Arthur Andersen performed its audits of WorldCom's financial statements with awareness that the Company was a "maximum" risk client. Thus, in preparing for its WorldCom audits, Arthur Andersen appropriately performed detailed assessments of the risks of fraud and error in WorldCom's financial statements. Indeed, as a result of such assessments, Arthur Andersen identified not only the possibility of fraud but also particular

ways in which WorldCom's Management could fraudulently manipulate the Company's accounting in order to boost its earnings. Yet despite identifying such risks, Arthur Andersen failed to exercise the necessary care, skill, professional skepticism and competence to test adequately for the risks identified in its assessments.

Arthur Andersen was obligated by GAAS to incorporate audit procedures that would enable the auditors to "obtain reasonable assurance" that the financial statements were "free of material misstatement, whether caused by error or fraud." See SAS No. 1, AU § 110 ; SAS No. 82, AU § 316.01. Arthur Andersen's assessment of WorldCom's audit environment and the risk of material misstatement due to fraud or error should have been integral to a determination of what those specific audit procedures should be. SAS No. 82, AU § 316.12. While professional auditing standards provide auditors with discretion in determining the appropriate audit procedures to carry out, in light of its risk evaluations, Arthur Andersen was required to adopt sufficient audit procedures to limit the risks it had identified to appropriate levels. See SAS No. 82, AU § 316.29. Such audit procedures could have involved: (i) performing detailed reviews of the Company's quarter-end or year-end adjusting entries and investigating any that appeared "unusual as to nature or amount;" (ii) performing substantive analytical procedures at a detailed level; (iii) interviewing personnel involved in areas in which risk of material misstatement due to fraud had been assessed; and (iv) confirming contractual terms relevant to the recognition of revenues with customers and third parties. See SAS No. 82, AU §§ 316.29; 316.30.

The Examiner concludes that the facts support a finding that Arthur Andersen failed to carry out sufficient audit procedures that were warranted by the risks it identified in those areas where the fraudulent accounting occurred. Particularly, Arthur Andersen failed to

adjust properly its audit procedures to address and reduce the risks of fraud and error that it had identified in connection with the Company's financial statements. For example, both published guidelines and Arthur Andersen's own risk assessments for WorldCom identified "top-side" adjustments, (i.e., corporate adjustments made to journal entries after the books for a reporting period had closed), as a significant risk for potential manipulations. Notwithstanding these warnings, Arthur Andersen auditors failed to carry out substantive testing to assess whether significant top-side adjustments had been made by WorldCom and, if so, whether there was any justification for such adjustments. If Arthur Andersen in 2001 had drilled down to the general ledger to check for such adjustments in the line cost category – WorldCom's largest cost category — it would have found:

- Top-side adjustments called "Prepaid Capacity Costs" amounting to hundreds of millions of dollars every quarter starting in the first quarter of 2001;
- No corresponding Prepaid Capacity Costs adjustments for quarters prior to the first quarter of 2001;
- No backup data for the Prepaid Capacity Costs adjustments; and
- Virtually no one within the General Accounting group who could support the basis for the Prepaid Capacity Costs adjustments.

This would have been a signal to Arthur Andersen that this cost category needed critical scrutiny and might well have led to discovery of the fraudulent capitalization of line costs far earlier. However, because there was no substantive testing in this area, this fraud went undetected.

In addition to adjusting its audit procedures to account for the risks identified in its risk assessments, Arthur Andersen overlooked or failed to place appropriate significance on a series of "red flags" that may have lacked importance individually, but taken collectively, should have placed a reasonable auditor on notice of potential improper earnings

manipulation. Some of these “red flags” included: (i) Company performance trends that were significantly at odds with industry trends; (ii) limitations placed by former WorldCom Management on the auditors’ access to employees and documents; and (iii) excessive and repeated delays by WorldCom in providing requested revenue-related documents.

The Examiner has attempted to determine why Arthur Andersen failed to carry out more substantive testing, due to its risk assessments and the “red flags” that were apparent. There does not seem to be a ready explanation. In general, Arthur Andersen was willing to question senior Management about particular audit issues, but they then relied on the perceived integrity of former Management when plausible verbal explanations were provided. The Examiner does not suggest that reliance on Management’s integrity is not warranted in most instances to some significant degree. However, the Examiner observes that in addition to such reliance, a vigilant auditor also must corroborate such representations of Management to gain reasonable assurance that the reliance is well placed. This occurred far too infrequently with respect to Arthur Andersen’s WorldCom audits.

This is not to say that Arthur Andersen failed completely to carry out substantive testing of the sort that might have discovered some aspect of the fraud. Some substantive testing clearly was carried out. However, such testing was minimal, since Arthur Andersen’s primary methodology was to carry out a controls-based audit, under which detailed substantive testing was only undertaken in limited instances when Arthur Andersen determined that particular internal controls and processes did not adequately mitigate the risk of material misstatement due to fraud or error. Since Arthur Andersen was generally satisfied (it turns out erroneously) with the Company’s financial reporting processes and did

not identify any material internal controls deficiencies, the perceived need for such substantive testing was lessened.

The Examiner also must criticize Arthur Andersen for its conclusion that WorldCom's internal controls were not materially deficient or weak. KPMG, as part of the ongoing restatement process, has identified a host of material internal control deficiencies that appear to have existed during some or all of the relevant period. Even accounting for the fact that KPMG has had the benefit of hindsight in the restatement process, material internal control deficiencies identified by KPMG include a number that appears to have been overlooked or inexplicably discounted by Arthur Andersen auditors.

Arthur Andersen's lapses in its WorldCom audits are all the more disconcerting in light of the detailed risk assessments that Arthur Andersen performed, the experience of its auditors, and its intimate knowledge of the Company. Arthur Andersen's risk assessments highlighted the significant risks associated with WorldCom's financial statements. Further, the Arthur Andersen engagement team was quite stable during the relevant period, and thus the engagement team should have had extensive collective knowledge about these risks. The lapses are even more troubling because, by the late 1990's, Arthur Andersen and its accounting peers had been repeatedly warned by regulators and professional oversight bodies that the profession-wide trend to perform less substantive testing was fraught with the risks that fraud perpetrated by management would go undetected.

The Examiner acknowledges that Arthur Andersen was purposefully deceived by WorldCom personnel. This deception lessens the criticism fairly leveled at Arthur Andersen. Nonetheless, it is just such deception that an auditor is supposed to confront, by exercising professional skepticism in carrying out its audits. The Examiner concludes that Arthur

Andersen failed to exercise such professional skepticism, making it all the more likely that WorldCom's deception would go undetected for so long.²⁵²

With the benefit of hindsight, the Examiner observes that it is often easy to ascribe blame to those who were in a position to have acted, but did not. The Examiner has tried to avoid the use of such hindsight. Thus, the Examiner has examined Arthur Andersen's conduct taking into consideration the facts and evidence that were known, or, in the exercise of appropriate diligence, should have been known to the Arthur Andersen auditors at the time of their audit work, as well as the professional standards that were in effect during the relevant period. The Examiner's conclusions are based on this approach and these standards.

B. Limitations to the Examiner's Investigation

The Examiner and his professionals reviewed thousands of pages of documents and conducted or participated in many interviews of former members of the Company's Audit Committee, former and current WorldCom employees with responsibility for accounting, financial management, and internal audit functions, and senior members of the Arthur Andersen audit team. The documents reviewed included Arthur Andersen's workpapers prepared in connection with its annual audits of the Company's financial statements for the

²⁵² The Examiner in this Third and Final Report describes the more significant deceptions of the auditors that are known to the Examiner. The Examiner acknowledges that given governmental investigations, pending prosecutions and his inability to interview the main architects of the fraud, he may not have had the opportunity to determine the full scope of the deception of Arthur Andersen. Based on what the Examiner has learned, he believes the deception was significant but not so great as to relieve Arthur Andersen for failure to detect any aspect of the fraud. However, if the deception ultimately is determined to be significantly greater than known to the Examiner, then Arthur Andersen and its former engagement team may have lesser responsibility for the failure to have detected the fraud. Conversely, if subsequently discovered data disclose even more red flags and other indicators of potential fraud that the Arthur Andersen team disregarded, then the extent of Arthur Andersen's liability may be increased.

years 1999 – 2001, as well as documents located in the desk files²⁵³ of most of the senior auditors assigned to the WorldCom audit teams during the relevant period.

The Examiner's investigation, however, was hampered by some significant limitations that impeded his ability to identify all pertinent facts and assess all potential claims that the Company may have and the viability of defenses to such claims. Such impediments include the lack of access by the Examiner to those individuals who have been indicted and/or pled guilty to criminal charges arising from this matter, as well as the limited cooperation that the Examiner received from Arthur Andersen.

1. Lack of Access to Key Former WorldCom Officers and Employees

Due to the pendency of criminal proceedings and investigations, the Examiner was unable to interview certain key former WorldCom officers and employees who presumably would have relevant knowledge. These individuals include Messrs. Ebberts, Sullivan, Myers, Yates and Normand, and Ms. Vinson. The Examiner did obtain copies of documents from their files, as well as e-mail communications from some of these individuals. While such evidence is useful, the Examiner's conclusions are limited by the lack of testimonial evidence by the authors.

2. Arthur Andersen's Limited Cooperation

The Examiner received only limited cooperation from Arthur Andersen. The Examiner obtained from other sources copies of those documents and workpapers maintained by Arthur Andersen relating primarily to the annual audits and quarterly reviews performed by the auditors on WorldCom's consolidated financial statements for the relevant period.

²⁵³ A "desk file" contains the documents maintained by individual auditors in connection with their audit work, in their file cabinets, desks, computers, and their designated storage area on Arthur Andersen's computer network. Such documents included correspondence, draft and final versions of memoranda, schedules and handwritten notes.

Other than a handful of documents, the Examiner did not have access to any documents relating to Arthur Andersen's audits of WorldCom's financial statements for any years prior to 1999. Such documents presumably would have enabled the Examiner to understand better the basis for some of the mediocre assessments made by Arthur Andersen of WorldCom's former Management and accounting and audit practices in connection with at least the 1998 audit engagement, as well as the nature of proposed audit adjustments apparently made by the auditors in years prior to the relevant period and any reports of related internal controls deficiencies.

The Examiner also obtained few documents relating to Arthur Andersen's audits of the Company's international divisions. Those documents provided to the Examiner suggest the presence of significant internal control weaknesses and troubling audit practices at WorldCom's international divisions, some of which are reported on later in this Chapter. Further, with the exception of documents located in the desk files, the Examiner did not obtain copies of the electronic files of the auditors, any members of Arthur Andersen's Professional Standards Group ("PSG"), or other reviewing partners at the firm. Moreover, it is likely that a number of documents were missing from the production of documents provided to the Examiner, based on missing bates number ranges. Arthur Andersen's counsel generally ignored the Examiner's requests to obtain copies of the missing documents, as well as copies of all management comment letters Arthur Andersen provided to WorldCom and its international divisions.

The Examiner was able to interview the senior Arthur Andersen auditors responsible for the WorldCom audits during the relevant period.²⁵⁴ These Arthur Andersen witnesses

²⁵⁴ These included: the engagement partner for WorldCom's and its predecessor's audits starting with audit years 1994 through 2000; the engagement partner for the 2001 audit; the engagement manager for the 1999 and

were individually cooperative during their interviews. However, their counsel frequently objected to questions that sought to probe their recollections of particular audit procedures that Arthur Andersen employed unless the Examiner's counsel first provided the witnesses with the opportunity to access and review, during the limited time period allotted for their interviews, the full work-papers associated with each audit area at issue. Those workpapers were in the possession of Arthur Andersen's counsel and thus available for the witnesses' review prior to the interviews. Arthur Andersen's counsel also refused to produce any other former Arthur Andersen personnel to be interviewed.²⁵⁵

In addition to the interviews, the Examiner invited Arthur Andersen to supplement the statements of its witnesses with additional evidence relating to its audit procedures. Thus, by letter dated August 29, 2003, the Examiner questioned the absence of evidence in the workpapers of several procedures, including certain analytical procedures, that either had been planned but do not appear to have been implemented, or that would be expected but do not appear to have been planned. Such procedures related to the audits of areas respecting purchase price adjustments, inter-company balances, "top-side" adjustments in the line cost area, FAS 121 asset impairment reviews, and fixed assets. For weeks, Arthur Andersen's counsel did not respond to the letter, stating instead that they had taken the letter "under advisement." After repeated follow-up by the Examiner's counsel, Arthur Andersen's

2000 audits and audit partner for the 2001 audit; the audit partner responsible for the audits of the line cost area and certain revenue and reserve processes in 1999; an audit manager and later, engagement manager who worked on audits of the line cost area; and a senior auditor who worked on a number of audit areas including the 1999 and 2000 audits of certain revenue and capital expenditure areas.

²⁵⁵ For example, in early October, 2003, the Examiner's counsel requested that Arthur Andersen's counsel produce for interview three auditors who were understood to have had involvement in the audit of the Company's revenue areas during all or portions of the relevant period. Counsel for Arthur Andersen failed to produce these witnesses despite repeated requests. Also, an audit partner assigned to the WorldCom engagement until 1999 refused, through counsel and without explanation, the Examiner's request for an in-person or telephone interview.

counsel finally responded, in a letter dated October 21, 2003, and refused to provide information on the basis that the invitation unfairly and impermissibly imposed a burden on counsel to review his clients' workpapers and provide an analysis to the Examiner on matters that should have been addressed during the interviews of the witnesses. Yet, when the Examiner's representatives had sought to address those matters at the interviews, Arthur Andersen's counsel objected repeatedly to the witnesses responding as to their recollection unless they could first peruse the workpapers during the interviews.

Unlike most of the other interviews conducted by the Examiner where counsel for persons being interviewed generally were restrained in voicing objections to the Examiner's inquiries, Arthur Andersen's counsel objected repeatedly during the interviews of Arthur Andersen witnesses, making the interview process far more difficult and time-consuming than it needed to be. Such tactics demonstrably served to limit the nature and volume of information that was provided by Arthur Andersen's witnesses.

Despite Arthur Andersen's limited cooperation, the Examiner has obtained sufficient information to determine whether Arthur Andersen's audit procedures relating to the audit areas at issue were deficient and whether any claims arise from such deficiencies.

C. The Nature and Extent of the Accounting Irregularities

1. WorldCom's Improper Accounting Practices

The WorldCom accounting irregularities were conceived in a corporate culture where the ends often justified the improper means. During the relevant period, senior WorldCom executives were focused on meeting the Company-created unrealistic Wall Street expectations relating to the Company's growth at a time of burgeoning costs and a slowing of revenue growth. Even when WorldCom finally revised its guidance to Wall Street regarding

its earnings projections in November 2000, and again, in November 2001 and January 2002, the revised targets continued to be unrealistic given the true internal trends WorldCom was observing in its expenses and revenues. As the Examiner previously has noted, however, failure was not a word in the WorldCom corporate lexicon. Dissent was actively discouraged. Indeed, as detailed more fully below, deception of the external auditors was promoted.

The Examiner's previous Reports and the June 2003 Report of the Special Investigative Committee to WorldCom's Board of Directors have detailed the Company's improper accounting entries. Accordingly, the Examiner will not detail the improper entries or the practices that spawned them in this Third and Final Report. However, it is important to describe the nature of the fraudulent accounting entries in order to evaluate the performance of the Company's external auditor.²⁵⁶

WorldCom's improper accounting took a number of forms, with the common goal of boosting revenues and reducing expenses. WorldCom's financial statements were manipulated initially by improper releases of accrued line cost, revenue and other reserves and, when the Company's reserves had been exhausted, by improper capitalization of line cost expenses. A summary of the improper accounting practices follows.

²⁵⁶ The magnitude of the Company's accounting irregularities continues to be investigated by KPMG in its reaudit of WorldCom's financial statements for the years 2000 and 2001 and its audit of the year 2002. Thus far, the Company has announced three proposed restatements of its financial statements for the period between 1999 and 2001. WorldCom's first two proposed restatements impacted the Company's EBITDA by about \$7.1 billion. This included a June 24, 2002 proposed restatement of \$3.8 billion for improperly capitalized line costs and an August 8, 2002 proposed restatement of \$3.3 billion for improper accounting reserves, revenues and miscellaneous non-revenue items. The Company also announced a third proposed restatement on March 13, 2003, with an aggregate value of \$79.8 billion, consisting of a write-off of all its existing goodwill and a substantial write-down of the carrying value of its property, plant and equipment ("PP&E") and intangible assets. The decision whether any further adjustments to the Company's prior period financial statements are necessary will be made by the Company at the conclusion of KPMG's re-audits for the relevant period.

a. Manipulation of Line Cost Accruals and Reserves

By at least 1999, WorldCom was relieving some of the pressure of its spiraling line costs on its bottom line by releasing line cost reserves into income, which resulted in a corresponding reduction in line cost expenses reported on the Company's income statement. The manipulation of line cost reserves was achieved through a number of means, including: (i) the failure to release reserves in accordance with GAAP, at the point when they were no longer necessary; (ii) the release of some reserves without any analysis to support that they were excess and should be released; and (iii) the use of reserves recorded for other purposes to offset line cost expenses.

These releases were recorded as "top-side" adjustments in the Company's general ledger, taking the form of round-dollar multi-million dollar journal entries without any supporting documentation.²⁵⁷ For example, a \$239 million journal entry was recorded after the close of the fourth quarter of 1999, releasing certain international line cost reserves. The sole support for the entry consisted of a post-it note bearing the notation "\$239,000,000." Another journal entry, for \$369,985,000, was recorded with no support in the first quarter of 2000, releasing line cost reserves to reduce the international line cost expenses. One of the most significant line cost reserve releases occurred after the close of the third quarter of 2000 and consisted of journal entries totaling \$828 million in releases of line cost reserves to reduce domestic line costs for the third quarter. None of these entries were supported by documentation. All of these journal entries were recorded following the close of the quarter

²⁵⁷ Other terms for such "top-side" entries are "non-standard entries," "post-closing entries," "manual adjustments," "management entries," or "unusual adjustments." They are defined, generally, as "financial statements changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions." See Panel on Audit Effectiveness, Report & Recommendations, at n.22 (Aug. 31, 2000).

but prior to the release of financial statements, often without the knowledge or over the objections of the personnel with responsibility for determining when such reserves should be accrued or released.

The reserve manipulations were facilitated at times when employees failed to release excess reserves when required, hoarding them instead until a future point. Accumulating excess reserves in “cookie jars” and releasing them at the next “rainy day” is a well-known type of earnings manipulation but improper according to GAAP.²⁵⁸ WorldCom personnel would “bleed” these hoarded reserves into income when its earnings targets were threatened by a growing gap between actual and projected earnings. At other times, releases of accrued reserves would be recorded, overriding determinations by other personnel that such reserves were needed to ensure that the Company had accrued the appropriate level of reserves in relation to its anticipated liabilities. The manipulation of the reserves occurred at least in 1999 and 2000 and inappropriately increased the Company’s EBITDA by about \$3.3 billion.

b. Improper Recognition of Revenues to “Close the Gap”

Beginning in at least 1999 and continuing through 2001, the Company boosted its earnings by improperly releasing revenue and other reserves into earnings. This again was achieved by recording large “top-side” entries after the close of each quarter but before financial statements were released to achieve the anticipated earnings targets. This effort took on greater importance as the Company’s finances deteriorated through most of 2001, with the involvement of personnel in the Company’s Business Operations and Revenue Accounting Groups, in what was labeled the “Close the Gap” effort. The Close the Gap

²⁵⁸ GAAP requires that reserves be released when it is determined that they are no longer needed for the purpose for which they had been accrued. Specifically, GAAP provides that the “effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both.” Accounting Principles Board (“APB”) Op. No. 20 (Accounting Changes), ¶ 31 (July 1971).

initiative involved officers at the highest level of the Company's former senior Management. The "Gap" was the difference between earnings targets, as contained in the Company's "guidance" to Wall Street, and the actual earnings that were going to be reported by the Company's operating units and as evidenced by the Company's internal monthly revenue reporting schedules (the "MonRevs").

Many of the Close the Gap items appear to represent legitimate efforts to increase the Company's revenues, such as a proposal to accelerate by one quarter the installation of a telephone system purchased by a government customer so that the Company could recognize the revenue from that contract during an earlier quarter. As such, the Close the Gap effort was not inherently improper. Nor was it unusual in that many public companies engage in such efforts to maximize their revenues towards the end of a reporting period.

However, other Close the Gap "opportunities" involved releases of revenue reserves that appear to have lacked support or were based on aggressive changes in the Company's accounting policies, many of which were not disclosed in the Company's public filings. Further, many of these Close the Gap items formed the basis for the "top-side" adjustments that eventually were made by the Revenue Accounting Group at the end of each quarter. Employees of the Group that originated these Close the Gap items have indicated that they did so with the understanding that Mr. Sullivan and the Company's accountants would review them to ensure that they complied with GAAP. However, the Examiner has not identified any evidence that these options were reviewed with Arthur Andersen prior to their being recognized as revenue. Arthur Andersen's involvement in reviewing these items appears to have taken place primarily, as would normally be expected, in the course of its annual audits.

During the relevant period, a handful of senior WorldCom officers closely tracked the Company's revenues and expenses and the Close the Gap process through frequent meetings and production of a number of periodic schedules.²⁵⁹ The main schedules reviewed by senior officers included a monthly and quarterly revenue report known as the "MonRev" and a report on the Company's capital expenditures known as the "CapEx Report." The preliminary MonRev was compiled by the Company's Revenue Accounting Group based on data gathered from the Company's many billing platforms, which summarized the customer billings and revenues from all of WorldCom's business.

At the end of each quarter, a final quarterly MonRev was prepared and distributed by the Revenue Accounting Group, containing the various "top-side" adjustments that Mr. Sullivan instructed them to record to close the gap between actual and projected earnings. Many of these "top-side" adjustments originated from the quarterly Close the Gap lists and had been characterized as "aggressive" by employees in the Revenue Accounting Group, because they believed such adjustments would have the most significant impact on earnings. The "top-side" adjustments were recorded by junior accounting clerks as journal entries in the WorldCom general ledger, with little or no supporting documentation. These were adjustments that, when taken together, substantially adjusted the general ledger revenue amounts to MonRev "target" amounts, closing any gaps between targeted and projected actual earnings. These entries were characterized by the revenue reporting and financial reporting personnel as "extraordinary" or "non-recurring" adjustments and were reflected in the "Corporate Unallocated" and "Extraordinary Revenue Item" lines of the MonRev and detailed in an accompanying schedule known as "Attachment X." The items reflected in the

²⁵⁹ One such schedule was identified as having been prepared in June 2001, for a power point presentation to the Board of Directors. However, it is uncertain whether it was presented to the WorldCom Board; none of the Directors who were interviewed recalled seeing such a presentation or hearing the phrase "Close the Gap."

Corporate Unallocated schedules “spiked” in the last months of the second and third quarters of 2000 and the second, third and fourth quarters of 2001, in amounts ranging from \$136 million to \$257 million. During some periods in 1999 and 2000, a so-called “normalized” MonRev report was prepared, excluding these “extraordinary” adjustments, so that “extraordinary” or “nonrecurring” revenues would be excluded from the calculation of commissions for the sales force.

Arthur Andersen did not receive the “full” MonRev but only the summary schedules, with some selected detail schedules. The Arthur Andersen personnel responsible for this audit area were not aware of the existence of the “full” MonRev or that the MonRev they received was only a small component of the schedules distributed to a limited number of WorldCom’s former senior Management. These Arthur Andersen auditors were also not aware of the existence of the “normalized” MonRev or its use. Arthur Andersen was provided with copies of the Corporate Unallocated Schedule, which it tested as part of its annual audits. Arthur Andersen was aware that the items reflected on this schedule were “top-side” adjustments made by WorldCom to incorporate such items as revenue reserve releases pursuant to settlements of customer disputes and reclassifications of revenue items.

Based in part on the Close the Gap initiatives, the Company was able to achieve its projected double-digit growth in a number of quarters, especially in the second and third quarters of 2001. Once sufficient opportunities had been selected from the Close the Gap list bridging the gap between actual and projected earnings, the remaining items would be deferred for possible use in the next quarter. The Company has thus far identified \$633 million from the Close the Gap initiative as proposed restatement items.

c. The Improper Capitalization of Line Costs

By April 2001, WorldCom had exhausted the reserves that it could release into earnings.²⁶⁰ The Examiner understands that, beginning in the first quarter of 2001, Mr. Sullivan directed that hundreds of millions of line cost expenses be capitalized, subtracting them from what otherwise would have been expenses against the Company's earnings for the successive quarters, and disguising most of those reductions by transferring them as additions to the Company's fixed assets. The capitalization of line costs was carried out with employees in the Company's General Accounting Office recording, at the direction of Mr. Sullivan and members of senior financial Management, multi-million round dollar journal entries in the general ledger titled "Prepaid Capacity Costs." The journal entries were recorded after the close of each quarter and just prior to the quarterly release of the Company's Form 10-Q's and accompanying financial statements. The journal entries lacked any supporting documents or explanations. Such entries totaled \$3.8 billion during the period between the first quarter of 2001 through the first quarter of 2002, reducing line cost expenses for each quarter, primarily through the transfer of such expenses to fixed asset accounts. Taken together, these entries allowed the Company to hold its line cost expense to revenue (E/R) ratio at 42 percent for those quarters, which was close to its historic E/R ratio. Without such capitalizations, WorldCom's line cost E/R ratio would have grown to over 50 percent, sharply diminishing WorldCom's reported results. The following journal entries were recorded as "Prepaid Capacity Costs" in the general ledger during this period:

²⁶⁰ On April 16, 2001, the Company's Chief Operating Officer sent an e-mail to the Controller regarding the deteriorating ratio between WorldCom's line cost expenses and the Company's revenues, observing: "last year we released a good deal of reserves that we don't have this year to release." The Controller confirmed: "You are correct, there are no reserves to take."

Improper Manipulation of Line Costs by Capitalization and Other Adjustments

Quarter	Date of Journal Entry	Total Amount of “Prepaid Capacity Costs” Entries Reducing Line Costs	Amounts Capitalized	Amount of Other Adjustments ²⁶¹
1Q 2001	April 20, 2001	\$771,000,000	\$544,000,000	\$227,000,000
2Q 2001	July 17, 2001	\$610,000,000	\$560,000,000	\$ 50,000,000
3Q 2001	October 19, 2001	\$742,745,000	\$742,745,000	
4Q 2001	January 23, 2002	\$941,000,000 ²⁶²	\$841,000,000	\$100,000,000
1Q 2002	April 12, 2002	\$718,204,000	\$718,204,000	
	April 17, 2002	\$100,000,000	\$100,000,000	

WorldCom personnel distributed the Prepaid Capacity totals principally to the property, plant and equipment (“PP&E”) accounts. The entries resulted in a significant variance between the amount of capital expenditures publicly reported by the Company and the amounts internally tracked by those responsible for budgeting and overseeing the planning for the Company’s capital expenditures.

2. Management’s Deception of the External Auditors

The Examiner investigated whether Arthur Andersen was aware of the accounting manipulations carried out by the Company in the relevant period. The evidence is not in dispute: Arthur Andersen had no knowledge of the improper capitalization of line costs or the Company’s improper manipulation of its line cost, revenue and other reserves to inflate its earnings.

The Examiner has further investigated to determine how it was that Arthur Andersen failed to become aware of the accounting fraud, particularly given the significant size of many of the journal entries by which the manipulations were implemented. The Examiner

²⁶¹ The other adjustments include reductions of other reserves and certain reclassifications of expenses.

²⁶² The journal entry for 4Q’01 was recorded in the amount of \$1.001 billion with an offset of \$60 million for a depreciation adjustment.

has determined that one reason Arthur Andersen failed to become aware of the manipulations was that WorldCom personnel shielded many of these entries by creating misleading schedules for the purpose of deceiving the external auditors. Examples of such deceptive schedules are provided below.

a. The “Special MonRevs”

The most glaring manipulation of schedules provided to the external auditors occurred in the preparation by the Revenue Accounting Group of a “Special MonRev” report during each of the third and fourth quarters of 2001. This report was provided to Arthur Andersen and concealed from the auditors the material “top-side” adjustments that had been made in those quarters. At the third quarter, reportedly, there was concern that Arthur Andersen might question the large dollar amounts that were being reflected in the MonRev’s Corporate Unallocated line and schedules. Thus, WorldCom employees modified the MonRevs for the third and fourth quarters that had been circulated to members of former Management, redistributing some of the amounts reflected in the Corporate Unallocated line to other lines on the schedule, categorizing these amounts as revenues from the various sales channels, rather than large “top-side” corporate revenue adjustments. The redistributed amounts were also spread over the three months of the quarter so that it would not appear that such amounts had been recognized as revenue during the final month of the quarter, thereby minimizing “red flags” for Arthur Andersen.

The “Special MonRevs” apparently were created to prevent Arthur Andersen from asking probing questions.²⁶³ The plan to deceive Arthur Andersen appears to have worked,

²⁶³ One employee disputed that the third quarter 2001 “Special MonRev” was intended solely for Arthur Andersen and stated that it was intended to substitute as the final MonRev circulated to the Company’s Management. The Examiner did not find this explanation credible.

since the auditors were not aware that the reports they were provided differed materially from the reports used by the Company.

b. The Concealment of Line Cost Reserve Releases

The Company improperly recorded in 1999 and 2000 releases of line cost reserves that had no support. Many of these releases were primarily grouped together for the purposes of the Company's books and records under a line item titled "Settlements." Other of these releases were recorded to reduce international line cost expenses.

A number of these releases were recorded with the knowledge and over the objections or refusals of mid-level finance or operational personnel, including a total of \$150 million in reserve releases during the second, third and fourth quarters of 1999, and \$330 million in releases during the first and second quarters of 2000. When those employees learned of these entries, they unsuccessfully protested them and expressed concern about a potential under-accrual of reserves. They refused to release additional line cost reserves of \$50 million in the fourth quarter of 1999, and \$60 to \$70 million in the fourth quarter of 2000 that had been requested by WorldCom Management. Even so, these same employees also understood that their protests should be confined to internal discussions and that they should not discuss their concerns or these entries with Arthur Andersen. Accordingly, these concerns were not communicated to Arthur Andersen. Instead, the employees provided Arthur Andersen with very general explanations for the consolidated amounts of the Settlements, stating that they had resulted primarily from the settlement of client billing disputes or from changes in the Company's accounting policies.²⁶⁴ In some cases, the reserve releases were indeed due to changes in accounting policies that were identified for Arthur Andersen. However, in other

²⁶⁴ It does not appear that these employees had any knowledge of additional domestic line cost reserve releases totaling about \$1.117 billion that were recorded at the direction of corporate Management during the third and fourth quarters of 2000.

cases, these amounts appear to have been recorded without support in order to artificially reduce line costs and meet earnings targets.

During the second quarter of 2000, Arthur Andersen was apparently provided a schedule which did not tie to the general ledger but was prepared instead to provide an “audit trail” for the auditors. Thus, the schedule provided to Arthur Andersen reflected a line cost reserve release that totaled \$100 million less than the actual \$255 million reserve release and \$100 million higher line cost expenses than those recorded by the Company in the general ledger. The total amount of domestic and international line cost reserve releases for 2000 vastly exceeded the total of such releases for 1999.

Arthur Andersen analyzed changes in the Company’s accounting policies relating to the consolidated line cost balances, such as changes in the period of time for which the Company accrued reserves for backbilling of line costs by its suppliers. Nevertheless, Arthur Andersen did not probe for any detail or perform any substantive testing to ascertain whether there was support for the individual reserve releases. Arthur Andersen also does not appear to have tested the release of international line cost reserves. If WorldCom employees had been forthcoming with the auditors about the nature and timing of these unsupported reserve releases recorded after the close of the quarter, Arthur Andersen presumably would have sought to review the particular entries at issue.

c. The Machinations to Hide the Capitalization of Line Costs

The improper capitalization of line costs was initiated through a series of multi-million dollar journal entries reducing line costs and transferring such amounts to a series of fixed asset accounts beginning in the first quarter of 2001. Because the scheme’s architects were aware that Arthur Andersen would not normally review individual journal entries and would focus instead on unusual variances in the consolidated account balances, the architects

took steps to reduce the likelihood that Arthur Andersen would notice and question these entries.

First, while huge Prepaid Capacity Costs journal entries were recorded each quarter, these amounts then were spread out over a series of asset accounts, principally in the Company's PP&E accounts. Second, those responsible for these entries engaged in a shell game, transferring some of these amounts out of the accounts that Arthur Andersen indicated they were preparing to test. Thus, in August 2001, Arthur Andersen informed former Management that it planned to review the Company's Construction in Progress ("CIP") accounts as part of its field test work for the 2001 audit. Accordingly, several weeks later, Company employees transferred out of the CIP accounts those portions of capitalized line costs they had placed in CIP accounts for the first and second quarters of 2001 into an asset clearing account. Several days later, those amounts were transferred again and disguised as 23 assets recorded in several accounts in the Property Accounting sub-ledger. Similar steps were taken during subsequent quarters. By engaging in this shell game, those responsible for the improper entries stayed several steps ahead of Arthur Andersen in shielding these entries from the auditors.

d. The Concealment of "Extraordinary Activity" in Recognition of Revenue Attributed to Minimum Deficiencies

During the second and third quarters of 2000, the Company released and recognized as revenues over \$233 million of reserves that had been previously accrued relating to liabilities owed by the Company's customers under "take or pay" contracts requiring minimum usage amounts. Those reserves, titled "Minimum Deficiencies," appear to have been identified and released into revenues through "top-side" adjustments at the end of the second and third quarters of 2000. Previously, the Company had historically recorded the

Minimum Deficiencies as accounts receivable, simultaneously offsetting such receivables with a dollar-for-dollar reserve. The Company would recognize revenues for these receivables by releasing the reserves when these sums were actually collected from the customers.

WorldCom was not historically active in collecting such amounts from its customers. During 2000, these reserve balances amounted to about \$180 million. Mr. Sullivan directed that \$100 million of these reserves be released at the end of the second quarter of 2000 due to a shortfall in revenues. This was achieved through the recording on the general ledger of three journal entries without any supporting documentation, leaving the Company under-reserved for its Minimum Deficiency billings. These and certain smaller releases depleted this reserve account. In the next quarter, Mr. Sullivan directed the release of another \$133 million, resulting in a substantial debit balance in the Minimum Deficiency reserve that was offset by an increase in bad debt expense.

As part of the 2000 audit, Arthur Andersen requested schedules reflecting the Company's revenue reserves for the legacy WorldCom and MCI groups. Employees in the Revenue Accounting and Financial Reporting Groups delayed providing this information for over three months due to concerns about the "extraordinary activity" that such schedules would present, including the debit reserve balances in the WorldCom Group balances. The legacy WorldCom Group reserve balances had not been replenished by year-end. Recognizing that they had to provide the information to the auditors, the WorldCom employees manipulated the data by consolidating the operations of the legacy WorldCom and MCI Groups, even though Arthur Andersen had requested separate schedules for the Trackers groups, and such separate schedules existed. However, the consolidated schedules

provided to the auditors combined the Minimum Deficiency reserve balances of both groups, drastically reducing the WorldCom Group debit balance and shielding the “extraordinary activity” from the auditors. WorldCom did not provide Arthur Andersen – and Arthur Andersen did not press for – monthly detail schedules for these revenue reserves.

Thus, by presenting consolidated quarterly schedules to Arthur Andersen, WorldCom’s former Management withheld from the auditors documents that would have raised questions about “extraordinary activity.” The schedules actually provided to Arthur Andersen did not tie to the general ledger. The auditors did question the small remaining debit balance in the combined reserves. Management explained that the Company had changed its policy and was aggressively pursuing the collection of Minimum Deficiency billings, but had reserved too large an amount of its reserves. Since the debit balance was immaterial, Arthur Andersen did not pursue the issue. Arthur Andersen also did not review this purported change in accounting policy to ensure that it was compliant with GAAP. This incident is an example of former Management taking advantage of its knowledge of audit procedures that Arthur Andersen would employ in order to shield fraudulent accounting. Unfortunately, it is also an example of Arthur Andersen failing to press for the information it had originally requested or to take note of the unusual delay in obtaining the requested schedules from Management.

e. “Massaging” Corporate Consolidated Credit Amounts

During the fall of 2000, the Company’s senior financial Management was engaged in a complicated effort to allocate the Company’s operations, revenues, expenses and liabilities amongst the two Tracker groups that were going to be created — the MCI Group and the WorldCom Group. See Section VII, infra. Arthur Andersen advised the Company as to particular allocation options and, once the Trackers became effective, audited the financial

statements associated with each of the groups, including the allocation methodology that the Company disclosed and applied.

During the allocation planning process, the Company's financial planning analysts prepared schedules reflecting proposed allocations for the Company's SG&A expenses based on the amounts recorded for 1999 through the second quarter of 2000. Those schedules apparently included a line item titled Corporate Consolidated that reflected significant and unexplained multi-million dollar amounts. Some of these amounts have since been identified as representing improper reductions to line cost expenses through reserve releases.

One WorldCom employee was reportedly concerned that the schedules reflecting such large amounts on this line might result in difficult questioning by the auditors. Accordingly, employees were directed to revise the schedules so that the Corporate Consolidated credits were redistributed to other lines and accounts on the schedule. An October 23, 2000 email stated: "You might need to massage your numbers . . . so that the large credit in the Corp Consol rollup does not show on the reports given to the auditors and investment bankers as this might give rise to some uncomfortable questions." A subsequent email instructed: "As far as the presentation of the Tracker SG&A, I would not show anything directly from Essbase or anything regarding the allocation of the Corp. adjustments. I think to show SG&A after the sprinkling of the Corp adjustments to the Tier 1 is ok. . . ."

The Examiner has not been able to determine whether this schedule was ultimately provided to Arthur Andersen in manipulated form, and if so, what steps Arthur Andersen took to test the schedule. This incident, however, is another example of efforts by WorldCom's former Management to minimize and avoid potential questions from the

external auditor by concealing unusual variances in account levels. Such practices appear to have been endemic to WorldCom.

D. The Liability of WorldCom’s Officers and Employees Arising out of the Accounting Fraud

The Examiner recommends that the Company has claims for fraud, civil conspiracy, and breach of fiduciary duties against Mr. Sullivan, who apparently masterminded the accounting fraud, and against David Myers, Buford Yates, Jr., Betty Vinson, and Troy Normand, all of whom pled guilty to criminal charges arising out of the accounting fraud. In addition, the Examiner recommends that the Company consider claims against Mr. Ebbers for breach of his fiduciary duty of care because, at a minimum, he failed to oversee adequately the preparation of WorldCom’s financial statements and made misleading representations about the accuracy of WorldCom’s financial statements to the Board, the Audit Committee, external auditors, shareholders and the public.

1. Fraud and Civil Conspiracy

a. Legal Standards

(i) Fraud

Mississippi law requires a plaintiff asserting a fraud claim to establish a “knowing and intentional misrepresentation,” reasonably relied upon that caused injury.²⁶⁵ Thus, to prove fraud under Mississippi law, a plaintiff must prove, by clear and convincing evidence, the following:

²⁶⁵ See Black v. Carey Canada, Inc., 791 F. Supp. 1120, 1123 (S.D. Miss. 1990). In a New York forum, the “most significant contacts” choice-of-law test typically applies to tort or tort-like claims analysis. See Solow v. Stone, 994 F. Supp. 173, 177 (S.D.N.Y. 1998); Granite Partners L.P. v. Bear, Stearns & Co., 17 F. Supp. 2d 275, 306 n.16 (S.D.N.Y. 1998). This test requires a court to apply the law of the state with the most significant contacts to the tortious wrongdoing. Under the application of this test, the Examiner concludes that Mississippi law would likely apply because the accounting fraud mostly appears to have occurred in Mississippi.

(1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) the speaker's intent that the representation should be acted upon by the hearer and in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) the hearer's reliance on the representation's truth; (8) the hearer's right to rely thereon; and (9) the hearer's consequent and proximate injury.²⁶⁶

(ii) Civil Conspiracy

To establish a civil conspiracy claim under Mississippi law, a plaintiff must show “a combination of persons for the purpose of accomplishing an unlawful purpose or a lawful purpose unlawfully.”²⁶⁷

b. The Accounting Fraud

(i) The Fraudulent Scheme

As the Company’s financial condition progressively worsened, Mr. Sullivan and his subordinates appear to have recognized that if WorldCom’s poor financial condition became public, WorldCom’s stock would precipitously decline and WorldCom would lose the investing public’s confidence and its investment grade bond rating. Mr. Sullivan, in conjunction with certain other senior executives and Accounting Department employees, deceived the investing public by manipulating WorldCom’s financial statements to camouflage the Company’s poor financial condition. The evidence reviewed by the Examiner reveals that Mr. Sullivan concocted a scheme pursuant to which he directed his subordinates to, among other things, improperly release line cost reserves into income, improperly recognize revenue, and improperly treat line costs as capital expenditures.

²⁶⁶ Holland v. Mayfield, 826 So. 2d 664, 674 (Miss. 1999); accord Nichols v. Tri-State Brick & Tile Co., Inc., 608 So. 2d 324, 330 (Miss. 1992); Mayfield Motor Co. v. Parker, 75 So. 2d 435, 437 (Miss. 1954); Mississippi Law of Torts § 10:1. Both the Mississippi and Federal Rules of Civil Procedure require a plaintiff to plead the elements of fraud with specificity. See Miss. R.Civ.P. 9(b); Fed. R.Civ.P. 9(b). Therefore, the heightened pleading requirement would apply to a fraud claim pursued in either a Mississippi or a federal court.

²⁶⁷ See Levens v. Campbell, 733 So. 2d 753, 761 (Miss. 1999) (numerous citations omitted).

Through these fraudulent accounting practices, Mr. Sullivan and his subordinates apparently hid the Company's true financial condition. Four former WorldCom employees have pled guilty to criminal charges arising out of this fraudulent scheme: Controller David Myers, Director of General Accounting Buford Yates, Jr., and Accounting Department employees Betty Vinson and Troy Normand. In addition, a federal grand jury indicted Mr. Sullivan on charges of conspiracy to commit securities fraud and securities fraud.²⁶⁸

(ii) Mr. Sullivan's Indictment

Mr. Sullivan's indictment details the fraudulent misconduct engaged in by Mr. Sullivan and his subordinates (which the Examiner's Reports corroborates in many respects) to manipulate the Company's reported earnings, as follows:

- In October 2000 and February 2001, Mr. Sullivan directed his subordinates to make accounting entries on WorldCom's general ledger by crediting line cost expense accounts and debiting, in corresponding amounts, various reserve accounts. These entries reduced publicly reported line costs by hundreds of millions of dollars in the third and fourth quarters of 2000.
- Mr. Sullivan later created a scheme in which WorldCom treated line cost expenses as capital expenditures, rather than a current expense. Pursuant to this scheme, he directed his subordinates, including Messrs. Myers, Yates, and Normand and Ms. Vinson to make journal entries in WorldCom's general ledger transferring billions of dollars from expense accounts to capital expenditure accounts.
- In particular, in April 2001, Mr. Sullivan directed his subordinates to transfer approximately \$771 million from line cost expense accounts to capital expenditure accounts.
- In July 2001, Mr. Sullivan directed his subordinates to adjust WorldCom's books by transferring approximately \$560 million from line cost expense accounts to capital expenditure accounts.
- In October 2001, Mr. Sullivan directed his subordinates to adjust WorldCom's books by transferring approximately \$743 million from line cost expense accounts to capital expenditure accounts.

²⁶⁸ Mr. Sullivan has pled not guilty to those charges.

- In February 2002, Mr. Sullivan directed his subordinates to adjust WorldCom's books by transferring approximately \$941 million from line cost expense accounts to capital expenditure accounts.
- In April 2002, Mr. Sullivan directed his subordinates to adjust WorldCom's books by transferring approximately \$818 million from line cost expense accounts to capital expenditure accounts.

See Sullivan Indictment, ¶¶ 20-33.

(iii) The Guilty Pleas

Messrs. Myers, Yates, and Normand and Ms. Vinson each pled guilty to criminal fraud charges in connection with this scheme. In particular, Mr. Myers, the Company's Controller, who reported directly to Mr. Sullivan, pled guilty to three counts of securities fraud, under 15 U.S.C. §§ 78j & 78m, and conspiracy charges, under 18 U.S.C. § 371, based upon the falsification of WorldCom's accounting records. He claimed "senior management" instructed him to falsify the books, but his plea agreement did not specify who in senior management did so.²⁶⁹ In addition to these federal charges, Mr. Myers also pled guilty to one count of conspiracy to commit securities fraud under Mississippi law.²⁷⁰

Mr. Yates, the Director of General Accounting, who reported to Mr. Myers and in some instances to Mr. Sullivan, pled guilty to securities fraud, under 15 U.S.C. §§ 78j & 78m, and conspiracy charges, under 18 U.S.C. § 371, based upon the fraudulent adjustments he made to WorldCom's financial statements. He claimed that his "supervisors" (whom he identified as Mr. Myers and Mr. Sullivan) directed him to make these fraudulent adjustments.²⁷¹ At his guilty plea allocution, Mr. Yates stated that he understood the

²⁶⁹ United States v. Myers, 02 CR 1261, Transcript of Guilty Plea Allocution, at pp. 14-15 (S.D.N.Y. Sept. 26, 2002).

²⁷⁰ See Press Release of Mississippi Attorney General, found www.ago.state.ms.us/news-events/oct02news.htm

²⁷¹ United States v. Scott D. Sullivan and Buford Yates, Jr., 02 Cr. 1144, Transcript of Guilty Plea Allocution of Buford Yates, Jr., at p. 14 (S.D.N.Y.).

fraudulent accounting entries in October 2000 had “the effect of . . . reduc[ing] WorldCom’s reported expenses and increas[ing] WorldCom’s reported net revenue by \$800 million.”²⁷² He further testified that “the purpose of these adjustments was to . . . inflate WorldCom’s reported earnings in order to meet the expectations of securities analysts and mislead the investing public of the company’s financial condition.”²⁷³

Mr. Normand and Ms. Vinson, both of whom reported to Mr. Yates, each pled guilty to two counts of securities fraud, under 15 U.S.C. §§ 78j & 78m, and conspiracy charges, under 18 U.S.C. § 371. Both stated that their “superiors” ordered them to enter false adjustments to WorldCom’s accounting ledger.²⁷⁴ Mr. Normand and Ms. Vinson further stated that despite their concerns about this accounting manipulation, they continued making the fraudulent accounting entries when their supervisors told them to do so.²⁷⁵

c. The Causes Of Action for Fraud and Civil Conspiracy

As detailed below, the Examiner believes that sufficient evidence exists to establish *prima facie* fraud and civil conspiracy claims against Messrs. Sullivan, Myers, Normand, and Yates and Ms. Vinson based on the alleged accounting fraud and that the Company should consider pursuing such claims.

i. Mr. Sullivan

The evidence reviewed by the Examiner indicates that Mr. Sullivan committed fraud by “masterminding” the accounting manipulations. As discussed above, to prove fraud under Mississippi law, a plaintiff must prove a “knowing and intentional misrepresentation”

²⁷² Id.

²⁷³ Id. at 15.

²⁷⁴ United States v. Betty Vinson, 02 Cr. 1329, Transcript of Guilty Plea Allocation, at p. 30 (S.D.N.Y. Oct. 10, 2002); United States v. Troy Normand, 02 Cr. 1341, Transcript of Guilty Plea Allocation, at p. 44 (S.D.N.Y.) Oct. 10, 2002).

²⁷⁵ Vinson Allocation, at p. 31; Normand Allocation, at p. 18.

reasonably relied upon that caused injury. Mr. Sullivan's misconduct appears to meet this standard. He allegedly directed his subordinates to make fraudulent accounting entries, which directly led to false material misrepresentations about WorldCom's financial health. Mr. Sullivan allegedly knew the falsity of these fraudulent accounting entries. The Company relied upon the accuracy of these entries in filing misleading financial statements with federal securities regulators and in representing to the investing public the false financial results. As a result of these apparently fraudulent accounting practices, the Company suffered injury in the form of deepening insolvency. As detailed further in the damages discussion in Section VII.G, *infra*, the misleading financial statements permitted the Company to incur substantial debt well beyond its means to repay. When WorldCom's true financial condition came to light, the Company filed for bankruptcy shortly thereafter.

Similarly, Mr. Sullivan's misconduct, as detailed above, satisfies the elements of civil conspiracy. He acted with and directed other persons (*i.e.*, Messrs. Myers, Normand and Yates and Ms. Vinson) to manipulate illegally WorldCom's financial statements.

ii. Messrs. Myers, Normand, and Yates and Ms. Vinson

Messrs. Myers, Normand, and Yates, and Ms. Vinson each pled guilty to making fraudulent accounting entries. In their guilty plea allocutions, each confirmed that they knew of these entries' unlawfulness at the time that they made them. Furthermore, each confirmed that they knew that these accounting practices enabled the Company to inflate its profits. Thus, they substantially contributed to the scheme that injured WorldCom by permitting WorldCom's officers to overstate profits, which boosted the Company's credit rating and allowed it to borrow substantial funds, thereby deepening the Company's insolvency. The Examiner believes that the above facts are sufficient to establish *prime facie* fraud and civil

conspiracy claims against Messrs. Myers, Yates, and Normand, and Ms. Vinson and that the Company should consider pursuing such claims. Indeed, in a civil proceeding, the guilty pleas would establish both the fraudulent nature of the accounting manipulations and the fact of the conspiracy under principles of collateral estoppel.²⁷⁶

2. Breach of Fiduciary Duties

a. Officers and Employees Engaged in the Accounting Fraud

Any officers of the Company who had knowledge of, and/or exercised a high degree of recklessness in not being aware of, the accounting irregularities, may be held civilly liable to the Company based on breaches of their fiduciary duties of care, loyalty, and good faith. See Appendix A. As officers, those individuals owed the Company the duties of “Obedience, Loyalty and Diligence.”²⁷⁷ In essence, they had “the duty to comply with the law[;] . . . a duty of undivided good faith since they are fiduciaries and trustees of their corporation and stockholders[; and]. . . a duty to exercise reasonable care and prudence, and not be mere ornaments and figureheads.”²⁷⁸

Accordingly, Messrs. Myers, Yates, and Normand and Ms. Vinson, who have already pled guilty to criminal fraud in connection with the Company’s accounting fraud, and Mr. Sullivan, who appears to have masterminded the accounting fraud and has been criminally indicted for the misconduct, all breached their fiduciary duties to WorldCom. At a minimum, these individuals breached their fiduciary duties of due care and good faith. In manipulating WorldCom’s financial records, these individuals also may have breached their

²⁷⁶ See *Floyd v. Childs*, 1996 WL 408061 (N.D. Miss. May 28, 1996) (guilty pleas sufficient to establish assault under principles of collateral estoppel); *United States v. Shaw*, 725 F. Supp. 896, 898 (S.D. Miss. 1989) (guilty plea estops defendant from denying civil liability for bribery).

²⁷⁷ *Boddy v. Theiling*, 199 S.E.2d 379, 382 (Ga. App. 1973).

²⁷⁸ *Id.*; see also *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

duties of loyalty to WorldCom to the extent that they engaged in such conduct in part to boost their compensation and the value of their stock options.²⁷⁹

b. Mr. Ebbers and Other Members of Senior Management Who May Not Have Been Directly Involved in the Accounting Fraud

Senior members of Management, including Mr. Ebbers, who may not have been directly involved in the accounting fraud, also owed WorldCom a fiduciary duty of care to ensure that the financial statements fairly presented the Company's financial condition.²⁸⁰ Mr. Ebbers had a duty of care as the CEO to oversee the preparation of financial statements and to make accurate representations about WorldCom's financial condition to the Board of Directors, the Audit Committee, the shareholders, the external auditors and the public. By failing to do so, Mr. Ebbers may have breached his duty of care.

As stated recently by the Delaware Chancery Court, the CEO:

is the party with superior access to information and the primary duty to ensure the accuracy of the financial statements. . . . [The CEO] was the key executive at the company and was responsible to [the] board for the accurate preparation of financial statements. . . . After all, it was his managerial responsibility to ensure the filing of accurate financial statements and he should not, as a fiduciary, benefit at the expense of the object of his trust when his efforts were insufficient.²⁸¹

²⁷⁹ The Examiner is aware that the Company initiated in the United States District Court for the Southern District of Mississippi, lawsuits against Mr. Sullivan and Mr. Myers asserting claims arising out of the accounting fraud and seeking the return of the compensation they obtained from WorldCom while the accounting fraud took place. See WorldCom, Inc. v. Sullivan, C.A. No. 02-CV-1187 (filed July 5, 2002); WorldCom Inc. v. Myers, C.A. No. 02-CV-1480 (filed Sept. 10, 2002). Both lawsuits have been stayed due to the pendency of criminal proceedings.

²⁸⁰ Mr. Ebbers did not cooperate with the Examiner's investigation, and the Examiner has not arrived at a conclusion regarding whether he knew of, or participated in, the accounting fraud.

²⁸¹ In re HealthSouth Corp. Shareholders Litig., C.A. No. 19896, 2003 Del. Ch. LEXIS 128 at *23-24 (Del. Ch. Nov. 24, 2003) (granting summary judgment in favor of derivative claims of unjust enrichment and innocent misrepresentation against the CEO and ordering the repayment by the CEO of the value of loans he had obtained from the corporation and had repaid with company stock prior to its devaluation upon the announcement of accounting irregularities).

Nor can a CEO avoid liability by arguing that he relied on his subordinates to detect or prevent the fraud, even if those subordinates “blew one — or several seasons’ full of pitches — past him. . . .”²⁸² Accordingly, a number of WorldCom’s former officers, including Mr. Ebbers, may be liable to the Company for breach of their fiduciary duty of care in connection with the accounting fraud even if they may not have known of, or been directly involved with, the fraud.

E. The Examiner Does Not Recommend that Claims Be Pursued Against Members of the Audit Committee and the Internal Audit Department

The Directors on the WorldCom Audit Committee and the officers who managed WorldCom’s Internal Audit Department owed fiduciary duties of due care, good faith and loyalty to the Company.²⁸³ Under applicable law, they were bound to take actions “on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the Company.”²⁸⁴ Implicit in such requirements is the duty of a director to inform him or herself deliberately and in good faith.²⁸⁵ As part of their duties, however, the Directors were entitled to rely on information provided to them by the Company’s officers and employees as well as third party professionals so long as those persons and entities appeared credible and trustworthy.²⁸⁶

Whether the Company has any causes of action against the members of the Audit Committee and the officers of the Internal Audit Department depends on whether these

²⁸² Id. at *28.

²⁸³ Boddy, 199 S.E.2d at 382; Emerald Partners, 787 A.2d at 90.

²⁸⁴ In re Intercat, Inc., 247 B.R. 911, 923 (Bankr. S. D. Ga. 2000) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)); see also Appendix A, § B.

²⁸⁵ Munford, Inc. v. Valuation Research Corp., 98 F.3d 604, 611 (11th Cir. 1996), cert. denied, 522 U.S. 1068 (1998); Smith v. van Gorkom, 488 A.2d 858, 872 (Del. 1985).

²⁸⁶ Ga. Code Ann. §§ 14-2-830(b)(1) and (2); 14-2-842(b)(1) and (2). See Appendix A, § D.1.

individuals acted appropriately in the exercise of their fiduciary duties. Significant to that analysis would be whether any of these individuals had any knowledge of the accounting irregularities, failed to exercise the appropriate diligence in becoming informed in the exercise of their duties, or were aware or should have been aware of “red flags” that would have put them on notice of the accounting fraud.

The Examiner has previously concluded that there were structural deficiencies in the workings of WorldCom’s Audit Committee and Internal Audit Department that played a significant role in their failure to detect any aspect of the fraudulent activity prior to June 2002. Despite these deficiencies, neither the Audit Committee Directors nor the Internal Audit Department officers appears to have acted, or failed to act, in any way that would give rise to claims for liability in connection with the accounting fraud.²⁸⁷ There is no evidence that any of these individuals had any knowledge of the capitalization of line costs prior to its discovery in June 2002. Moreover, the Audit Committee was given categorical assurances by Arthur Andersen as to the absence of any concerns with regard to the integrity of the Company’s financial statements. Thus, there did not appear to be any significant “red flags” that came to their attention prior to June 2002 that, had they been acted upon, would have led to the discovery of the accounting irregularities.²⁸⁸ Indeed, once the Internal Audit Department became aware of the improper line cost entries, its officers and staff aggressively

²⁸⁷ Cf. In re WorldCom, Inc. Securities Litig., Master File 02 Civ. 3288 (DLC), 2003 U.S. Dist. LEXIS 21363 at *10-17 (S.D.N.Y. Dec. 1, 2003) (dismissing claims against the WorldCom Audit Committee based on Section 10(b) of the Securities Exchange Act of 1934 due to the failure to plead sufficient allegations that they “had access to information contradicting [the Company’s] public statements, that [they] failed to renew information that [they] had a duty to monitor, and that [they] ignored obvious signs of fraud.” (citation omitted)).

²⁸⁸ In the course of its 2001 audit of the Company’s capital expenditures, the Internal Audit Department learned about certain differentials in the amounts of capital expenditures reported internally and externally that were attributed to certain corporate adjustments. If the internal auditors had pursued this information at the time, it is possible that they would have detected the fraudulent line cost capitalization earlier. By the same token, however, they were provided assurances by Management regarding the differential. Since they did not perform a financial audit of this area, they did not pursue this discrepancy. The Examiner does not believe that this conduct rises to the level of any type of legal liability for the officers of the Internal Audit Department.

pursued investigation of those entries and notified the Audit Committee as appropriate. The Audit Committee properly proceeded to have the improprieties investigated and disclosed. Accordingly, the Examiner has not seen evidence that the Audit Committee Directors and the Internal Audit Department personnel violated their fiduciary duties with respect to the Company's accounting matters and thus does not recommend that the Company consider any claims against them.

F. Arthur Andersen's Potential Liability for the Accounting Irregularities

1. Introduction

Arthur Andersen's²⁸⁹ potential liability depends on whether Arthur Andersen during the relevant period complied with the professional standards applicable to it, namely GAAS and the associated guidance applicable thereto. Arthur Andersen's potential liability will be impacted by the fact that WorldCom employees sought to deceive the auditors. Further, the extent of that liability may be affected should additional evidence be developed regarding other "red flags" or deficiencies in the audit procedures performed.

The Examiner acknowledges that Arthur Andersen's liability for failure to detect the accounting irregularities is not free from doubt and will depend heavily on how a fact finder is likely to view the totality of the facts and circumstances surrounding Arthur Andersen's conduct. The Examiner concludes that a fact finder is most likely to determine that notwithstanding the deception by Company personnel, Arthur Andersen was negligent in the

²⁸⁹ In referring to Arthur Andersen's potential liability, the Examiner includes former Arthur Andersen personnel who worked on the WorldCom audits and quarterly reviews or had managerial, supervisory and/or review responsibility for such audits during the relevant period. Arthur Andersen was an Illinois limited liability partnership. While Mississippi law likely controls claims against Arthur Andersen, Lee v. Bankers Trust Co., 166 F.3d 540, 545 (2d Cir. 1999), Mississippi would look to Illinois law in determining potential liability of former Arthur Andersen partners. Miss. Code Ann. § 79-12-93. Under Illinois law, LLP partners are liable for their own misconduct and for the misconduct of employees they supervise and control. Ill. St. 805/205/15(b) & 15(c).

work it performed on behalf of the Company and that without such negligence, WorldCom's improper accounting could not have gone undetected for so long.

Arthur Andersen was obliged by the applicable professional standards "to plan and perform the audit to obtain reasonable assurance about whether the financial statements were free of material misstatement, whether caused by error or fraud." See SAS No. 1, AU § 110; SAS No. 82, AU s§ 316.01. Arthur Andersen fell short of that standard, amounting to negligence, based on significant deficiencies in its planning and implementation of the WorldCom audits. Despite risk assessments and "red flags" that collectively should have alerted the audit team to the possibility of fraudulent earnings manipulation, the Arthur Andersen audit team did not make any significant adjustments to its audit procedures. Time and time again, Arthur Andersen failed to conduct the sorts of substantive testing that its own risk assessments supported. Instead, Arthur Andersen continued to rely on the "integrity" of the Company's former Management and its representations as to certain unusual occurrences.

Arthur Andersen's negligence is more compelling due to the fact that some of the fraudulent earnings manipulation that occurred at WorldCom was neither complicated nor buried deep in the bowels of the Company's books and records. Thus, while there was some deception by former Management, it is also undisputed that many of the improper accounting entries were set forth plainly in the Company's general ledger in the form of large (hundreds of millions of dollars) journal entries that had no supporting documentation. A few focused questions, coupled with substantive testing, would have led the auditors to some of the fraudulent accounting. But those questions either were not asked or, when asked, were satisfied by perfunctory and misleading explanations by former Management that may have

sounded reasonable at the time but that, given the risks identified by the audit team and the “red flags,” should have been scrutinized more extensively.

If Arthur Andersen had exercised the appropriate degree of professional skepticism and tested Management’s representations, it is possible, indeed likely, that the auditors would have detected some aspect of the accounting irregularities. Thus, the Examiner concludes that Arthur Andersen’s negligence was a contributing factor in the Company’s failure to detect the various manipulations perpetrated by Management of the Company’s accounting.²⁹⁰

2. The Professional Standards Governing Arthur Andersen’s Conduct

Arthur Andersen’s liability for WorldCom’s accounting irregularities depends on whether Arthur Andersen planned and performed its audits of WorldCom in accordance with GAAS, professional standards established by the American Institute of Certified Public Accountants (“AICPA”), as well as common law standards and legal precedent applying those standards.²⁹¹ As such, an auditor’s “good faith compliance” with GAAP and GAAS shall be sufficient to discharge the auditor’s “professional obligation to act with reasonable care.”²⁹²

Under GAAS, Arthur Andersen was obligated to design its WorldCom audits by adequately assessing the Company’s control environment and risks, including the risks of

²⁹⁰ While Arthur Andersen’s audits of WorldCom and its subsidiaries clearly encompassed a vast amount of audit areas, the Examiner focused his attention specifically on Arthur Andersen’s performance in those areas that are at issue in the restatements. By doing so, the Examiner has not formed any opinion, and takes no position with respect to the quality of Arthur Andersen’s audit procedures in those areas that were not impacted by the accounting fraud.

²⁹¹ United States v. Arthur Young & Co., 465 U.S. 805, 811 (1984). While professional standards relating to auditing of public companies have evolved since the accounting irregularities at Enron and WorldCom were announced, the Examiner has considered those professional standards that were in effect during the relevant period.

²⁹² In re CBI Holding Co., Inc., 247 B.R. 341, 362 (S.D.N.Y. 2000) (citation omitted).

fraud. Arthur Andersen then was required to implement controls-based and substantive testing based on such assessments. Specifically, GAAS required Arthur Andersen specifically to assess the risk of material misstatement due to fraud and error as part of its normal audit procedures. During the relevant period, AU § 316 of the AICPA Professional Standards (“Consideration of Fraud in Financial Statement Audit” based on SAS No. 82) described misstatements arising from fraudulent financial reporting as “intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users,” such as:

- Manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared;
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information; [and]
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

SAS No. 82, AU § 316.04.

The AICPA Professional Standards identified the following risk factors, among others, whose presence might indicate fraudulent reporting:

1. A motivation for management to engage in fraudulent financial reporting evidenced by management: (i) whose compensation is highly dependant on bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive financial targets; (ii) who are excessively interested in maintaining or increasing the entity’s stock price or earnings trend through the use of “unusually aggressive accounting practices;” or (iii) who commit to analysts, creditors, and other third parties to achieve unduly aggressive or clearly unrealistic forecasts.
2. Indications of management failure to display and communicate an appropriate attitude regarding internal controls and the financial reporting process, and “strained” relationships between management and the auditor, such as: (i) Unduly aggressive financial targets and expectations set by management for operating personnel; (ii) formal or informal restrictions on the auditor which inappropriately limit access to people or information; or (iii) “[d]omineering management

behavior” in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work.

3. Assets, liabilities, revenues or expenses based on significant estimates involving unusually subjective judgments or uncertainties, or subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity. . . .

SAS No. 82, AU § 316.17. Many of the risk factors identified above clearly applied to WorldCom during the relevant period.

Moreover, auditors have a responsibility to exercise “professional skepticism” in connection with the audit, evidenced by “a questioning mind and critical assessment of audit evidence” SAS No. 82, AU § 316.27. The exercise of professional skepticism in response to the auditor’s assessment of the risk of material misstatement due to fraud may include “(a) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (b) increased recognition of the need to corroborate management explanations or representations concerning material matters -- such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity.” *Id.* Such a standard requires that the auditor “neither assumes that management is dishonest nor assumes unquestioned honesty.” *See* Report of Panel on Audit Effectiveness at 3.8 (quoting SAS No. 1, AU § 230.09). This mindset is particularly important where the auditor is reviewing audit areas that are subject to a high degree of judgment by management as well as to when the auditor relies on the explanations of management. However, “[a]n auditor cannot rely solely on management representations. The purpose for requiring an independent auditor is to test management’s judgment of how the company’s financials should be presented.”²⁹³ Management’s representations “are not a

²⁹³ *In re Russell Ponce*, Admin. Proc. File No. 3-8944, 2000 SEC LEXIS 1814 at *38 (Aug. 31, 2000).

substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.” SAS No. 19, AU § 333.02 (Reliance on Management Representations).

Auditors have been cautioned by the Auditing Standards Division of the AICPA that they:

. . . . should be skeptical about the answers they receive from management. Explanations received from an entity’s management are merely the first step in an audit process, not the last. Listen to the explanation, then examine or test it by looking at sufficient competent evidential matter. The familiar phrase “healthy skepticism” should be viewed as a “show-me” attitude and not a predisposition to accepting unsubstantiated explanations.²⁹⁴

Accordingly, Arthur Andersen had a duty to design and perform sufficient audit procedures that would enable it reasonably to detect the presence of fraud in the WorldCom financial statements and to approach the audit and Management’s representations with an appropriate degree of professional skepticism. Arthur Andersen should have performed substantive testing in those areas where the risk of material misstatement due to fraud was identified. In fact, auditors are specifically guided by professional standards to perform, in response to their assessment of risk of material misstatement due to fraud, a detailed review of the entity’s quarter-end or year-end adjusting entries and the investigation of any that appear “unusual” as to nature or amount. SAS No. 82, AU § 316.29.

During the relevant period, however, Arthur Andersen, like many of its peers, had moved away from substantive testing in favor of controls-based audits. In controls-based audits, the auditor primarily reviews internal control procedures, rather than primarily performing substantive tests. This approach is fraught with the risk that it will fail to detect

²⁹⁴ See In re Carroll A. Wallace, CPA, Initial Decisions Release No. 178, Admin. Proc. File No. 3-9862, 2000 SEC LEXIS 2798 at *131 (Dec. 18, 2000) (quoting “Audit Risk Alert – 1993, General Update on Economic, Regulatory Accounting and Auditing Matters,” AICPA Auditing Standards Division (1993)).

fraudulent earnings manipulation undertaken by management personnel intent on concealment. Indeed, Arthur Andersen and its peers were cautioned by regulators and others about this danger. For example, the SEC’s Chief Accountant during the relevant period, Lynn Turner, noted in remarks to the Panel on Audit Effectiveness²⁹⁵ (the “Panel”) in 1999 that 80 percent of the fraud cases from 1987 until 1997 involved a company’s top senior management and emphasized the danger of intentional fraud in the controls-based audit methodology:

Keep in mind that top management is the very group responsible for ensuring the adequacy of the control environment. The irony of today’s audit process is that significant audit assurance is derived from internal controls; however, the very group of individuals charged with ensuring the effectiveness of internal controls is responsible for committing fraud.²⁹⁶

The Panel issued its Report and Recommendations on August 31, 2000, echoing Mr. Turner’s sentiments and recognizing that management “precipitates” fraudulent financial reporting and can manipulate a company’s accounting records while preparing false reports to prevent the auditors from detecting fraud through their audit procedures. The Panel acknowledged that company management also has the ability to override a company’s internal controls and can use various methods to do so, including “top-side” adjustments. Moreover, the Panel reasoned that management’s unique position in a company places the auditor in a difficult position where “on the one hand, to accomplish the audit requires the

²⁹⁵ At the request of the chairman of the SEC, the Public Oversight Board appointed the Panel on Audit Effectiveness in 1998 to “assess whether independent audits of the financial statements of public companies adequately serve and protect the interests of investors.” The panel was composed of eight members from the accounting profession, academia, the legal field, the SEC, and the private sector.

²⁹⁶ Lynn E. Turner, Speech at the Panel on Audit Effectiveness (October 7, 1999) (citing a March 1999 report sponsored by the Commission of Sponsoring Organizations of the Treadway Commission).

cooperation of management; on the other hand, management is in a position to mislead the auditors in their quest for valid evidence.”²⁹⁷

The Panel specifically warned auditors of the potential for earnings management, “top-side” entries, and the improper recognition of revenue by company management, and urged auditors to perform more substantive testing, particularly in such areas where there were risks of such manipulations. The Report stated:

The Panel is concerned that the auditing profession has not kept pace with a rapidly changing environment. The Panel believes that the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management. . . . Professional skepticism should mean more than only words in the auditing standards -- it should be a way of life for auditors. The objectives in an audit should include detecting material financial statement fraud -- that goal should drive both auditing standards and the way they are applied. . . . The Panel accepts the premise that a GAAS audit is not, and should not become, a fraud audit. It accepts the premise that reasonable, not absolute, assurance is a sufficiently high standard of responsibility. . . . [T]he Panel nonetheless is concerned that auditors may not be requiring as much evidence to achieve reasonable assurance as they have in the past, especially in areas where they believe that risk is low.

Report at §§ 3.27 – 3.28.

The Panel found that auditors did not always confirm adequately management’s representations to them or appropriately investigate “red flags” identified during an audit, despite the fact that auditing standards caution that management representations complement but should not replace other auditing procedures that the auditor should perform.²⁹⁸ Arthur Andersen used inquiry of WorldCom Management as one method to obtain evidence of conditions that existed as of the balance sheet date. Under the GAAS third standard of audit fieldwork, such inquiry is an acceptable method of obtaining “sufficient competent evidential

²⁹⁷ Panel on Audit Effectiveness, Report and Recommendations, at 86, § 3.45.

²⁹⁸ AICPA AUI § 326.19 (Evidential matter: Auditing Interpretations of Section 326); and SAS No. 19, AU § 333.02 (Reliance of Management Representations).

matter” in order “to afford a reasonable basis for an opinion on the financial statements.”²⁹⁹

However, inquiry of management does not suffice as the sole means of testing an area in a company environment where there is potential for earnings manipulation, “top-side” entries, and improper revenue recognition, as was the case with WorldCom.

Accordingly, the Panel recommended that the auditing profession perform additional forensic-type procedures during the annual audit and the review of quarterly financial information to address such issues and to help detect fraudulent financial reporting. The Panel cautioned that management often effects financial misstatements through the use of “non-standard entries” to record fictitious transactions or other events and circumstances, particularly near the end of the reporting period, and suggested that auditors design tests to detect and examine such entries, including incorporating a “forensic-type fieldwork phase” in which the auditors would “presume the possibility of dishonesty at various levels of management, including collusion, override of internal control and falsification of documents.” Recommended procedures included: (i) the performance of substantive testing designed to detect the override of internal controls by management centered around those areas noted by the audit team as high risk, the disclosure of significant accounting policies, material balance sheet accounts with multiple turnover through the year, and non-standard or “top-side” entries; (ii) a surprise or unpredictability element in the tests performed, including unannounced visits to locations, interviews of financial and non-financial personnel such as information technology personnel, and testing of accounts that are designated as low risk or

²⁹⁹ SAS No. 1, AU § 150.02.

ordinarily are not tested annually; and, (iii) testing of details or precise analytical procedures in lieu of testing of controls since controls could be overridden by management.³⁰⁰

The Examiner recognizes that the Panel's August 2000 Report and Recommendations did not set forth regulatory requirements applicable to Arthur Andersen during the relevant period. Indeed, many of the Panel's recommendations were not formally incorporated into auditing standards until after the accounting scandals of Enron and WorldCom had surfaced, with the adoption of SAS No. 99, becoming effective in December 2002. Nonetheless, the comments of the SEC's Chief Accountant and the issuance of the Panel's Report in August 2000 put the profession and Arthur Andersen on notice that their current audit procedures might be deficient with respect to the detection of financial fraud and earnings manipulation.³⁰¹ Certainly, such notice should have affected the planning of procedures in connection with Arthur Andersen's audits of WorldCom's financial statements for the audits of the financial statements for the years 2000 onward. Indeed, there is evidence that Arthur Andersen did incorporate prior to their effective date some of the recommendations that were made by the Panel. For example, Arthur Andersen incorporated a Fraud Brainstorming Session amongst the audit team in connection with its audit of the 2001 financial statements. But, as evidenced by the audit procedures actually employed by Arthur Andersen in connection with the WorldCom audits, Arthur Andersen's changes appear to have been focused on performing risk assessment procedures without any meaningful change in or

³⁰⁰ Panel on Audit Effectiveness, Report and Recommendations, at 89-90, § 3.51.

³⁰¹ The SEC's comments and the Panel's Report were complemented by numerous administrative proceedings in which the SEC sanctioned public accounting firms and auditors for their failures to detect management's fraudulent earnings manipulation and accounting. See e.g., In re Carroll A. Wallace, CPA, Initial Decisions Release No. 178, Admin. Proc. File No. 3-9862, 2000 SEC LEXIS 2798 (Dec. 18, 2000); In re Russell Ponce, Admin. Proc. File No. 3-8944, 2000 SEC LEXIS 1814 (Aug. 31, 2000); In re Herbert Woll, C.P.A., Admin. Proc. File No. 3-10020, 1999 SEC LEXIS 1915 (Sept. 22, 1999); In re Miguel A. Cabrera, Jr., C.P.A. and M.A. Cabrera & Co., P.A., Admin. Proc. File No. 3-9825, 1999 SEC LEXIS 279 (Feb. 10, 1999).

adoption of any additional audit procedures incorporating substantive testing in those areas at issue, even though the risks warranted such detail analysis.

3. Arthur Andersen's Business Audit Process for WorldCom

Arthur Andersen was initially engaged as external auditor to LDDS and continued as the external auditor once LDDS was renamed WorldCom. Throughout the WorldCom engagement, the Arthur Andersen engagement team was made up of auditors who worked principally out of Arthur Andersen's Jackson, Mississippi office, with assistance from auditors in Arthur Andersen's other offices, including the Virginia office once the MCI merger had closed.

When WorldCom was a small start-up company, Arthur Andersen performed substantive, transaction-based audits of the Company's financial statements, including review and confirmation of entries in the general ledger. As the Company grew, however, Arthur Andersen adopted instead a risk-based model called the Business Audit Process/Business Risk Model, that included a combination of controls and process testing and substantive tests, depending on the level of residual risk that remained after the Company's controls and processes had been assessed.

In such an audit, the auditors focus on testing controls and processes, performing limited substantive testing where such controls are determined to be effective. This model is acceptable under GAAS, provided that the audit plan itself is appropriately designed and implemented. However, as stated above, Arthur Andersen and its peers had been cautioned that such audits, in the absence of a "forensic-type" fieldwork phase that would include the review of journal entries and supporting documentation, were fraught with the risk that the auditors would be unable to detect fraud intentionally perpetrated and concealed by company management.

Arthur Andersen stated in material provided annually to the WorldCom Audit Committee, that its Business Audit Process, unlike the “traditional audit,” involved “a comprehensive, business risk framework,” allowing the auditors to identify areas “of highest risk” to WorldCom’s business and thereafter to “customize” the audit approach to WorldCom’s environment. The Business Audit process consisted of the auditors’ gaining an understanding of the Company’s business, assessing WorldCom’s existing risk controls, determining any residual audit risk, and setting procedures to “manage” and reduce that residual audit risk. Arthur Andersen marketed its audit approach to WorldCom as an improvement to the traditional audit approach in that it would allow the auditors to focus particularly on those areas of greater risk to the audit based on the Company’s business and audit environment.

4. Arthur Andersen Was on Notice of the Potential for Fraud

Arthur Andersen was required by GAAS to assess the risk of material misstatement due to fraud as part of its planning for the audits of WorldCom’s financial statements. See SAS No. 82, AU § 316. Auditing standards set forth certain risk factors and “red flags” that may indicate the presence of fraud or improper manipulation of the entity’s financial statements. SAS No. 82, AU § 316.16. While auditors must exercise judgment in evaluating the significance of such risk factors or “red flags,” GAAS obligates them to assess the planned audit procedures and adjust such procedures where they are deemed insufficient to address the risk. SAS No. 82, AU § 316.26.

In evaluating those risks and exercising such judgment, auditors are bound to exercise “professional skepticism” involving “a questioning mind and critical assessment of audit evidence,” to staff the audit engagement with personnel who have sufficient knowledge, skill and ability to understand the nature of the entity’s internal controls, and, where necessary, to

consider more carefully particular changes to the entity's accounting policies and procedures by management. SAS No. 82, AU § 316.27. Importantly, the extent of the audit procedures performed by the auditors should reflect their assessment of the risk of material misstatement due to fraud and may include such measures as increasing audit sampling sizes and performing more extensive analytical procedures. SAS No. 82, AU § 316.28. Further, auditors cannot rely on representations from management as a substitute for audit procedures necessary to provide a reasonable basis for the audit opinion. SAS No. 19, AU § 332.02.

Arthur Andersen identified as part of its WorldCom risk assessments the potential for fraud and earnings manipulation in connection with the Company's financial statements, including many of its improper accounting practices that the Company's former Management actually employed. Moreover, Arthur Andersen auditors noted or reasonably should have noted a number of "red flags" that, with the risks already identified, should have caused Arthur Andersen to strengthen its audit procedures by incorporating more substantive testing in key audit areas.

The Examiner summarizes below the Arthur Andersen risk assessments and "red flags" that should have lead to greater substantive testing by Arthur Andersen.

a. Arthur Andersen's Assessments of WorldCom's Audit Environment

Arthur Andersen performed annual risk assessments for each WorldCom audit engagement. Such risk assessments appear to have been sophisticated tools that provided a road map for how the auditors assessed the Company's business environment and risks, its former Management, and its accounting practices. Those assessments evolved over the relevant period as the Company evolved, and included the "SMART Tool" assessment performed by the auditors for the purpose of evaluating the risks to Arthur Andersen in

undertaking the engagement, as well as Fraud Brainstorming Sessions conducted by the audit team in connection with its audit of the 2001 financial statements.³⁰²

The Arthur Andersen assessments of the Company's accounting practices and the integrity of its former Management should have heightened Arthur Andersen's awareness and reasonably resulted in a greater degree of substantive testing in particular risk areas. These include the identification and assessment of the potential for earnings manipulation and the significant risk of error and fraud in the financial statements, as well as the auditors' lukewarm assessment of Management's integrity, accounting practices, attitude towards and cooperation with the auditors, and commitment to establishing appropriate internal controls.

As previously reported, Arthur Andersen repeatedly rated WorldCom as a "maximum" risk client in evaluating the business risks to Arthur Andersen in undertaking this engagement.³⁰³ Arthur Andersen reserved its "maximum" risk classification for those of its clients with serious risk factors, including "moderate management integrity risks, serious concerns with respect to financial health or the client's expectations or commitment," or a combination of other risk factors. While the "maximum" risk characterization by itself should not necessarily have resulted in more stringent audit procedures, it did require the audit team to conduct an "Expanded Risk Discussion" to identify high-risk areas and to assure that the WorldCom audit procedures were designed to minimize such risks. In

³⁰² The Examiner described in the Second Interim Report the tools Arthur Andersen used in connection with accepting the WorldCom engagements, as well as those used as part of the planning of its audits to assess and document conditions that might require extension or modification of audit tests, such as the risks of material error or fraud or the existence of related party transactions. Second Interim Report at 198-212. Other tools employed by Arthur Andersen in the audit planning process included the Business Risk Model, an Expanded Risk Discussion, and a Fraud Risk Practice Aid.

³⁰³ The WorldCom engagement's "maximum risk" rating stemmed from the volatility of the telecommunications industry, market capitalization, the Company's future merger and acquisition plans, and its reliance on a high stock price to fund those acquisitions, as well as certain assessments of the Company's control environment and Management.

addition, the “maximum” risk classification required a significant level of involvement by Arthur Andersen’s management to ensure that the risks were reduced to an acceptable level. The underlying assessments made by the audit team as part of the Expanded Risk Discussion, as well as in connection with the determination to rate the WorldCom engagement as “maximum risk,” are instructive.³⁰⁴

At a minimum, the following risk assessments made by Arthur Andersen should have heightened the auditors’ awareness and placed them on notice of the significant potential for fraud:

(i) Potential Indicators of Fraud Identified by Arthur Andersen

Arthur Andersen noted a number of audit areas with the potential for fraud and manipulation of the Company’s accounting. These included the potential for misstatement of line costs and manipulation of business processes relating to inter-company transactions by former Management in order to achieve financial targets. The audit team noted throughout the relevant period that Company Management had previously engaged in aggressive purchase accounting policies and faced pressure to maintain high stock valuations in anticipation of security offerings or mergers while using the Company’s stock as currency for transactions. The team also noted a concern that stock options formed a significant portion of the compensation of senior Management.

³⁰⁴ Senior former Arthur Andersen personnel were emphatic in describing the SMART Tool risk assessment as having no bearing on the design and performance of the annual audit. Rather, these persons contended that the assessment was directed at whether Arthur Andersen should accept the engagement and, if so, what steps it would take to address the risks such an engagement posed internally to Arthur Andersen. But, the SMART Tool assessments were specifically referenced in other audit planning materials (including the Fraud Risk Practice Aid) and appear to reflect the collective views of the senior members of the audit team about WorldCom’s accounting policies and Management and its audit environment. As such, the Examiner disagrees that this assessment should be divorced from the audit planning process.

Arthur Andersen, in preparing for the 1999 audit, characterized WorldCom's accounting policies as "aggressive," based on pressure by the Company's former Management to maintain high stock valuations, which could create the opportunity for earnings manipulations in the areas of purchase accounting entries, allowances for doubtful accounts, and the basic revenue process. Despite noting these concerns, Arthur Andersen concluded that it would mitigate such risks by reviewing significant judgmental items, such as allowances for accounts receivables, line cost accruals and legal reserves, to ensure that Management was not intentionally misstating earnings in an attempt to bolster the stock price.³⁰⁵

Arthur Andersen also identified a number of ways that WorldCom Management could, if it wished, engage in fraud and manipulate the Company's accounting records as part of its June 2001 Fraud Brainstorming Session at its Las Vegas audit planning meeting.³⁰⁶ The audit team concluded that the existing audit procedures, which consisted generally of controls- and process-based testing, a review of variances to the consolidated balances as compared to the prior year and inquiry of Management with reduced substantive testing, sufficiently addressed the potential for earnings manipulation and fraud in the areas they had identified.

The auditors also noted, in planning the 2001 audit, a potential at WorldCom for the misstatement of revenues, expenses and/or liabilities and assets, and inadequate disclosures. They identified and ranked according to likelihood and significance a number of ways in

³⁰⁵ The following year, however, Arthur Andersen improved this assessment to "conservative," because, as witnesses explained, WorldCom did not have any planned mergers and acquisitions during 2000. However, this explanation is unpersuasive. WorldCom was still in an acquisition mode during part of 2000 and 2001, with the proposed Sprint merger being pursued until July 2000, and the Intermedia/Digex acquisition, which did not close until July 2001.

³⁰⁶ The session was repeated in February 2002 at the conclusion of the 2001 audit to discuss any new issues. No significant changes were made to the initial assessment.

which such fraudulent activities could be carried out. The audit team concluded that WorldCom's Management had the highest and most significant likelihood to: (1) manipulate purchase price accounting adjustments and subsequent adjustments within the one year window, and (2) manipulate allowances for bad debts by manipulating aging, or by the CFO deciding how much to record regardless of the facts, and manipulating sales allowances.

The audit team identified and designated the following other possible attempts to manipulate earnings to be equally significant but less likely at WorldCom:

1. Failing to disclose related parties, commitments, contingent liabilities, loan covenants, loan defaults, and other key facts that may give rise to liabilities and impact the Company's financial condition;
2. Failing to disclose significant events and changes in accounting policy impacting the Company, thus making the financial statements misleading;
3. Manipulating accounting entries through "top-side" journal entries to increase revenue;
4. Improperly capitalizing expenses as fixed assets; and
5. Capitalizing software costs for software development inappropriately.

The audit team further identified and designated as equally likely but less significant: (i) failing to record discounts earned by major customers; and, (ii) excluding some vendor invoices from accounts payable processing. Finally, the audit team identified the following as possibilities but ranked them as having less significance and likelihood at WorldCom:

1. Keeping books open to include revenues from the first part of the next period including possibly manipulate clock on computer;
2. Creating fictitious revenues through phony sales or contracts; and,
3. Manipulating deferred revenue calculation for customer deposits and payments on contracts.

Significantly, the audit team considered the possibility that WorldCom's former Management could manipulate the Company's financial statements for 2001, using a number

of the very methods that actually were employed by WorldCom Management, including top-side adjustments and capitalization of expenses. Regrettably, the audit team concluded that its audit procedures and its review of the Company's public financial statement disclosures sufficiently addressed such possibilities. As detailed more fully below, those procedures performed in connection with the accounting areas at issue were insufficient and failed to incorporate the substantive testing that was warranted in light of the risks Arthur Andersen had identified, and the concerns expressed by regulators and industry panels.

(ii) The Integrity of WorldCom's Management was Given Lukewarm Ratings

Arthur Andersen assessed the integrity of WorldCom's former Management to be only "Fair" in the course of undertaking the engagement for the 1998 audit. While that rating was upgraded to "Good" in subsequent years, an e-mail prepared in connection with the 1999 engagement characterized the 1998 rating as "low." The engagement partner stated in his interview that the e-mail was likely in error and that he would not have signed off on the engagement had Management's integrity been characterized as "low." He also did not identify any areas of concern in connection with WorldCom's audits.

In contrast, the auditor responsible for completing the initial draft of the 1999 SMART Tool assessment told the Examiner that she had referred to the 1998 assessment and had understood that the relationship between WorldCom and Arthur Andersen had historically been "rocky" and characterized by delays by Company personnel in providing the auditors with requested documents and information. She was instructed by the engagement manager to change the rating for Management's integrity to Good for 1999 on

the basis that the relationship with the client had apparently improved over the past year.³⁰⁷

The Examiner was not made aware of any other reason why the rating improved.

The improvement in that rating caused the computerized SMART Tool program initially to downgrade the internal assessment of the risk of the WorldCom engagement to Arthur Andersen from “maximum” risk to “high” risk. However, this change was manually overridden at the request of the firm’s professional review partners in Chicago, and WorldCom was again classified as a “maximum” risk client since, in the words of the audit reviewing partner, “if this job is not maximum, none are” Regardless of the reasons for the upgrade of the auditors’ assessment, such an initially lukewarm rating of management integrity calls into question the heavy reliance that Arthur Andersen placed on the integrity of WorldCom's former Management when using uncorroborated inquiry of Management as a tool to test significant audit areas where risk of fraud had been assessed.

(iii) Mediocre Accounting and Disclosure Practices and Significant Risks of Error

The audit team rated WorldCom’s use of sound accounting and disclosure practices relating to inappropriate management of earnings as only “Fair Minus” in connection with the 1998 engagement. Arthur Andersen also repeatedly rated as “Significant” the risk of error in WorldCom’s accounting and financial reporting in both 1998 and 1999. Such ratings appear to have been grounded on: (i) the proposals by Arthur Andersen to Management during prior audit years of audit adjustments in the areas of line costs, allowance for bad

³⁰⁷ During 1998, the audit partner was Paul Ogden whom, we were told, did not have a good relationship with Mr. Sullivan. He was replaced on the WorldCom engagement by Kenneth Avery in 1999, but continued to work at Arthur Andersen on other matters. One former senior WorldCom officer who interacted with Arthur Andersen suggested that Mr. Ogden had been removed from the WorldCom engagement at the request of Mr. Sullivan. The engagement partner denied this. Since Mr. Ogden declined our requests for an interview, we were unable to corroborate that statement or obtain additional information about his relationship with WorldCom Management, and the circumstances of his departure from the WorldCom audit.

debt, income taxes and intangibles — all areas with account balances that were material to the Company and reflected “significant estimates by management;” (ii) purchase price allocation adjustments by the Company; (iii) significant investments maintained by the Company on a cost and equity basis which, in the past, had resulted in misapplication of GAAP; and, (iv) the use by the Company of multiple billing systems requiring human intervention and creating risks in the billing and collection areas.³⁰⁸ Arthur Andersen also assessed the Company a Fair rating in 1998 and 1999 in connection with its responsiveness to Arthur Andersen’s accounting and reporting advice, including audit adjustments and disclosures.

**(iv) WorldCom’s Questionable Cooperation
with the External Auditors**

Arthur Andersen rated as “Fair Minus” in 1998 and “Fair” in later years WorldCom’s behavior towards the scope of the auditors’ work, relating to the imposition of unreasonable restrictions, deadlines or disputes. The Company was given Fair ratings throughout the relevant period for providing the auditors unrestricted access to information and personnel. The auditor responsible for completing the 1999 SMART Tool assessment explained her understanding that the audit relationship with WorldCom had been previously characterized by excessive delays in providing documents and information to the auditors. Apparently, the 1999 rating reflected an improvement to the audit relationship. There are, however, a number of examples of excessive delays discussed below that called into question such a

³⁰⁸ Witnesses stated that the risks had moderated by 2000 and 2001, and the ratings improved due to the decrease in the Company’s acquisitions and the improvement in Management’s experience in this area. As noted, that explanation is difficult to accept in light of WorldCom’s acquisition of Intermedia in 2000-2001, and its attempt to merge with Sprint that continued until July 2000. Moreover, improvement in experience does not necessarily equate with a decrease in Management’s aggressive accounting.

rating, as well as Arthur Andersen's reliance on former Management's integrity and uncorroborated representations. See Section V.F.4.b.iii, intra.

**(v) The Auditors' Assessment of the Company's
Commitment to Establishing and Maintaining
Internal Controls**

In 1998 and 1999, Arthur Andersen rated as "Fair" WorldCom's commitment to establishing and maintaining a satisfactory internal control system, including the quality of responses to known control problems. In 1998, WorldCom received a "Fair Minus" rating for the quality of its Management's policies to prevent and detect fraud, including policies relating to conflicts of interest, codes of conduct, and effective communication of entity values. That rating improved to "Fair" in subsequent years. The Examiner was not able to obtain any explanation of such ratings. The ratings appear, on their face, at odds with the representations of Arthur Andersen that its auditors had not noted any material weaknesses to the Company's internal controls. Again, such lukewarm assessments call into question any strong reliance on the integrity of the Company's former Management or the Company's overall internal control environment.

**b. The "Red Flags" That Should Have Caused Professional
Skepticism and Resulted in Substantive Testing in Key
Audit Areas**

In addition to its risk assessments, the Arthur Andersen audit teams identified a number of significant "red flags" in the course of their WorldCom audits that, taken collectively and in the context of the audit team's evaluations of risk and the audit environment, should have raised concerns and prompted substantive testing of audit areas that had been identified as being particularly susceptible to fraud or error. Indeed, a number of these "red flags," such as unreasonable limitations on the auditors' access to documents and personnel and unexplained delays in providing requested information to the auditors, are

identified by GAAS as “risk factors” that may indicate that the financial statements are materially misstated due to fraud and that should be considered in designing and performing audit procedures. See SAS No. 82, AU § 316.17.

Because of the low turnover during the relevant period of senior audit team members, the auditors were in a position collectively to observe these “red flags” over the years.³⁰⁹ The senior auditors appear to have treated the “red flags” they observed in one of two ways. On the one hand, to the extent these incidents related to the audit team’s ability to gain access to documents and information, the auditors chose the path of least resistance, working to reduce any tension their requests caused with WorldCom personnel by accepting the restrictions placed by WorldCom former Management and accepting, at times, less detail than what they originally sought. Except for one small incident, no member of the audit team interviewed by the Examiner recalled any instance where they concluded that they had not received the information or documents that they needed to conclude their audit work.³¹⁰ However, there are a number of significant instances, detailed below, where if the auditors had persisted in their original requests, they may have identified information that would have triggered further scrutiny and, possibly, the detection of some aspect of the fraud.³¹¹ While each of these items, taken individually, may not have been deemed significant, the collective effect

³⁰⁹ For example, the same engagement partner, Mark Schoppet, led the audit for about seven years until he rotated from his audit responsibilities after the 2000 audit. Similarly, several senior members of the audit team, including the engagement manager (and later audit partner) Kenneth Avery, participated in the audits for all three years of the relevant period, as well as the quarterly review performed by Arthur Andersen of the WorldCom financial statements for the first quarter of 2002.

³¹⁰ One auditor generally recalled that she had never received certain support documents she had requested from the Revenue Accounting Group relating to an intercompany reserve she was reviewing during the preliminary testing stage for the 2000 audit. However, she also indicated that she eventually concluded that she did not need that information to complete her audit work.

³¹¹ Strangely, despite extensive risk assessment and planning sessions, as well as the similarity of some of these items to “risk factors” specifically identified by professional standards as relating to material misstatement due to fraud, none of the members of the audit team recalled having any significant discussions about the matters detailed below, particularly in relation to whether such matters raised questions about the Company’s accounting practices or the adequacy of Arthur Andersen’s audit procedures for WorldCom.

of these incidents should have sparked scrutiny of the detail supporting the Company's financial statements in the affected audit areas.

On the other hand, where the "red flags" related to substantive accounting issues, they were resolved primarily through uncorroborated inquiry to former Management, with little or no analytical or substantive testing to determine whether Management's explanations were credible.³¹² The audit team's acceptance of Management's explanations appears to have been founded, for the most part, on its reliance on the integrity of former Management. A former senior member of the audit team explained to the Examiner that, had the audit team concluded that they could not have relied on Management's integrity, Arthur Andersen would have resigned from the engagement. The Examiner disagrees that the audit team had no alternative but to trust in Management's integrity and accept its representations. The audit team was required by professional standards to test Management integrity by scrutinizing at least some of the representations it received through substantive testing, which had been called for based on Arthur Andersen's assessments of the risks and the audit environment, in those audit areas that posed significant risks of fraud or earnings manipulation.³¹³

³¹² The auditors did request information from Management regarding the presence of any "top-side" adjustments, and it cannot be disputed that Management provided false responses and representations to the effect that no significant or unusual "top-side" adjustments existed at the consolidation level, while manipulating the schedules it provided the auditors in response to their requests. Nevertheless, the auditors with responsibility over the areas at issue did not, except in rare instances, conduct detailed substantive testing by drilling down to the supporting documentation or the general ledger, or seek to corroborate through documentary evidence the representations of Management. Such acceptance of the explanations given by Management proved ill-advised and is at odds with the auditors' duty to exercise "professional skepticism." The Examiner observes that it is not improper on occasion for an auditor to accept management's representations regarding an area under inquiry, without corroboration. But, at the same time, it is worth reiterating that GAAS cautions about "increased recognition of the need to corroborate management explanations or representations concerning material matters -- such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity." SAS No. 82, AU § 316.27.

³¹³ The Examiner does not suggest that an external auditor, conducting public company audits in 1999 through 2001, was required to assume that a company's management was likely to lie to the auditor. Similarly, absent specific "red flags," the auditor should assume that management is neither dishonest nor unquestionably honest. SAS No. 82, AU § 316A.16. Notwithstanding, the required professional skepticism should have led to

The Examiner summarizes below those “red flags” that collectively, in conjunction with the Arthur Andersen risk assessments, should have caused greater scrutiny as well as substantive testing of particular audit areas.

(i) Indicia of Potential Fraud in WorldCom’s Accounting

Unusual variations from industry trends, such as higher growth levels, increased earnings per share, or an inflated stock price, are often an indicator of aggressive and inappropriate accounting. Professional auditing standards caution auditors to be alert to “excessive” interest by management in maintaining or increasing the Company’s stock price or earnings trends through “unusually aggressive accounting practices,” as well as management’s practice of committing to analysis that the Company will achieve “unduly aggressive or clearly unrealistic forecasts.” SAS No. 82, AU § 316.17. Accordingly, one of the significant tasks of a public company auditor is to compare the Company’s financial performance to industry trends. Arthur Andersen performed such tests regarding WorldCom, reviewing, among other things, the Company’s financial performance, including such indicators as the guidance provided to Wall Street by the Company, the fluctuations of the Company’s price per share, and the Company’s line cost expense to revenue ratio (“E/R ratio”). Arthur Andersen also used a proprietary software package called FIDO, which purported to assess comparisons between the financial performance of its audit client and of its competitors, taking industry trends into consideration.

Despite some concerted effort by the auditors in this particular area, Arthur Andersen erroneously concluded that WorldCom’s trends were in line with its peers during the relevant

substantive testing of at least a sufficient number of Management’s explanations so that Arthur Andersen had satisfactory assurance that the representations were credible.

period, and that a number of variations were due primarily to WorldCom's push to reduce its line cost expenses. However, the following variations should have caused further scrutiny:

- **WorldCom's Ability to Meet Aggressive Revenue Targets During the Economic Downturn in the Telecommunications Industry.**

A first "red flag" was that WorldCom in 2000 and 2001 reported revenue growth far greater than its competitors in 2000 and 2001. This contrast was clearly discernable but it did not cause Arthur Andersen to assess whether the growth was real as opposed to the result of some sort of accounting manipulation. The Examiner received no satisfactory explanation from Arthur Andersen audit team members why this disconnect between WorldCom and its competitors provoked no inquiring analysis by the auditors.

During much of 2000 and 2001, as the economic downturn began to affect telecommunications companies, WorldCom's competitors were experiencing minimal growth rates at best. Nonetheless, quarter after quarter during this period, the Company set revenue growth targets of 12 to 15 percent in year to year growth (at least for its WorldCom Group). And quarter after quarter, until the third quarter of 2001, WorldCom delivered those targets, earning favorable reviews from Wall Street and outstripping its competitors. WorldCom maintained its double-digit growth targets during the second and third quarters of 2001 even though, internally, managers were predicting shortfalls that would prevent the Company from reaching such growth levels. In the fourth quarter of 2001, WorldCom publicly reported a 7.1 percent growth rate – nearly half of its revenue target but substantially more than it would have achieved without the accounting irregularities. By February 2002, the Company was publicly downgrading its guidance for the WorldCom Group to "mid-single digits" revenue growth but, internally, was projecting instead nearly a 7 percent decline in its revenues year over year.

It is now clear that WorldCom would have reported results that were in line with its competitors but for the brazen manipulations of its financial statements. There is no evidence that Arthur Andersen had any awareness of the growing internal concerns within the Company during 2001 about the aggressiveness of the revenue growth targets that had been set and the difficulty in meeting such targets. Arthur Andersen did note, however, the industry's economic downturn and the fact that WorldCom's reported results often outstripped those of its competitors. The auditors observed that, in contrast to other competitors, WorldCom was meeting its targets and the expectations of the analysts quarter after quarter. While such achievements may not have been an issue during the late 1990's when the telecommunications industry was booming, the Company's ability to meet its aggressive expectations should have raised the auditors' antennae at a time when WorldCom's performance contrasted so sharply with that of its peers. Instead, Arthur Andersen seemed to take comfort in the fact that the growth rates, though high, remained stable and that the Company was meeting its expectations. Arthur Andersen ascribed WorldCom's standing to the success of its efforts to improve operational efficiencies and reduce reliance on leased lines. Thus, Arthur Andersen failed to flag this as a potential indicator of improper accounting manipulation, concluding instead that the contrast WorldCom presented was due to its concerted focus on improving efficiencies and reducing costs.

■ **Flat Line Cost E/R Ratios.**

Arthur Andersen auditors observed in the course of their audits that WorldCom's line cost E/R ratio was stable during 2000 and 2001, holding at approximately 42 percent. Indeed, those responsible for the Company's fraudulent accounting practices relating to line

costs manipulated the accounting in such a way as to ensure that the line cost E/R ratio stayed stable and was not subject to any sudden decreases that would have to be explained to the auditors. Yet, given a volatile market, WorldCom's flat line cost E/R ratio was in sharp contrast to its competitors, who were experiencing steadily increasing line cost E/R ratios over the same period. Arthur Andersen compared WorldCom's line cost E/R to the industry's average, observing that, the industry average line cost E/R exceeded 54 percent in 2000, and nearly 49 percent in 2001. WorldCom's line cost E/R ratio was considerably lower than Sprint's 60.5 percent and AT&T's 48.7 percent line cost E/R ratios for 2001.

Arthur Andersen noted the stability of the World/Com line cost E/R ratio as well as the industry trend to higher E/R ratios, the failures of other telecommunications providers and a perception of excess telephone capacity worldwide. Nevertheless, the auditors accepted that WorldCom's stable ratio was due to a concerted and effective effort by WorldCom's former Management to contain its line costs and other expenses, and improve efficiencies. The auditors also noted, without explanation, that the operations and focus of WorldCom's competitors differed from WorldCom's.

The auditors do not appear to have done any substantive testing to confirm the methods that the Company used to reduce line costs or to have sought internal documents to verify the Company's actual E/R ratios. The software that Arthur Andersen maintained would allow it to compare the Company's business performance with trends at its competitors and within the telecommunications industry does not appear to have been used to compare line cost E/R ratios. Instead, Arthur Andersen appears to have relied solely on the uncorroborated representations of former Management for the conclusion that WorldCom's level line cost E/R ratio, which differed so markedly from the rest of its industry, was due to

in-house cost containment measures. If the auditors had sought and obtained internal WorldCom documents, they should have learned that the Company's expenses — like those of its competitors — were outstripping its revenues. But for the accounting irregularities, WorldCom's actual line cost E/R ratio would have exceeded 52 percent during 2000 through 2001.

At minimum, the substantial difference between WorldCom's E/R ratio and those of its competitors should have sparked skepticism by Arthur Andersen. Such skepticism was all the more required for two reasons. First, the disparity between the WorldCom line cost E/R ratio and that of its competitors was significant. Second, line costs were WorldCom's largest cost category, demonstrating that if the E/R disparity were the result of any sort of manipulation, the magnitude of the accounting irregularities would be correspondingly large. Yet, Arthur Andersen chose simply to rely on Management's representation that it was working hard to control line costs and improve efficiencies and their belief that WorldCom's business structure differed from that of its competitors. The Examiner believes such an explanation fails to reflect the type of skepticism required by the professional standards.

■ **Increase of Revenue and Line Cost Reserve Releases as a Result of "Top-Side" Round Multi-Million Dollar Entries.**

Another sign that should have raised questions was the increase in the Company's reserve releases in the revenue and line cost areas for 2000 and 2001 as compared to prior years. Many of these releases were effected through "top-side" adjustments made by former Management after the normal close of the prior period and were embodied in round-dollar adjustments recorded towards the end of each quarter.

The line cost reserve releases took the form of individual journal entries such as: a \$239 million journal entry in the fourth quarter of 1999; a \$370 million entry in the first

quarter of 2000 releasing international line cost reserves; several entries totaling \$828 million in the third quarter of 2000 affecting line cost expense; and, a \$407 million entry in the fourth quarter of 2000 releasing deferred tax liabilities.

The Corporate Unallocated schedules reflected such releases as: \$100 million and \$133 million for “Minimum Deficiencies” in the second and third quarters of 2000 respectively; \$22.5 million in reserves titled “Swap HQ” for each quarter in 1999, 2000 and 2001 amounting to \$90 million each year; \$29.8 million in the second and third quarters of 2001 for “TCOMs Early Termination”; and \$15 million for “UUNet Credit reclass” and \$20 million for “MN/EM Credit reclass” in the second quarter of 2001.

Arthur Andersen was aware that the amounts reflected on the Corporate Unallocated schedule were the product of “top-side” adjustments and reclassifications. Accordingly, the auditors performed audit procedures to test a sample of those amounts, focusing primarily on certain large amounts. Many of the round-dollar amounts, including those described above, do not appear to have been questioned. The tests performed on the sample consisted of inquiry to Management and, in a handful of instances, review of supporting documentation though never the actual journal entries. Even the limited testing that was done appears deficient. In the case of one of the “Swap HQ” entries, Arthur Andersen understood and noted that such amounts were related to the Intermedia merger. However, Company witnesses were consistent in identifying such amounts during their interviews as related to certain agreements between WorldCom and a number of railroad companies. Nevertheless, Arthur Andersen satisfied itself that those amounts, where material, were in accordance with GAAP.

Such large round-dollar entries, especially when they occur in the last month of the quarter or at the end of the reporting year, are often indicia of fraudulent earnings manipulation. See e.g., SAS No. 82, AU § 316.25. Yet, because Arthur Andersen did not test the details or even drill down to the journal entry level, or, for the most part, review supporting documentation, the auditors did not seek to learn when or by whom these entries were actually directed and recorded. If they had made such further inquiries, they might have discovered that these items were indeed “top-side” adjustments entered at the direction of corporate Management after the close of the quarter and with little or no supporting documentation. Such facts should have raised serious concerns about the propriety of such entries under GAAP. At a minimum, these large round-dollar entries and corresponding increases in these revenue releases should have alerted the audit team to the potential for fraudulent activity.

■ **Changes in Significant Accounting Policies.**

Another indication of potentially aggressive and inappropriate accounting is the frequent change in a company’s accounting policies, which results in a reduction in expenses or an increase in revenues. WorldCom, during the period between 1999 until 2002, made some significant and frequent changes to its accounting policies.

One example of such changes was the Company’s purported decision to aggressively pursue the collection of Minimum Deficiency billings from its customers. As discussed above, Minimum Deficiencies constituted the value of the amount of services for which a customer had contractually agreed, even if the customer did not actually utilize the minimum amount provided for in its contract. Historically, the industry, including WorldCom, had not

been aggressive or successful in seeking to collect the minimum usage amounts from customers.

In the second and third quarters of 2000, WorldCom Management informed Arthur Andersen of an accounting policy change relating to Minimum Deficiencies, asserting that it would now aggressively pursue such amounts that were due. As a result of this policy change, Management represented to Arthur Andersen that it was appropriate to release approximately \$233 million in Minimum Deficiency reserves in the second and third quarters of 2000. Arthur Andersen does not appear to have analyzed that change in policy to determine whether it was indeed in accordance with GAAP or whether WorldCom had a sound factual basis for believing it could collect such amounts. At a minimum, the Examiner believes that this policy change should have provoked close scrutiny by Arthur Andersen to ensure that such policy change and reserve release accorded with GAAP. However, Arthur Andersen does not appear to have scrutinized this change.

Another example of WorldCom changes in accounting policies related to the method by which WorldCom recorded accruals for the backbilling of amounts it owed to the Local Exchange Carriers (“LECs”) for use of their lines. The Company historically accrued reserves for 100 percent of amounts billed to WorldCom by LEC’s and disputed any differences between its calculations and those of the LEC’s. Under-billings represent charges that the Company believes are valid based on its calculations, but are not yet billed. Prior to the merger with MCI, WorldCom’s line cost accrual was based on 12 months of under-billings. LEC’s had statutory authority to back-bill the Company for charges up to 24 months old, but, under industry-wide Gentlemen’s Agreements, had previously agreed not to do so. Subsequent to the merger, the Company changed its accounting policy and adopted

MCI's more conservative under-billing accrual method of 24 months. This appears to be due to the fact that the LEC's appeared poised to renege on the Gentlemen's Agreements and begin backbilling for charges over a 24 month period for the maximum time period.

Based upon Management's reviews of back-billings in the second and fourth quarters of 2000 (for 15 and 27 months after the MCI merger, respectively), WorldCom Management noted that the Company had not received any significant back-billings older than 90 days. In the early part of 2000, Management determined that a 12-month reserve was more appropriate, based on that historical information and the Gentlemen's Agreements with the LEC's. As a result, the 24-month period was reduced to 12 months. Later in 2000, the Company again reduced the 12-month period to 90 days, based upon a determination that the Company was settling its billings within the 90-day period and since the merger, had not been required to pay under-billings for periods in excess of 90 days. These changes resulted in approximately \$200 million accrued reserves being released into earnings during 2000.

Arthur Andersen reviewed the changes in the backbilling accounting policies on each occasion and found the changes to be in accordance with GAAP. However, while the changes in accounting policies may have been sound, the frequency of three changes over two years, including two changes in 2000, should have alerted the auditors to the potential for aggressive accounting and should have been further explored. Such frequent changes are often an indication of potential fraud, or at minimum, an indication that the Company is seeking to increase earnings by changes in accounting policy. While this is not necessarily problematic under GAAP, it may be an indication of potentially aggressive and improper accounting. It should be noted that KPMG has been unable to locate documentation by the Company to support these changes, as reflected in the Company's Form 8-K filed on June 9,

2003. Presumably therefore, if Arthur Andersen had sought documentation to support these accounting policy changes in 2000, it too would have found no support.

■ **2001 Audit Report by Internal Audit Department Relating to Capital Expenditures.**

Arthur Andersen did not rely on the audit work performed by WorldCom's Internal Audit Department, with the exception of certain rare instances documented in its workpapers. However, as part of its audits, Arthur Andersen did obtain copies of certain audit reports prepared by Internal Audit and participated in the Audit Committee meetings where Internal Audit's annual audit plan and reports were presented and discussed. However, there was an unusual lack of substantive interaction between Arthur Andersen and Internal Audit. This was, perhaps, partially explained by the fact that WorldCom's Internal Audit department did not generally perform financial audits.

In January 2002, during a meeting between Arthur Andersen, the head of the Internal Audit Department and Management, Arthur Andersen appears to have been provided with a copy of the final report issued by the Internal Audit Department for its 2001 audit of the Company's capital expenditures area. The report discussed the amounts of capital expenditures as budgeted and approved through Authorizations for Expenditures ("AFE's") and tracked internally. Those amounts were over \$2 billion less than the amounts of capital expenditures publicly reported by the Company. In a footnote, the report explained that its totals did not include certain amounts attributed to "Metro lease buyouts, line costs and *Corporate Accruals.*" (emphasis added). The reference to unidentified "Corporate accruals" in this context should have at least sparked an inquiry by the external auditors. However, there is no indication that this report was reviewed – or even read – by the Arthur Andersen auditors as part of the 2001 audit or otherwise. If inquiry had been pursued, Arthur Andersen

would likely have learned that the \$2 billion difference reflected the improper line cost capitalizations in 2001. However, since Arthur Andersen ignored this “red flag,” it undertook no substantive testing of this discrepancy.

■ **Forced Recordation of Line Cost Reserve Release Entry.**

During a quarterly review of the second quarter of 2000, Arthur Andersen learned of a \$33.6 million entry reducing line cost reserves that had been recorded in the books of one of the Company’s foreign subsidiaries, headquartered in England, at the direction of former U.S. Management. The entry was made in April 2000, after the close of the quarter and the reporting of the subsidiaries’ financial information to Management, without the knowledge and over the subsequent objection of senior financial employees of the subsidiary, including its Controller. After being apprised of the entry by an employee in the General Accounting office, the Controller learned that Mr. Yates had directed that the entry be recorded.

The journal entry was labeled “Line Cost Adjustment” and bore the heading of “March Top Level Adjustment.” The U.K. Controller was unaware of any support for such an entry. Accordingly, the Controller protested the entry to Messrs. Myers and Yates to no avail. He was informed by Mr. Yates and Mr. Myers that the entry had been directed by Mr. Sullivan and that he would have to accept the entry. The entry apparently boosted the subsidiary’s results so that it would meet its budgeted margins.

Subsequently, the Controller was asked by former Management to shift this release from the U.S. account to which it had been recorded to the statutory books of the subsidiary. The Controller refused to make such an entry in the statutory books because it lacked support, transferring it instead to the books of a management company that was not a legal entity, effectively removing it from the subsidiary's operating results but leaving the amount

in the Company's consolidated financial statements. Meanwhile, the Controller continued unsuccessfully to press for the reversal of this entry.

The Arthur Andersen team responsible for auditing the subsidiary's financial statements learned of the entry and informed Mr. Avery, the engagement manager for the overall audit. Mr. Avery spoke with Mr. Myers who told him that: (i) the entry was due to a dispute between WorldCom and British Telecom; (ii) EMEA management was incorrect in urging that it had no support; and, (iii) the entry would be reversed during the third quarter of 2000. Mr. Avery indicated to the Examiner that he did not recall ever learning that the Controller had transferred the entry to the records of a separate management company, even though the e-mail informing him of the entry clearly describes how it was handled.

The Arthur Andersen audit team accepted Mr. Myers' explanations and the representation that the entry would be reversed but did not perform any substantive testing to ensure that the initial entry was proper and that the entry was indeed reversed during the following quarter. The team also did not seek any documentation to corroborate Mr. Myers' explanation, which, on its face, seems questionable. At minimum, Arthur Andersen should have pursued the basis for the Company's recording a \$33.6 million entry in one quarter, only to reverse it in the next quarter. Instead, the auditors assumed the entry had been reversed based upon a review of variances in the consolidated financial statements that did not appear unusual. Because \$33.6 million was fairly insignificant in relation to the consolidated financial statements, its presence would likely not have resulted in an unusual variance. However, the amount was higher than the \$19.5 million minimum threshold set by Arthur Andersen for proposing adjusting entries.

In fact, the entry was not corrected and has been identified for restatement by the Company as part of its August 2002 proposed restatement. Apparently, the entry reflected the improper reduction of a line cost reserve. Arthur Andersen was on clear notice that, although this entry had been directed by corporate Management in the U.S., the foreign subsidiary's Controller had disputed its propriety because it lacked support, and that former Management had represented that it would be reversed.³¹⁴ Based on these facts, the auditors should have scrutinized the entry by reviewing supporting detail and, at minimum, sought to confirm that the entry was reversed during the third quarter. However, the significance of this matter does not appear to have registered with the auditors.

■ **Aggressive Treatment of In Process Research and Development Expenses.**

At the closing of the merger between WorldCom and MCI, the Company was required to address the accounting for the substantial research and development expenses that had been incurred by MCI. While GAAP requires that research and development expenses be expensed as they are incurred, the acquiring entity in an acquisition of an enterprise that has previously incurred and expensed sums for research and development must expense that portion of the purchase price that is attributed to the in-process research and development of the acquired entity. See Financial Accounting Standard Board (“FASB”) Interpretation No. 4.

The Company initially took an aggressive stance with respect to the valuation of MCI’s in-process research and development, recording a nearly \$7 billion charge in the pro

³¹⁴ The Arthur Andersen engagement partner indicated that Arthur Andersen generally would confer with Management and conduct its own analysis in the event of disputes between the financial management of the Company’s entities so that such disputes would be reconciled for audit purposes. In this instance, however, no such independent analysis was performed by the audit team. No explanation was provided for the lack of analysis.

forma financial statements the Company filed with the SEC. Arthur Andersen was involved in auditing the Company's valuation, and together with two other firms, performed valuation analyses. They estimated the value of the in-process research and development to be in the range of \$3.1 billion. After extensive comments from the SEC, as well as continued work by Arthur Andersen involving its Professional Standards Group in Chicago, the Company agreed to reduce the charge to \$3.1 billion from 7 billion.

During the relevant period, the SEC and accounting professionals had been expressing concerns about the excessive amounts of purchase price premiums that were being attributed to in-process research and development and immediately being expensed by a number of acquiring companies, thereby reducing the allocation to goodwill and averting future amortization charges and reductions to their reported earnings. While the Company ultimately agreed to resolve the matter by taking a charge in keeping with the valuation analyses that had been performed, former Management's initially highly aggressive approach, taken together with Arthur Andersen's assessment of Management as being aggressive with respect to purchase accounting issues in general, was one more indication that the Company engaged in aggressive accounting that should be scrutinized.

(ii) Herding of External Auditors through Gatekeepers

WorldCom's former senior financial Management sought to restrict the contacts between the Arthur Andersen audit team and Company personnel by requiring that the auditors first communicate any requests for documents or information to the Company's Vice President for Financial Reporting, Stephanie Scott, and/or the Controller, David Myers, both of whom functioned as the Company's "gatekeepers" for the audits. Such communications included requests for documents to be prepared by the client ("PBC") that were compiled during the audit planning process and identified on lists provided to WorldCom ("PBC

Lists”), as well as requests for documents and information the auditors determined they needed during their fieldwork stage.

While centralizing communications between company personnel and external auditors is not unusual or inappropriate, the restrictions placed by WorldCom on the access of Arthur Andersen to Company personnel and documents appear to have been excessive. This was a longstanding source of contention between WorldCom and Arthur Andersen. Indeed, such restrictions appear to have been a constant theme of the Arthur Andersen and WorldCom audit relationship during the relevant period. This type of restriction, where excessive, is noted as a possible indicator of fraud by management in SAS No. 82, AU § 316.25.

Senior former WorldCom Management appear to have regularly chastised and reminded the Arthur Andersen audit team members that they should not seek to access Company documents or personnel directly without first having discussed their needs with Ms. Scott, Mr. Myers, or their staffs. Mr. Avery set forth the process in a November 1, 1999 e-mail to the audit team:

... concerning the substantive testing or balance sheet reviews we need to forward all PBC request lists to me and I will give them to Stephanie and David[;] they will then disburse the requests to the appropriate individuals who will then in turn return the completed PBC to Stephanie and David... additionally, during the course of fieldwork you will probably identify additional areas that may require PBC’s, in the event that you do the same line of command is to be followed. . . .

Mr. Avery further reminded the audit team that “[i]t is imperative that we follow the applicable chain of command in order to keep the firm out of hot water and limit the number

of personal chewings I receive to 2-3 a day.”³¹⁵ At one point, Mr. Avery was chastised by Ms. Scott for providing information directly to Mr. Sullivan without first clearing it with her.

Indeed, Ms. Scott and her direct reports constantly chastised the auditors for going directly to WorldCom officers and employees without her involvement or prior knowledge. Thus, in January 2000, Ms. Scott admonished the auditors for providing a PBC list relating to the 1999 audit directly to the Revenue Accounting Group that was inconsistent with the PBC list that she had approved. Thus, in a January 19, 2000 facsimile, Ms. Scott noted to the auditors that the PBC list they provided to Ron Lomenzo and Lisa Taranto was “not what I approved. Ron Lomenzo will provide support for accounts, but it will be in the former WorldCom format. Ron will send to me and I will approve before AA is given a copy.” The next day, she returned to Arthur Andersen its PBC list which she had revised noting: “I had not approved the attached list as provided to Ron Lomenzo. It is inappropriate to make changes to schedules after I approved and assert to others that the schedules have my blessing.” Her revised PBC list rejected Arthur Andersen’s requests for supporting documentation for the billing adjustment reserves, schedules supporting the calculation of certain reserve components, the reconciliation of the Accounts Payable sub-ledger to the General Ledger, and copies of the journal entries and supporting billing system reports to record revenue and accounts receivable in the general ledger. Arthur Andersen does not appear to have challenged or placed any significance on Management’s refusal to provide such information. Indeed, such requests do not appear to have been part of subsequent PBC lists.

³¹⁵ Mr. Avery and his counsel both discounted the language in this e-mail when Mr. Avery was questioned by the Examiner’s counsel, describing it as “tongue-in-cheek.”

WorldCom personnel seemed singularly obsessed with keeping the external auditors away from particular individuals. Thus, the auditors appear to have rarely interacted with certain employees or officers in several key groups, such as the Revenue Accounting Group, the Internal Audit Department and the Operations Department, from which certain information relevant to their audits originated. Auditors who sought to speak to particular employees of the Property Accounting and Capital Reporting Groups were apparently directed to a handful of representatives from those groups. Further, during a visit in 2001 to the United Kingdom to meet with personnel at the Company's international subsidiary, the new engagement partner, Melvin Dick, was not permitted to meet with certain accounting and sales personnel that he and Mr. Avery had requested to meet. The gatekeepers restricted those meetings to certain personnel, explaining that the personnel that had been designated by the auditors were not the appropriate parties. Arthur Andersen appears to have accepted such restrictions without any significant push back.

Although they were aware when they were restricted from meeting or talking to particular people, the audit team may not have been conscious of the full extent of the restrictions WorldCom enforced with its personnel. In one telling instance, employees in the Property Accounting Group who were contacted directly by an auditor sought Ms. Scott's approval to furnish certain requested spreadsheets that supported the summary level detail they had initially provided the auditor relating to costs capitalized as line installation costs and as Local Exchange Carrier ("LEC") fees. Arthur Andersen received this information, but internal WorldCom personnel were told to "Talk to [the auditors] about going behind our back on this." However, the auditors do appear to have been aware of WorldCom's

requirement that all information requested on Arthur Andersen's PBC lists flow to the auditors through the gatekeepers.

Most of the schedules provided to Arthur Andersen that have been determined to be false or misleading were manipulated after they had been prepared by employees in the relevant reporting areas and provided to the Company's former senior Management for their review and approval prior to being submitted to the external auditors. While there is no evidence that the auditors were aware that schedules were being modified and manipulated at that level, the fact that they were being "herded" through the office of the Controller and head of Financial Reporting was well known.

Arthur Andersen was also restricted from accessing the general ledger on its own. Former Management was internally adamant about refusing to provide computerized access to the general ledger through Essbase to Arthur Andersen. Internal communications suggest that Arthur Andersen may have battled Management for such access prior to the relevant period. Nevertheless, with few exceptions, the auditors during the relevant period do not appear to have even sought such access to the general ledger, relying instead on being provided schedules and information generated by former Management.

Thus, former senior Management steered the auditors to particular employees to respond to their questions and became agitated when the auditors sought to obtain information from other employees. Such limitations should have heightened the auditors' skepticism and alerted them to the possibility that Management might be engaging in steps to shield information from the auditors, particularly since such conduct is noted by professional standards as a possible indicator of fraud. See, e.g., SAS No. 82, AU § 316.17(a) (Risk factors for material misstatement due to fraud include "formal or informal restrictions on the

auditor that inappropriately limit his or her access to people or information [and d]omineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work.”)

However, it does not appear that the auditors ever questioned, or, even considered, that those responsible for gathering the PBC documents might have a role in changing those very documents to reduce potential questions by the auditors and to conceal the aggressive accounting. Instead, the audit team appears merely to have accepted such restrictions.³¹⁶

(iii) Delays in Obtaining Information from the Revenue Accounting Group

Throughout the relevant period, Arthur Andersen assessed WorldCom a “Fair” rating with respect to its behavior towards the audit process and delays in providing the auditors access to documents and information. One of the auditors involved in this assessment indicated her understanding that the audit team had, in the past, experienced unexplained delays in obtaining information. Further, during the relevant period, she and other members of the audit team experienced significant difficulties in obtaining information from the Revenue Accounting Group, which was a key information source for the auditors.

In one instance, the audit team had been seeking information relating to certain revenue reserve items on the MonRev for a number of weeks but that information had not been provided. One of the engagement seniors seeking to obtain that information complained to the engagement manager:

I am concerned about the ability to tie into Monrev. I know . . . Angela [Newell] has expressed concerns to you with Lisa [Taranto] and her lack of responsiveness. Her hard times with Lisa are very similar to the problems that I

³¹⁶ The herding was rationalized by the audit team as the Company wanting to make sure that the auditors were provided with the information they had sought in the most efficient way possible, thus reducing duplicative or inappropriate audit fees. The audit team did not view such restrictions as placing any limitations on the conduct of the audit or their access to the documents and information they had requested.

had last year as well. To completely get our arms around this, we are going to need someone to express to her the importance of assisting us perform this testing. She is the person that would have to provide us with the assistance to perform these tests.

A few days later, the auditor complained to another member of the audit team:

. . .The problem is with the Revenue Assurance Group in Atlanta. Lisa Taranto is unable and unwilling to provide us with information (consistent with last year). Kenny [Avery] is aware of this issue and I believe has informed David [Myers]. We were led in circles last year at year end until Stephanie [Scott] got involved. I am aware that others within WorldCom (namely Steve Rubio and other NR people) have similar concerns with her. She reports to Ron Lomenzo who is of course a direct report to Scott [Sullivan].

In another instance relating to the 2000 audit, Arthur Andersen persisted for three months requesting certain schedules relating the reserve balances of the legacy WorldCom and MCI Groups. When schedules were eventually provided in response to those requests, they were provided in consolidated form (rather than the separate Tracker groups) and had been manipulated to conceal the significant debit balances in the WorldCom Group's reserves resulting from the releases in Minimum Deficiency reserves.

The Arthur Andersen engagement manager indicated to the Examiner's representatives that he had sought to resolve such problems by appealing to Ms. Scott and/or Mr. Myers and that the requested information was always eventually provided. Some delays in providing documents and information to auditors often occur and are not necessarily grounds for concern. Such persistent delays and non-cooperation, especially from the employees most responsible for recording the Company's revenues, should have raised alarms. Moreover, at WorldCom, there was a distinct pattern of delays in providing access to documents and information from the Revenue Accounting Group, one of the groups potentially responsible for the manipulation that occurred in many of the Company's improper reserve releases into earnings.

Arthur Andersen did not view these delays as anything more than isolated instances of employees who were thought to be too busy to deal with the auditors. Indeed, the delays were handled in a non-confrontational manner. When the auditors experienced similar delays in obtaining information from Ms. Taranto's supervisor, Ron Lomenzo, the Vice President for Revenue Accounting, the overriding concern expressed by the engagement manager to the auditor's supervisor was the need to treat Mr. Lomenzo carefully and not escalate tensions with the Company. Thus, Mr. Avery cautioned in a January 21, 2000 e-mail:

. . . . we need to talk to Joan [Lynch] about her demeanor with the Company specifically Limenzo (sic), she has been what was described to me as rude, snippy and pushy about the schedules needed for the audit. I understand the time constraints that we are operating in; however, this is not the first time this kind of message has been sent up through the ranks. I do not think permanent damage has been done and we do not need to talk to Stephanie [Scott] about it any further she just ask me what was going on. I explained that Joan was trying to work under the time frame of sign off and was probably trying to convey those time constraints to Ron [Lomenzo] and others and they probably misunderstood those as demands. She just wants us to be careful as always.

The previous day, Mr. Avery, in describing to members of the audit team an incident that appears to have related to changes made to the PBC List by the auditors, reassured the auditors that Ms. Scott had eventually acknowledged that the auditors were not at fault. He noted, however, "that Ron Limenzo (sic) is a direct report to Scott Sullivan and we should handle him with the utmost (sic) care."

Such delays originating from one of the units in the Company that was in a position to and in fact did manipulate the Company's accounting should have been a "red flag" noted by Arthur Andersen. See SAS No. 82, AU § 316.25 (Identifying as a fraud risk factor, "[u]nusual delays by the entity in providing requested information.") Instead, it was merely

taken in stride and never considered an obstacle or, indeed, worthy of reporting to the Audit Committee.

5. Arthur Andersen's Failure to Detect or Report on Internal Control Deficiencies

WorldCom disclosed in its June 9, 2003 Form 8-K filing that KPMG had issued a management comment letter to the Audit Committee noting many material internal control deficiencies identified during its reaudit of the Company's financial statements for the relevant period. Many of these deficiencies existed during the relevant period and should have been observed and similarly noted by Arthur Andersen.

Arthur Andersen did not provide the Audit Committee with any management comment letters, or even any statements of concern as to presence of internal control risks to the Company's financials during the relevant period. To the contrary, the auditors concluded that there were no material internal control weaknesses or reportable conditions at WorldCom during their audits of the relevant period.³¹⁷ Senior members of the Arthur Andersen audit team were emphatic during their interviews that such letters were not required for WorldCom. In fact, the last management comment letter we have been able to locate was a draft letter provided by Arthur Andersen to WorldCom Management and discussed by the Audit Committee in January 1997 in connection with the 1996 audit.³¹⁸ The

³¹⁷ GAAS requires that auditors report to the Audit Committee significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements SAS Nos. 60, 78, AU § 325.02. Such items are often reported in the form of management comment letters to the Audit Committee.

³¹⁸ Arthur Andersen's counsel refused to respond to repeated written and oral requests for a final copy of this management comment letter, as well as copies of all management comment letters provided by Arthur Andersen to WorldCom for the period that it audited WorldCom's financial statements. Mr. Schoppet, the engagement partner, did not recall the 1997 letter and expressed doubt whether this letter was ever finalized by Arthur Andersen and provided to the Company since it did not appear to be in the form with which he professed to be familiar. He suggested that this might be a draft prepared by someone on the audit team but never provided to the Company. He indicated that he was not aware of any material reportable internal control weaknesses that

draft management comment letter noted a number of deficiencies and prophetically recommended that the Company institute fraud training for its senior financial management, stating:

As with most large entities, the Company is facing increased risks in its ability to prevent, deter, and detect fraud and other improper activities. As the Company positions itself to aggressively compete in the local service arena, its reputation and integrity will continue to be very important. Any fraudulent or improper activity could tarnish this image and negatively impact the Company and its business activities. . . . With the aid of the Internal Audit Department, the Company should consider implementing the following practices: Performance of fraud and illegal acts risk assessments within appropriate business units and operating departments to identify those areas where the Company may be more susceptible to improper acts[;] Development of analytical reports and performance of tests, based upon risk assessments, to identify anomalies that may indicate potential fraud[;] Mandatory fraud training for upper management to heighten awareness regarding their fiduciary responsibility to prevent, deter and detect fraud. Additionally, management should be made aware of the potential personal liability they may face as a result of fraud and other illegal acts. . . .

It does not appear that any particular procedures, including any fraud training for Management, were instituted by WorldCom to address such matters.

Arthur Andersen did provide so-called business improvement memoranda to Ms. Scott and Mr. Myers according to a memorandum to the file by the engagement manager. These memoranda were not, however, provided to the Audit Committee or even referenced in Andersen's communications with the WorldCom Audit Committee. Similarly, there is no evidence that the memoranda went to the Internal Audit Department. The field auditors would apparently maintain listings of operational deficiencies they noted for possible inclusion in management comment letters and provide such lists over the course of

were detected by Arthur Andersen while he was engagement partner. However, the draft 1997 letter was located in the files of the Company employee responsible for compiling materials that were presented to the Audit Committee and the letter bears the handwriting and initials of certain Company employees. Thus, the Examiner concludes that the letter was indeed provided by Arthur Andersen to the Company at least in draft form and discussed, according to minutes, at the Audit Committee.

the audit to the audit partners for determination whether such items were material or reportable conditions. The audit partners would determine what matters would be brought to the attention of Management. Some of these management memoranda reflect items that were not deemed by Arthur Andersen to be material or reportable conditions but that appear to be significant, and were, in fact, later deemed material weaknesses by KPMG. These include: the lack of sufficiently experienced finance and accounting personnel and resources in the financial reporting area; the lack of procedures to reconcile the general ledger and subledger accounts, including those relating to accounts receivable; the need for improvement in the segregation of duties for those personnel responsible for recording journal entries; and the absence of controls over access to the computerized accounting systems.

Arthur Andersen's handling of this process is disconcerting, especially in light of the myriad of material weaknesses in the internal controls and reportable conditions that were disclosed in the Company's June 2003 Form 8-K. Arthur Andersen was required by professional standards to review and obtain an understanding of the Company's internal controls, especially in light of the controls-based audits that it performed. SAS No. 82, AU § 316.27.

The Examiner recognizes the benefit of hindsight in KPMG's review. Nonetheless, it seems certain that some, and possibly most, of these conditions existed at the time that Arthur Andersen was auditing WorldCom's financial statements and that they were either not observed by Arthur Andersen or deemed to be immaterial. Regardless, either of those conclusions would be troublesome, suggesting that Arthur Andersen did not appropriately test and assess the Company's internal control environment in these important areas to the degree necessary for a controls-based audit or did not place appropriate significance on the

nature of the weaknesses that were discovered. Moreover, Arthur Andersen may have breached duties it owed to the Company by failing to identify and disclose such deficiencies to the Company's Audit Committee, in accordance with GAAS, to the extent they were material at the time. See SAS Nos. 60, 78, AU § 325.

It is inexplicable that Arthur Andersen had not noted or deemed material any of the internal control weaknesses later identified and deemed material by KPMG, including the following:

- Accounting and financial reporting personnel who lacked experience and were over-extended in their responsibilities due to insufficient staffing;
- Lack of procedures relating to the review and monitoring of general ledger accounts, the control over the close process, and the reconciliation of subsidiary ledgers to the general ledger, including cash accounts, and the billing process;
- Lack of procedures to reconcile the MonRev report to the general ledger;
- A lack of or insufficient supporting documentation for many journal entries, particularly in the accounts receivable and line cost expense and accrued liabilities areas, where some accounts receivable journal entries contained as descriptions notations to "see revenue department;"
- Deficient formal communication and coordination among operational functions in the revenue and accounts receivable departments;
- Unresolved reconciliation items between the SAP general ledger used at WorldCom and the legacy systems that were used by companies acquired by WorldCom;
- A consolidation process that was largely undocumented with only a few individuals having a limited understanding of only certain parts of the process;
- No established or documented policies and procedures to ensure the proper recording of elimination journal entries;
- A need for significant improvement in the segregation of duties, responsibilities and management review controls;
- The lack of an independent review over accounting personnel with the ability and responsibility to post and reconcile accounts under their control;

- Numerous employees with system access permission beyond their position needs;
- Multiple departments with access and the ability to record journal entries in the revenue and accounts receivable department sub-ledgers and general ledger accounts;
- A severe lack of policies, procedures, and standardization of operating and financial controls and a general lack of documentation related to existing controls;
- A failure to review and reconcile the inter-company accounts; and
- Failures by the Company to complete or file statutory financial statements on a timely basis, which has subsequently resulted in significant late adjustments and potential tax and legal exposure in foreign jurisdictions.

6. Arthur Andersen's Relationship to WorldCom May Have Shaped Its Responses to Its Risk Assessments and to "Red Flags."

The Examiner has identified in prior sections both troubling risk assessments and "red flags" about WorldCom. These assessments and "red flags," taken together, are the sort of data that would have caused a reasonable auditor to step up testing to ensure that its audit was being carried out in accordance with the GAAS, as those tests must be adjusted, in accordance with GAAS, for the data discovered in the audit process. This did not occur to any material extent, and the Examiner has sought to determine why.

The Examiner has reached no firm conclusion. However, the Examiner observes that a likely reason was Arthur Andersen's overriding desire to grow its non-audit business relationship with WorldCom. Consistent with such a desire, it would be natural for Arthur Andersen to wish to trust the representations of former Management rather than press for an increase in corroborating documentation, which could strain the business relationship by increasing the amount of time and fees that may need to be incurred for the audit.

Thus, it appears that Arthur Andersen's relationship with WorldCom was marked by efforts to reduce tensions with senior financial Management and to demonstrate a service-

oriented approach to the Company's Management, while seeking to develop additional business opportunities. Such efforts are certainly to be expected in the client-service oriented auditing industry and were not per se inappropriate, particularly during the relevant period. Further, business development efforts to expand the nature of the services provided by Arthur Andersen and its consulting subsidiary were also not improper at the time, which predated the restrictions enacted by the Sarbanes-Oxley Act of 2002. However, it is possible that certain incidents would have been handled differently by an audit team less affected by such considerations.

The drive for growing the business relationship was expressed in the participation by senior members of the Arthur Andersen engagement team in frequent business development or SOAR³¹⁹ meetings to discuss targeting efforts to obtain potential business opportunities from WorldCom for Arthur Andersen and its consulting subsidiaries. For example, during the 2000 SOAR team's meeting for the 1999 audit, the team discussed Arthur Andersen's internal goal of achieving \$18.5 million in net fees by the following year from WorldCom audit and non-audit services.³²⁰ Much of the e-mail correspondence between Mr. Schoppet and Mr. Sullivan to which we obtained access appears to relate to potential opportunities for Arthur Andersen to provide consulting services to WorldCom and its subsidiaries. While this was not an unusual industry occurrence, it is possible that the heavy emphasis on increasing the level of services Arthur Andersen could provide and nosing out potential competitors for

³¹⁹ SOAR was an Arthur Andersen firmwide business development initiative bringing together on an ongoing basis the senior members of the engagement teams for the firm's large clients to discuss business development opportunities. The WorldCom SOAR team included the main partners on the WorldCom audit, as well as other members of the Arthur Andersen engagement team.

³²⁰ Arthur Andersen's (and its consulting subsidiary's) total fees for audit and non-audit services for WorldCom were \$17,923,000 for 1999, \$26,688,000 for 2000, and \$16,790,000 for 2001.

the services they were providing and hoped to provide, may have served to minimize the importance of some of these incidents as “red flags.”

The importance of the WorldCom relationship to Arthur Andersen is echoed in the words of the audit engagement manager, Mr. Avery, in a November 1, 1999 e-mail to the audit team. Thus, shortly after the announcement of the contemplated Sprint merger, Mr. Avery expressed concerns about the potential competition to Arthur Andersen from Ernst and Young, Sprint’s external auditor:

... we have an opportunity to provide value to Stephanie [Scott]/David [Myers] by keeping them informed of what is going on out in the field. Of course, I realize that what is done with that information can sometimes harm our relationships in the field but make no mistake Stephanie/David have significant influence with Scott Sullivan. With the upcoming Sprint merger the desire for control [by WorldCom’s Management in Jackson] will be even greater. We must demonstrate that we can provide the information they need in the manner they need such that they will be loyal supporters during what will most likely be at least an attempt by E&Y for the audit. . . I realize at times this client pushes our patience and sanity to the limit -- in the end though we are all part of one of the largest telecommunications clients in the world, one that will have on a pro forma basis \$55 billion in revenues when the Sprint merger is completed. Additionally, as each of you know this is a high profile client for the firm and the telecommunications practice as a whole. In the next couple of weeks we will be sending out a firm fiscal 1999 report card to give you an idea of the impact and recognition the client receives throughout the firm. I am confident that we have a good plan and the right assets to execute it. Thanks to all of you on the front end and if we pull it off this year who knows where the 2000 client service team meeting will be.

The same emphasis on accommodating the client is seen after Arthur Andersen was replaced by KPMG as the external auditor in 2002. Thus, in an e-mail from the former Arthur Andersen engagement partner, Mark Schoppet to Mr. Sullivan, Mr. Schoppet assured that WorldCom would continue to receive the same level and quality of service from KPMG that it had received from Mr. Schoppet and the Arthur Andersen audit team. Mr. Schoppet assured Mr. Sullivan that he would continue to play a role on the audit, even though he had technically rotated off the audit due to SEC rules and that, once his time-out period had

ended, he anticipated returning as engagement partner.³²¹ Mr. Schoppet also reminded Mr. Sullivan of the many times that he “worked” the partners in the Arthur Andersen Professional Standards Group (“PSG”) on behalf of WorldCom to ensure that WorldCom achieved its desired outcome on audit issues. He offered to play the same role at KPMG but noted that it would take some time until he got to know the appropriate people at KPMG.³²²

As noted, Arthur Andersen’s obvious desire to grow the WorldCom business relationship was not per se improper, particularly at the time made. However, it supports the conclusion that the Arthur Andersen-WorldCom relationship did not carry with it, from the Arthur Andersen side, the dose of professional skepticism that was required. This is not to say that the Arthur Andersen auditors, if shown particular evidence of the accounting irregularities, would not have moved swiftly to investigate. The Examiner has no evidence to the contrary. But, absent strong evidence of something amiss, the evidence supports the conclusion that Arthur Andersen personnel would be hesitant to take action that might upset their audit client, such as by insisting on obtaining documents and access to personnel that former Management had deemed irrelevant or inappropriate, or protesting strongly the delay in the provision of requested data.

7. The Deficiencies in Arthur Andersen’s Audit Procedures as to Items Subsequently Restated

The deficiencies in Arthur Andersen’s audits of WorldCom stem primarily from its failure to exercise professional skepticism and incorporate the needed substantive testing procedures that were warranted in those audit areas that were most impacted by the

³²¹ KPMG emphatically rejected Mr. Schoppet’s representations to Mr. Sullivan when its engagement partner became aware of the e-mail and denied that there was ever any plan to have Mr. Schoppet return to the WorldCom audit as engagement partner.

³²² Mr. Schoppet described the e-mail as nothing more than an effort to reassure a client that it would receive the same level and quality of service from the new external auditor.

accounting irregularities. Substantive testing was warranted in those audit areas based on the risks of fraud that Arthur Andersen had identified, the “red flags” described above, and to corroborate or otherwise test the representations received from former Management.

Each fraudulent manipulation at issue was achieved through “top-side” adjustments directed by the Company’s former senior financial Management. Each manipulation was then concealed from the auditors through such means as false and misleading responses to their inquiries and manipulated documents and schedules: \$3.3 billion of reserve releases and other adjustments, including \$1.49 billion in line cost reserve releases; at least \$960 million in revenue and other reserve releases and other adjustments; and \$3.8 billion in improperly capitalized line costs. Such top-side adjustments should have been anticipated by Arthur Andersen. Regulators had repeatedly cautioned auditors about “top-side” or “non-standard” adjustments and identified such entries as presenting a risk that a company’s management is engaged in fraudulent manipulation of its accounting. See Section V.F.1, supra. Professional standards thus required the auditors to design tests to identify and scrutinize such entries to obtain reasonable assurance that the financial statements were free of fraud or material misstatement. See e.g., SAS No. 82, AU § 316.29.

Arthur Andersen did recognize in its audit plans the need to scrutinize WorldCom’s financial statements pertaining to “top-side” adjustments. For example, Arthur Andersen for the 1999 audit identified the need to provide special attention to significant “top-level” adjustments made by the Company to its financial statements relating to line costs. Similarly, the audit team also recognized and ranked highly during its 2001 Fraud Brainstorming Session, the overall potential for “top-side” entries. However, the audit team failed not only to scrutinize the Company’s financial records to identify “top-side”

adjustments but also to drill down to the detail level to test those adjustments that it identified.

The very crux of the auditor's responsibility was to implement meaningful audit procedures to address the possibility of improper "top-side" adjustments by Management. Instead, Arthur Andersen accepted WorldCom's representations on the "top-side" adjustments, subjected the representations only to a rule of reason, and failed to implement any type of detailed testing to confirm them. Such an approach lacks the professional skepticism called for by auditing standards and flies in the face of the numerous cautions and warnings provided to the accounting profession during the relevant period.

A discussion of how Arthur Andersen missed those "top-side" adjustments in those relevant areas is provided below, in the context of a discussion of the auditors' planned and implemented audit procedures in those areas.

a. Improper Capitalization of Line Costs

Arthur Andersen's lack of substantive audit procedures relating to capital expenditures and line costs was critical to Arthur Andersen's failure to detect WorldCom's improper capitalization of line costs. Arthur Andersen's audit procedures over the three audit years involved reviewing processes and testing controls related to: capital expenditures and the initiation and approval of capital projects through the Authorization For Expenditure ("AFE") process; the initiation and inputting of purchase information and orders into the various systems; the tracking and identification of completed Construction in Progress ("CIP") projects; and the analysis of depreciation expenses. Arthur Andersen also appears to have generally reviewed the Company's capitalization policies in certain areas.

To test the completed and open CIP projects, the auditors also reviewed a small sample of projects to gain comfort that the internal controls were effective. Arthur Andersen

performed some testing of transfers of assets to the Company's PP&E accounts, but that testing consisted essentially of inquiries to former Management, even though the auditors did note the presence of large multibillion dollar balances in the net transfer column of the PP&E roll-forward schedules they reviewed. Such balances at the end of the audit year were unusual since the transfer column did not net to a zero balance. However, the testing did not involve gaining an understanding of the sources for the items recorded to the consolidated balances of the PP&E accounts. Had the auditors sought to document the fixed asset components of the accounts, as required by GAAS irrespective of any risk assessments, they presumably would have identified significant portions of the fixed asset account that were not attributable to any AFE's. Arthur Andersen's approach was thus effective only if all entries to fixed assets were made through the AFE process. That was clearly not the case.

Significantly, as discussed above, Arthur Andersen, in its risk assessments, identified risks that the Company's accounting in the areas of line cost expenses and capitalization policies might be tainted by material misstatement due to fraud. Substantive testing in this area was warranted. Such testing should have revealed, at minimum, a number of indications that would have caused a reasonable auditor to probe more deeply: the recording, typically in the third month of the quarter or thereafter, of certain large round-dollar journal entries (some in excess of \$700 million) by accounting clerks in the General Accounting office at the direction of their supervisors; the unusual labeling of such entries as "Prepaid Capacity Costs;" the transfer of such costs to fixed assets through these entries; the lack of supporting documentation for these journal entries; and the lack of explanation by most personnel to justify such entries.

Arthur Andersen also missed an opportunity to detect the fraud by failing to evaluate available data that showed a significant disparity between internal and external capital expenditure data. Thus, Arthur Andersen appears to have been oblivious to a very important development in the capital expenditure area that was well-known within the Company's Operations Department, which was responsible for managing the Company's capital expenditures, and questioned even by outside vendors to the Company.

During 2001, Operations employees were asked to institute draconian measures to achieve substantial cuts in the Company's capital spending in light of the deterioration of the Company's finances. However, as former senior Management sought more reductions, the Operations managers became increasingly frustrated because their internally reported capital expenditure numbers differed materially from the capital expenditure amounts publicly reported by the Company. By the end of 2001, the differential amounted to approximately \$2.1 billion, a very significant number even for a company the size of WorldCom. Outside vendors who were being assured by the Company that they were being provided a significant degree of the Company's capital contracts, had begun to question which competitors were obtaining those additional contracts for the billions of dollars worth of capital projects that the Company publicly reported.

By the spring 2002, the Operations employees were preparing materials for senior Management and the Board of Directors regarding the capital expenditures budget. Because the source of the \$2.1 billion in differentials for the 2001 expenditures was unknown, that differential was initially attributed to "Corporate" in a number of power point presentations prepared for senior Management. Apparently, Mr. Sullivan directed that this specific reference to Corporate and the differential be deleted.

At the end of May 2002, an employee in the group was finally granted access to the Company's Corporate Consolidated cube in the general ledger through the Essbase software program, access that he and his group had previously repeatedly sought but had been denied. He then observed that the \$2.1 billion differential was attributed to certain unusual journal entries labeled "Prepaid Capacity Costs" and persisted in further investigation of such entries. He and his supervisor were informed that the entries reflected capitalized line cost expenses. This occurred just prior to the Internal Audit Department discovery of the improper "Prepaid Capacity Costs" entries in early June 2002.

In January 2002, Arthur Andersen was on notice of the inconsistency between WorldCom's internal and externally-reported capital expenditure numbers, when Arthur Andersen was provided with the report by the Internal Audit Department of its 2001 Capital Expenditure audit. This report identified \$4.9 billion in capital spending for 2001, which was over \$2 billion less than the publicly announced capital spending. The report noted, without further explanation, that it was excluding from its totals those amounts attributed to "Metro Lease Buyout" line cost or "Corporate Accruals." Arthur Andersen does not appear to have scrutinized the report, and this reference was neither questioned nor even noted by Arthur Andersen. Further, Arthur Andersen did not coordinate its audits of this area with the Internal Audit Department.

Arthur Andersen auditors responsible for this audit area do not appear to have had any knowledge of this significant differential between the internal and external capital expenditure numbers. While it does not appear that information relating to the actual differential was ever withheld from the auditors by those employees responsible for managing the Company's capital expenditures, it also does not appear that the auditors

performed any testing or asked any questions that would have elicited this type of information. Nor did the auditors ever appear to have sought access to this portion of the general ledger or the underlying journal entries. By failing to perform any substantive testing to understand the source of the capital expenditure amounts publicly reported, to reconcile those amounts to the general ledger, and, to ensure that internal controls were not being circumvented by the addition of capital expenditures as corporate adjustments outside of the normal AFE process, the auditors missed a substantial opportunity to detect the capitalization of line costs.

The fraudulent line cost capitalization was indeed shielded by those former members of Management responsible for it by offering deceptive explanations regarding the success of the Company's efforts to reduce line costs, and by engaging in a shell game, transferring many of the capitalized amounts to various property accounts and assets, in order to minimize the appearance of unusual variations in the consolidated balance totals. When, in August 2001, Arthur Andersen indicated that its auditors were interested in testing certain items in the Company's accounts for CIP projects, the WorldCom employees transferred the capitalized line cost entries outside of the CIP projects account and into other asset accounts. Regardless of such deception, however, Arthur Andersen's audits of this area were not designed to probe the level of detail that would have permitted its detection of such entries because they lacked procedures to corroborate former Management's representations and assure that the Company's normal processes were not being circumvented through "top-side" entries. Indeed, if the auditors had merely gone to the general ledger and associated journal entries, the massive "Prepaid Capacity Costs" entries would have been obvious; there was no real deception at that level. Because Arthur Andersen did not drill down, the fraud went

undetected. The Examiner believes that a vigilant auditor would have probed much more deeply.

b. Line Costs Reserve Releases

Arthur Andersen's audit procedures relating to line cost reserves were similarly deficient. Generally, the auditors tested the internal controls in place relating to domestic line costs and documented how the Company calculated line cost expenses and accruals related to such expenses. The auditors also compared certain line cost percentages to prior periods, but took comfort that WorldCom's line cost E/R ratio was stable, despite the fact that such E/R ratios reflected a markedly different trend from competitors. Additionally, from the workpapers provided to the Examiner, Arthur Andersen does not appear to have examined or tested the Company's international line costs, where many of the improper line cost reserve releases were recorded. Based on interviews of WorldCom former and current employees, WorldCom personnel were aware that Arthur Andersen did not plan audit tests in this significant area. That awareness facilitated the fraudulent manipulation of the international line cost releases since the likelihood that such releases would be closely examined by the external auditors was remote.

Further, Arthur Andersen's audit procedures relating to "top-side" adjustments in the line cost area were performed at the consolidated Company level on the erroneous premise that any "top-side" adjustments would have been recorded by former Management at a top reporting level, after the reporting entities had closed their books and the information had been provided to the corporate level of the Company's senior Management. As we now know, the "top-side" adjustments were indeed directed by former Management personnel after the reporting entities had closed their books. Management, however, caused these "top-side" adjustments to be recorded as journal entries to the general ledger, and not as entries at

a corporate reporting level. This gave the entries the appearance that they had been recorded in the normal course of business. New schedules incorporating such entries in the consolidated balances of particular items were subsequently generated as final schedules for the purposes of financial reporting.

Arthur Andersen's audit procedures included an inquiry to former Management whether any "top-side" adjustments were made as part of the consolidation process, outside the normal course of business. WorldCom Management annually provided false representations that no significant "top-side" adjustments had been recorded at the consolidation level outside the normal course. Arthur Andersen accepted the representations in reliance on former Management's integrity and conducted no testing to corroborate them other than a review of any substantial variances in the consolidated balances. Indeed, the audit team responsible for testing line cost accruals and reserve releases did not appear to have any procedures to test the possibility of "top-side" adjustments at the individual line cost level, other than reviewing unusual variances quarter over quarter, and year to year. They relied instead on other procedures to be performed by the auditors who were responsible for testing the consolidated financial statements, including the inquiry to Management regarding the existence of such adjustments at the consolidation level.

Detailed audit procedures were warranted by the multimillion dollar amounts of domestic line cost reserve releases that were, at times, described as "Settlements" by WorldCom in the schedules provided to Arthur Andersen. The actual journal entries reflected that the releases were recorded at the end of each quarter after the close, and lacked any substantive documentation supporting the basis for the entries. One such entry, recorded days after the close of the fourth quarter of 1999, for \$239 million, was supported by nothing

more than a “post-it” note bearing the number \$239,000,000. Such facts alone should have sparked further inquiry by a reasonable auditor. Given industry warnings about “top-side” adjustments, such detail testing, even on a sampling basis, was warranted.

Further, even if the auditors focused their testing on internal controls and processes, one would reasonably expect that the auditors would have sought to understand and test, at least on a sampling basis, the sources for many of the significant amounts in the consolidated balances they reviewed, including reserve releases, since such entries are subject to a high degree of judgment by former Management. Instead, the auditors obtained information about the general source categories from Management, without taking any meaningful steps to confirm such information unless unusual variances were observed. Even then, the testing consisted primarily of inquiry to former Management and a review of the Company’s changes in accounting policies, to the extent accounting policy changes were responsible for the variances. Nor does it appear that Arthur Andersen sought to confirm that the Company had accrued sufficient reserves in this area, relying instead on the Company’s analysis of its consolidated reserve accruals and determining that the Company had sufficient accrued reserves on a consolidated basis.

Accordingly, the auditors missed a number of opportunities to detect some or all of a total of \$3.3 billion of improper reserve releases and other transactions during 1999 and 2000 that were not in accordance with GAAP. These releases were directed by former members of senior Management and recorded by clerks in the General Accounting office without, in a number of cases, the knowledge, and, in most cases, without the approval of those managers responsible for determining the Company’s line cost accruals. By failing to pursue detailed

testing and substantive procedures to corroborate Management's explanations, the auditors again missed a number of opportunities to detect this aspect of the accounting fraud.

c. Revenue Reserve Releases

Arthur Andersen's audit procedures relating to the release of revenue reserves are distinguished from its procedures in the line cost area because the auditors were aware of "top-side" adjustments related to revenue reserve release and performed procedures involving some substantive testing. However, like the audit procedures in the other areas, Arthur Andersen's testing of the Company's recognition of revenue fell short of professional standards.

Arthur Andersen focused its revenue audits on a review and testing of the consolidated schedules of the Company reflecting the quarterly and annual revenues recorded by the Company. While Arthur Andersen obtained copies of the final quarterly MonRev's, and reviewed the processes by which revenue was recorded through the various billing systems, as well as generally how the MonRev was generated, the auditors did not rely on the MonRev for the purpose of their revenue audit. They did, however, test certain schedules of the MonRev, including the Corporate Unallocated Schedule described in Section V.C.1(b), supra.

Notwithstanding those tests, Arthur Andersen apparently had only a superficial understanding of how the MonRev was produced, documenting in the workpapers that the MonRev was generated based on the information obtained from the Company's automated systems with some "top-side" adjustments being made at the corporate level to better reflect appropriate geographic classifications of the revenues and reserve releases. The auditors obtained and reviewed consolidated balance schedules, comparing the consolidated levels to prior periods. They understood that many of the revenue items identified in the MonRev

were subject to significant judgment by former Management. They examined variances or unusual items by making inquiries to such Management and, in very limited instances, performed substantive testing to corroborate those explanations. The auditors also performed extensive testing of the Company's billing systems, gaining an understanding of the process by which the Company calculated various reserves, and memorializing their understanding in a series of memoranda that are part of the workpapers.

However, Arthur Andersen's procedures in the revenue reserve release area permitted the auditors barely to scratch the surface and prevented them from understanding how the Company was recording its revenues, especially during the last months of each quarter when the earnings manipulation occurred in the revenue area. The auditors appear to have had no knowledge of the process by which the MonRev was finalized by the Revenue Accounting Group. Similarly, they did not appear to have any sense how the items on the Corporate Unallocated Schedule were derived, although they were aware that the items constituted corporate adjustments made after the close of the quarter and, as such, seemed to focus some substantive testing on those items.

Moreover, the auditors do not appear to have had any knowledge of the Company's 2001 Close the Gap effort or how it impacted the MonRev and the Company's ability to meet its earnings targets. For instance, the auditors do not appear to have had any knowledge that several versions of the MonRev were created and adjusted by WorldCom personnel before a final MonRev was circulated or that, at times, the Revenue Accounting Group circulated a "normalized" MonRev excluding non-recurring or "extraordinary" adjustments so that sales commissions would not be inflated by the artificial boosts to revenue. A reasonable auditor, who had probed and discussed the actual process with responsible employees in the field, and

had exercised the appropriate degree of professional skepticism, would have been alarmed by the separate revenue schedules, the large amount of round-dollar releases, the timing of such releases, the lack of supporting documentation, and the Company's ability to meet earnings targets as a result of such releases (in amounts of as much as \$133 million), and probed further. That clearly did not happen. As a result, Arthur Andersen missed detecting the Company's improper manipulation of its revenues.

Most important, the auditors knew that the top-side revenue reserve releases by former Management involved substantial judgment by Management as to the timing and amount of such releases. This was a clear "red flag" of a need for detailed substantive testing on at least a sampling basis to confirm that there were proper bases and documentation for the Management judgment. This did not occur. One must assume that if it had occurred, Arthur Andersen (as did KPMG in the restatement process) would have questioned the bases for the reserve releases.

The auditors reviewed the Corporate Unallocated schedules and tested them by sampling certain entries they selected, giving particular attention to those entries that, in their judgment, appeared unusual because they were large round-dollar entries, or represented variances from previous quarters. In some limited instances, the auditors appear to have conducted a limited degree of substantive testing, reviewing underlying agreements and documentation supporting the entries, or if the entries represented a change in accounting policies, reviewing the underlying changes and gaining comfort that these particular entries were in accordance with GAAP. In most instances, however, the auditors' testing was satisfied by inquiry to former Management, who sometimes orally provided false information and misleading schedules concerning the propriety of these entries. In other instances, the

auditors appear to have noted erroneous information about some of these entries, although it is unclear whether the information was erroneously provided by Management to Arthur Andersen or erroneously recorded by the auditors in their work-papers. Generally, the auditors do not appear to have performed any tests to confirm the representations that they received from Management about the nature and propriety of the releases. They certainly did not review journal entries for these releases. In some cases, they asked Management for monthly detail schedules but accepted less than what they had requested in the form of quarterly consolidated schedules. They do not appear to have performed any tests to confirm that the balances of certain line items reflected on the schedules they obtained agreed to those amounts recorded in the general ledger.

Arthur Andersen also did not challenge, or even appear disturbed by, the unusual delays its auditors experienced in obtaining information and documents from the Revenue Accounting Group. Nor did the auditors appear to have pressed for the detailed information and schedules they had sought directly from this group during their 1999 audit but were denied by the head of Financial Reporting. See Section V.F.3(b)(ii), supra.

All of these “red flags,” taken collectively with Arthur Andersen’s risk assessments and the auditors’ knowledge that “top-side” adjustments were being recorded in this area, placed Arthur Andersen on notice of the real potential for material misstatement of the financial statements. Thus, this area cried out for detailed substantive testing. Instead, Arthur Andersen grounded its audit procedures on the representations of the very Management in a position to fraudulently manipulate WorldCom’s recognition of revenues in order to meet earnings targets. Thus, Arthur Andersen was unable to detect nearly \$958 million in improperly recognized revenues.

8. The Potential Claims Against Arthur Andersen

The Examiner believes that the Company has claims against Arthur Andersen on the basis that Arthur Andersen's audits of WorldCom did not meet the requirements of applicable professional standards. Whether Arthur Andersen and its former partners are liable for failure to meet professional standards will be a question of applicable state law.³²³ Under Mississippi law, a cause of action for accountant malpractice exists where the auditor was negligent and the negligence was the proximate cause of any injury to the audit client.³²⁴ In an accountant malpractice case, "[e]xpert testimony is required 'to support an action for malpractice of a professional man in those situations where special skills, knowledge, experience, learning or the like are required.'"³²⁵ As stated in Wirtz:

It is implied in all contracts for the employment of public accountants that their services are to be furnished with reasonable care and in good faith without fraud or collusion, and that standard accounting practices will be followed, and that, where different theories as to proper practices are involved they will follow the one they deem fairly applicable to the situation presented. While not an insurer against damage to his client, in the exercise of his professional capacity, it is generally recognized that a public accountant may be held liable on principles of negligence, to one with whom he is in privity or with whom he had a direct contractual relation, for damages which naturally and proximately result from his failure to employ the degree of knowledge, skill, and judgment usually possessed by members of that profession in the particular locality.³²⁶

³²³ O'Melveny & Myers v. FDIC, 512 U.S. 79, 84-85 (1994).

³²⁴ See Wirtz v. Switzer, 586 So. 2d 775, 779-80 (Miss. 1991) (citing Hickox v. Holleman, 502 So. 2d 626, 633 (Miss. 1987) (setting forth the elements of an attorney malpractice case)); see also Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 323 (Ms. 1987). The Second Circuit's choice of law rules suggest that Mississippi law would apply to any tort and contractual claims against Arthur Andersen and its partners arising out of the audits of WorldCom's financial statements since Mississippi appears to have the greatest interest in such claims. In particular, the most significant contacts between the senior members of the Arthur Andersen audit team and WorldCom Management occurred in Mississippi, the engagement agreements and audit opinions were signed in Jackson, Mississippi, and most of the audit work was conducted in Mississippi. See Krock v. Lipsay, 97 F.3d 640, 646 (2d Cir. 1996); Lazard Freres & Co. v. Protective Life Ins. Co., 108 F.3d 1531, 1538-40 (2d Cir. 1997), cert. denied, 522 U.S. 864 (1997) (citing Wm. Passalacqua Builders v. Resnick Developers, 933 F.2d 131, 137 (2d Cir. 1991)).

³²⁵ Wirtz, 586 So. 2d at 780 (citing Hickox, 502 So. 2d at 635).

³²⁶ Id. at 779 (citing 1 Am. Jur. 2d Accountants § 15 (1962)).

An auditor undertakes the duty to “exercise good faith and to observe [GAAS] . . . with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances.”³²⁷ As such, the auditor’s departure from GAAS constitutes grounds for malpractice claims.³²⁸

During its years as WorldCom’s auditor, Arthur Andersen regularly entered into engagement agreements pursuant to which it conducted its annual audits. Arthur Andersen represented to the WorldCom Audit Committee in its engagement agreements that its audits would be conducted “in accordance with generally accepted auditing standards” and that they would thus examine “on a test basis, evidence supporting the amounts and disclosures in the financial statements, assess the accounting principles used and significant estimates made by management and evaluate the overall financial statement presentation.” As such, Arthur Andersen may also be liable to WorldCom for breaching the professional duties of due care implicit in its contractual agreements with WorldCom where there is: (1) the existence of an agreement between the parties; (2) due performance of the contract by the party alleging the breach; (3) a breach by the other party; and (4) damages resulting from the breach.”³²⁹

Arthur Andersen may seek to defend against claims brought by the Company, by, among other defenses, arguing that the improper acts of the Company’s former Management should be imputed to the Company. Such a defense may be available to Arthur Andersen in

³²⁷ CBI Holding, 247 B.R. at 362 (quoting Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531, 538 (S.D.N.Y. 1990).

³²⁸ Id. at 362-63 (granting judgment in favor of successor to bankruptcy debtor on claims against external auditor of accountant malpractice, negligence, and breach of contract); see also, In re Sharp Int’l Corp., 278 B.R. 28, 33-35 (E.D.N.Y. 2002) (denying auditor’s motion to dismiss).

³²⁹ Levisohn, Lerner, Berger & Langsam v. Medical Taping Sys. Inc., 10 F. Supp. 2d 334, 343 (S.D.N.Y. 1998); see also K. Bell & Assocs., Inc. v. Lloyd’s Underwriters, 827 F. Supp. 985, 988, rev’d on other grounds, 97 F.3d 632 (2d Cir. 1996); Wirtz, 586 So. 2d at 779; Reuben H. Donnelley Corp. v. Mark I Marketing Corp., 893 F. Supp. 285, 290-91 (S.D.N.Y. 1995) (setting forth the same elements of a breach of contract claim under New York law); Restatement (second) of Contracts Ch. 10, § 235 (1981).

professional negligence or breach of contract claims where, as here, members of the Company's senior Management were involved in fraudulent conduct respecting the financial statements that Arthur Andersen appears to have negligently audited.³³⁰ Whether Arthur Andersen may impute the improper conduct to the Company will be a matter of Mississippi law.³³¹ There is no Mississippi precedent directly on point on this matter. However, the Mississippi Supreme Court has suggested that the imputation defense would not be recognized.³³²

Even where the imputation defense may be recognized, there are certain exceptions to it. First, under the adverse interest doctrine, the Examiner believes that sufficient evidence may be established that those officers who were the architects of the improper accounting at WorldCom were acting in their own personal interests, adversely to the interests of the Company, which ended up in bankruptcy as a result of their fraudulent conduct. This may defeat the defense.³³³

Further, the "innocent decision maker" exception would appear to apply since the Company's Audit Committee and Internal Audit Department, once they became aware of certain facts relating to the improper line cost capitalization, moved expediently to stop the

³³⁰ See *In re Bennett Funding Group, Inc.*, 336 F.3d 94, 99-100 (2d Cir. 2003); *Official Committee of the Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand LLP*, 322 F.3d 147, 156 (2d Cir. 2003); *Hirsh v. Arthur Andersen & Co.*, 72 F.3d 1085, 1094 (2d Cir. 1995); *Shearson Lehman Hutton v. Wagoner*, 944 F.2d 114, 118-19 (2d Cir. 1991).

³³¹ *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 84-85 (1994). See Appendix B, § B.3.b.

³³² See Appendix B, § B.3.b, discussing *Knox Glass Bottle Co. v. C.R. Underwood*, 89 So. 2d 799 (Miss. 1956), cert. denied, 353 U.S. 977 (1957).

³³³ This defense would be unavailing to Arthur Andersen where the officers engaged in the fraudulent activity were acting adversely to the Company and in complete furtherance of their personal interests. *Wight v. BankAmerica Corp.*, 219 F.3d 79, 87 (2d Cir. 2000); *Bennett Funding*, 336 F.3d at 100; *Jack Greenberg Inc. v. Grant Thornton LLP*, 212 B.R. 76, 85-87 (E.D. PA 1997); *Allard v. Arthur Andersen & Co.*, 924 F. Supp. 488, 495 (S.D.N.Y. 1996); *Sharp*, 278 B.R. at 36; *CBI Holding*, 247 B.R. at 365.

fraudulent activity and investigate and disclose the misconduct. See Appendix B, § A.³³⁴ Accordingly, if Arthur Andersen had detected any aspect of the fraud, the auditors would have been obligated to report the fraud to the Audit Committee to whom they reported. The members of the Audit Committee, as well as the Internal Audit Department, if they had been notified, presumably would have acted appropriately to stop the fraud.

Finally, in comparative negligence jurisdictions such as Mississippi,³³⁵ imputation generally does not provide a complete defense to claims of malpractice and/or negligence of the type that WorldCom may pursue against Arthur Andersen.³³⁶ The Allard case is particularly instructive because, unlike the typical comparative negligence situation where a fact finder weighs the negligence of the respective parties, in Allard, the corporate fiduciary wrongdoer was not negligent, but instead engaged in intentional misconduct. Arthur Andersen argued that the fiduciary's intentional wrongdoing should be imputed to the company and preclude the bankruptcy trustee's negligence claims against Arthur Andersen. The court rejected this analysis, noting that "imputation would not necessarily operate as a complete bar to the Trustee's negligence and malpractice claims" in a comparative negligence jurisdiction.³³⁷ Thus, the Allard case applies comparative negligence principles against a negligent accounting firm even in a situation of intentional misconduct by a corporate fiduciary. Accordingly, imputation likely does not provide a basis to dismiss any

³³⁴ Nor would such a defense defeat the Company's claims if there existed at the Company at the time that the fraudulent conduct was perpetrated "innocent decision makers" who were in a position to prevent or stop the wrongdoing had they been made aware of the misconduct. Bennett Funding, 336 F.3d at 101; Smith v. Arthur Andersen LLP, 175 F. Supp. 2d 1180, 1999-1201 (D. Az. 2001); Sharp, 278 B.R. at 36; CBI Holding, 247 B.R. at 364-65; Weschler v. Squadron, Ellenoff, Plesent & Scheinfeld, L.L.P., 212 B.R. 34, 36 (S.D.N.Y. 1997).

³³⁵ As noted the Examiner believes it likely that Mississippi law will apply to the claims against Andersen.

³³⁶ See Allard v. Arthur Andersen LLP, 924 F. Supp. 488, 495 (S.D.N.Y. 1996).

³³⁷ Id. at 495.

malpractice and/or negligence claims against Arthur Andersen, and the Examiner believes that such claims would likely reach a fact finder.

G. The Damages Potentially Recoverable Due to the Accounting Fraud

1. Applicable Damages Standards

As noted above, the Examiner concludes that there is substantial evidence to support claims that: (i) Messrs. Sullivan, Yates, Normand and Myers, and Ms. Vinson engaged in fraudulent accounting practices designed to conceal WorldCom's worsening financial condition; and (ii) Arthur Andersen and its former partners and employees negligently deviated from the applicable professional auditing standards in failing to uncover this massive fraud. Mississippi law will determine the nature and extent of any damages the Company may recover for this malfeasance and/or negligence.³³⁸

In particular, the Company may obtain those economic damages proximately caused by any wrongdoing or negligence.³³⁹ The Company, however, may not recover any damages that are "uncertain, contingent, or speculative" because Mississippi law precludes recovery "where resort must be had to speculation or conjecture for the purpose of determining whether or not the damages resulted from the act of which complaint is made, or some other cause, or where it is impossible to say what of any portion of the damages resulted from the fault of the defendant and what portion from the fault of the plaintiff. . . ."³⁴⁰

³³⁸ See O'Melveny, 512 U.S. at 84-85 (1994); River Oaks Furniture, Inc. v. BDO Seidman, LLP, 276 B.R. 507, 545-546 (N.D. Miss. 2001) (applying Mississippi law to damages claims against auditor).

³³⁹ See Wirtz, 586 So. 2d at 779 (listing elements of accounting malpractice case); Allard, 924 F. Supp. at 492 ("tortfeasors generally are responsible for all injuries proximately caused by their breach of duty.").

³⁴⁰ River Oaks, 276 B.R. at 549 (quoting Hudson v. Farrish Gravel Co., 279 So. 2d 630, 635-36 (Miss. 1973)).

2. Special Considerations Regarding Damages Attributable to Arthur Andersen

Regarding Arthur Andersen and its former partners and employees, Mississippi's comparative negligence rule may reduce any damages "in proportion to the amount of negligence attributable to the person injured" ³⁴¹ Further, Arthur Andersen may argue for an offset of damages to the extent that any negligence or malfeasance by WorldCom's officers and employees contributed to Arthur Andersen's failure to perform its duties. ³⁴²

It does not appear, however, that the Company would be barred from recovering damages from Arthur Andersen despite the contribution to the losses by WorldCom's former personnel who perpetrated the accounting irregularities. ³⁴³ As stated in River Oaks, "accountants are not to be rendered immune from the consequences of their own negligence merely because those who employ them may have conducted their own business negligently." ³⁴⁴ Further, the court in River Oaks rejected as a complete defense to an auditor negligence claim a corporate executive's active interference with the audit and, instead, stated that comparative negligence principles applied even where an executive attempted to conceal defalcation from the auditors. ³⁴⁵

3. The Damages May Include Executive Compensation, Audit Fees, and the Costs of WorldCom's Deepening Insolvency

The Examiner has not conducted a detailed evaluation of the amount of damages that the Company could recover from Mr. Sullivan and the WorldCom personnel who assisted in

³⁴¹ Miss. Code Ann. § 11-7-15 (1972); see River Oaks, 276 B.R. at 546-47.

³⁴² See River Oaks, 276 B.R. at 547 (discussing the rule set forth in National Surety Corp. v. Lybrand, 9 N.Y.S.2d 554, 563 (App. Div. 1939)). The disposition of such a defense would be a matter of first impression under Mississippi law.

³⁴³ Miss. Code Ann. § 11-7-15 (1972); see River Oaks, 276 B.R. at 546-47.

³⁴⁴ 276 B.R. at 547.

³⁴⁵ See 276 B.R. at 545-46.

the accounting fraud, or from Arthur Andersen and its former partners and employees involved in the WorldCom audits. Such a determination would require expert analysis, which falls outside the scope of the Examiner's mandate.

At a minimum, however, the Examiner recommends that the Company should consider pursuing recovery of the compensation paid to Messrs. Sullivan, Myers, Yates, and Normand, and Ms. Vinson during the period of their accounting wrongdoing.³⁴⁶ The Company also should consider seeking to recover from all potential defendants the substantial audit fees that it has and will incur in connection with its accounting restatements and for the re-audit of its financial statements for the years 2000 and 2001 by the successor auditor, KPMG.

In addition, some courts have acknowledged the availability of damages to insolvent corporations based on the theory that a party's wrongdoing contributed to the corporation's deepening insolvency. Under the deepening insolvency theory, a corporation is injured by improper accounting practices that conceal the corporation's insolvency, thus enabling the insolvent corporation to incur additional debt.³⁴⁷ Such accounting practices artificially maintain the liquidity of the corporation by concealing its true financial condition, thereby enabling the corporation to secure additional financing from creditors. In doing so, the corporation sustains damages where the additional debt: (1) forces the corporation into bankruptcy; (2) creates substantial debt-servicing obligations that may impact the

³⁴⁶ The Company should consider similar claims for relief against Mr. Ebberts and possibly other former Company personnel who had responsibility for the Company's financial statements.

³⁴⁷ See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co. Inc., 267 F.3d 340, 348 (3d Cir. 2001); accord In re Gouiran Holdings, Inc., 165 B.R. 104, 107 (E.D.N.Y. 1994) (applying New York law, and refusing to dismiss claims under the deepening insolvency theory because, "under some set of facts two years of negligently prepared financial statements could have been a substantial cause of [the debtor] incurring unmanageable debt and filing for bankruptcy protection."); see also, American Bankruptcy Institute, "Recent Developments in Officer and Director Issues," 060503 ABI-CLE 21 (June 6-8, 2003).

corporation's ability to pay its daily operating expenses and to run its business profitably; and (3) causes suppliers, customers, employees, and investors to lose confidence in the company's ability to meet its obligations.³⁴⁸

Other bankruptcy estates have sought to recover deepening insolvency damages against auditors resulting from negligent accounting practices. The Examiner recommends that the Company should consider pursuing deepening insolvency damages against Arthur Andersen and its personnel responsible for the WorldCom audits, and the WorldCom personnel who perpetrated the accounting wrongdoing.³⁴⁹

For example, in Allard v. Arthur Andersen & Co., a bankruptcy trustee sought damages against the bankrupt company's external auditor, Arthur Andersen, based on allegations of federal securities law violations, malpractice, negligence, and contractual breaches in connection with Arthur Andersen's audit of the company's financial statements. The trustee argued that the auditor's negligent audits permitted the company to continue to obtain credit and accumulate debt at a time when fraudulent accounting perpetrated by management concealed the company's insolvency. The Allard court noted that the infusion of additional credit harmed the company because:

trade credit may provide an illusory financial cushion that lulls shareholders into postponing the decision to dissolve the corporation. . . . Shareholders may under these circumstances miss an opportunity to "cut their losses" by shutting down operations before management can fritter away whatever valuable assets

³⁴⁸ See Lafferty, 267 F.3d at 349-50.

³⁴⁹ See In re Flagship Healthcare, Inc., 268 B.R. 721, 728 (S.D. Fla. 2001) (court ruled that trustee had standing to pursue a claim seeking damages under the deepening insolvency theory); In re Latin Investment Corp., 168 B.R. 1, 2 (D.D.C. 1993) (holding that the trustee's allegations of damages arising from, *inter alia*, fraudulent perpetuation of debtor corporation were distinct from those damages sustained by creditors). The Examiner is not aware of any Court applying Mississippi law that has awarded damages against an auditor, or any other party, based on the deepening insolvency theory. *But see*, River Oaks, 276 B.R. at 549-51 (rejecting similar theory where other intervening factors caused the Company's insolvency). To the extent a court construes such damages to be "uncertain, contingent, or speculative," they may be barred as a matter of Mississippi law. *Id.* at 549.

the corporation still possesses. . . .[,] and “the corporate body [could be] ineluctably damaged by the deepening of its insolvency.”³⁵⁰

The court rejected Arthur Andersen’s motion for summary judgment on the grounds that the infusion of credit benefited the debtor company and, therefore, “deepening insolvency” did not represent a viable damages theory, noting that the deepening insolvency damages theory has been sustained by other courts and ruling that Arthur Andersen was not entitled to judgment as a matter of law. Id.³⁵¹

If the Company successfully asserts the deepening insolvency theory of damages, it may be able to seek to recover the amount of additional debt that WorldCom incurred from the time of its actual insolvency to the time when it filed for bankruptcy protection (*i.e.*, the amount of the Company’s deepening insolvency due to the fraudulent accounting concealment of WorldCom’s true financial condition).³⁵² Although the Examiner has not determined the precise point at which WorldCom became insolvent, some evidence suggests

³⁵⁰ Allard, 924 F. Supp. at 494 (quoting Schacht v. Brown, 711 F. 2d 1343, 1350 (7th Cir.), cert. denied, 464 U.S. 1002 (1983)). See also In re Investors Funding Corp. of New York Securities Litig., 523 F. Supp. 533 (S.D.N.Y. 1980) (“[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it. . . .”); Robertson v. White, 633 F. Supp. 954, 964 (W.D. Ark. 1986) (“the artificial prolongation of [the debtor’s] existence disabled officers, directors, and/or members from taking action to redress wrongs done to it; . . . it became a helpless victim of further looting through its insolvency, whereas if it had been in receivership, its assets would have been saved rather than squandered.”); accord Corcoran v. Frank B. Hall & Co., 545 N.Y.S.2d 278, 285 (A.D. 1989) (failure to disclose true financial condition of insurance company, which results in insolvency of insurer, constitutes an injury to the company).

³⁵¹ The Court subsequently granted summary judgment in favor of the auditor on the trustee’s federal claims and dismissed, without resolving the damages issue, the state claims for lack of subject matter jurisdiction without prejudice to refiling in state court. Allard, 924 F. Supp. at 426.

³⁵² See American Bankruptcy Institute, “Recent Developments in Officer and Director Issues,” 060503 ABI-CLE 21 (June 6-8, 2003); Corcoran v. Ambassador Group, Inc., Index No. 28414/85 (N.Y. Sup. Ct. October 30, 1986), aff’d, 516 N.Y.S.2d 568 (A.D.), motion for leave to appeal dismissed, 524 N.Y.S.2d 434 (1987); Corcoran v. Frank B. Hall & Co., 545 N.Y.S.2d 278, 283 (A.D. 1989); Curiale v. Peat, Marwick, Mitchell & Co., 603 N.Y.S.2d 996 (A.D. 1995); Robertson v. White, 633 F. Supp. 954, 970-971 (W.D. Ark. 1986).

that insolvency may have occurred before the \$11.9 billion public debt offering in May 2001.³⁵³

Because most of the Company's debt has been discharged as a result of the order confirming the bankruptcy reorganization plan (approximately \$5 billion in debt remains), those responsible for the deepening insolvency may argue that this discharge substantially lessens the damages available under the deepening insolvency theory and that the amount of the debt discharged in bankruptcy should offset the amount of the deepening insolvency damages. The Examiner is not aware of any cases that have addressed this issue, but he questions the viability of this defense because the bankruptcy proceedings will not make the Company's creditors whole. Under these circumstances, permitting tortfeasors to rely upon a bankruptcy discharge as a defense would favor the tortfeasors' interests over those of the injured creditors. In any event, at a minimum, after the bankruptcy discharge, WorldCom will retain approximately \$5 billion in debt, most of which it at least arguably incurred after reaching the point of its insolvency.

³⁵³ WorldCom had financial troubles well before 2001. Thus, by the fourth quarter of 2000, WorldCom's financial condition no longer merited a "BBB" investment grade rating and, instead, WorldCom's financial performance was more consistent with companies receiving a non-investment grade rating of "BB" or lower. Then, after receiving the \$11.9 billion from the May 2001 public debt offering, within just eight months (10 months earlier than projected), WorldCom had exhausted those proceeds to meet its ordinary operating expenses. Further, shortly thereafter, WorldCom needed to borrow billions of additional dollars to continue meeting its operating expenses. That WorldCom needed billions of dollars in financing to meet ordinary expenses over a sustained timeframe highlights WorldCom's difficult financial situation as of May 2001. Assuming that WorldCom became insolvent prior to the May 2001 public debt offering, at a minimum, the Company would have incurred over \$14 billion in debt after this point, which would represent the Company's deepening insolvency. See Second Interim Report at 84-85.

VIII. ACQUISITIONS

A. Introduction and Summary

1. First and Second Interim Reports

In the Examiner's First Interim Report, he reported about WorldCom's growth over the years, fueled primarily by numerous acquisitions. First Interim Report at 58-63. The Examiner commented on the "enormous" volume of WorldCom's acquisitions and observed that until 2002, WorldCom was "constantly and even feverishly in 'deal mode'". Id. However, at that early stage of his investigation, the Examiner drew no conclusions regarding whether WorldCom's acquisitions were sound and conducted in accordance with good corporate governance principles.

In his Second Interim Report, the Examiner reported in greater detail about WorldCom's strategic planning and acquisitions. The Examiner found that WorldCom engaged in little strategic planning and, instead, pursued a growth and acquisitions strategy that was largely opportunistic. The Examiner further found that, particularly from 1999 onwards, WorldCom's former Board of Directors became increasingly passive on numerous issues. This passivity included the Board's approval of multi-billion dollar transactions proposed by WorldCom's former Management on the basis of virtually no data. The transactions involving EDS (1999), SkyTel (1999) and Intermedia (2000-01) were the principal examples of the WorldCom Board's failure to give significant scrutiny to Management's proposals. Second Interim Report at 13-81.

Notwithstanding such Board passivity, the Examiner determined that, with only one exception, he found no basis to question whether the WorldCom Board, had it demanded

adequate data about specific acquisitions, would have rejected any of them. The exception was the Intermedia merger, which was proposed on September 1, 2000, with the closing occurring on July 1, 2001. The Examiner preliminarily concluded in the Second Interim Report that a properly informed and vigilant WorldCom Board might have rejected the \$6 billion Intermedia merger on September 1, 2000 and almost certainly would have rejected the amended Intermedia merger agreement in February 2001. Second Interim Report at 52, 63-64.

2. Subsequent Investigation and Summary of Conclusions

Since the Second Interim Report, the Examiner has continued his investigation of acquisition-related issues, with particular focus on the Intermedia merger. The Examiner reviewed additional documents and conducted additional interviews of WorldCom's former personnel and investment bankers. Based upon this further investigation, the Examiner reports his further conclusions on Intermedia-related issues.

First, if the WorldCom Board had been presented with a meaningful summary of available data as of September 1, 2000 (instead of a 35-minute telephonic presentation with no written data or Board package provided), the Examiner believes the Board probably would have nevertheless approved the transaction. The goal of the transaction was to obtain control of Digex, an Intermedia-controlled entity, which could be accomplished at a projected cost of about \$6 billion -- \$3 billion of new equity and \$3 billion of assumed debt, with the actual sale cost to be reduced significantly by the sale of Intermedia's non-Digex assets. The \$6 billion cost was \$2-3 billion less than the projected cost of a direct acquisition of Digex. Given that the Digex managed Web hosting business was, at that time, widely viewed as an attractive growth area, the Examiner believes that a properly informed

WorldCom Board may have concluded as of September 1, 2000 that it was prudent to pursue the acquisition.

Second, even though a properly informed WorldCom Board may have approved the Intermedia transaction on September 1, 2000, the Examiner remains troubled by the failure of WorldCom's former Management and the Company's outside service providers to advise the Board properly. Among other things, the Examiner observes:

- The likelihood of achieving significant sales proceeds from an Intermedia asset sale apparently was a factor in the Board's approval of the transaction on September 1, 2000. WorldCom's investment banker, Chase Securities, Inc. ("Chase"), told the Board on September 1, 2000, that the Intermedia non-Digex assets could probably be sold for \$3 – 3.5 billion, thus reducing the cost of the transaction from approximately \$6 billion to \$2.5 – 3 billion. However, WorldCom Management appears to have failed to advise the Board that WorldCom's Corporate Development Group had estimated the likely Intermedia sale proceeds at less than half that number – \$1.457 billion. The Examiner concludes that the significant disparities in the sales proceeds estimates should have been clearly disclosed to the Board.
- On September 1, 2000, WorldCom's outside counsel addressed the WorldCom Board about the Intermedia transaction. Counsel described the transaction generally and also addressed a waiver of Delaware law that had been obtained from Digex.³⁵⁴ Such advice was appropriate. Counsel failed, however, to advise the WorldCom Directors regarding the risks associated with approval of the transaction on the basis of little data and with no time for in-depth consideration of the transaction. The Examiner believes that such advice should have been provided by outside counsel.

Third, the Examiner has further investigated whether a properly informed WorldCom Board would have rejected the amended Intermedia transaction in February 2001. By February 2001, WorldCom had the ability to withdraw from the Intermedia transaction due to litigation by Digex shareholders and the declining financial performance of Intermedia. Virtually everyone the Examiner has interviewed – including in-house and outside counsel –

³⁵⁴ Absent a waiver, Delaware law prohibited a Digex/WorldCom consolidation for 3 years. WorldCom wanted flexibility to consolidate Digex with WorldCom more quickly and thus insisted on the waiver.

confirmed this understanding. Further, the Examiner has confirmed that the likely cost of the Intermedia transaction as of February 2001 had risen to over \$5 billion and possibly close to \$6 billion, given the large drop in likely Intermedia sales proceeds and the costs that WorldCom might incur to settle the Digex shareholder litigation and to support Digex's operations.

In the Second Interim Report, the Examiner preliminarily concluded that a vigilant and properly informed WorldCom Board probably would have rejected the amended Intermedia transaction. Second Interim Report at 52, 64. The Examiner now confirms this preliminary conclusion. There is evidence to support the view that, as of February 2001, Mr. Ebbers, and possibly Mr. Sullivan, still believed that the Intermedia transaction made sense, due to the potential for Digex to be successful in the managed Web hosting field. However, there is substantial evidence that other WorldCom personnel felt that the transaction did not make sense as of February 2001. Further, there is no evidence that either Management or its advisors made a detailed economic analysis regarding the continued viability of the transaction, taking into account the steep decline in the value of the non-Digex Intermedia assets and WorldCom's own declining results.

The Examiner has determined that there are many reasons to believe that a properly informed, non-passive WorldCom Board would have rejected the amended Intermedia transaction if Management and the Directors had fulfilled their fiduciary duties. The Examiner concludes that the Board should have considered additional facts, including the following:

- WorldCom had the right to walk away from the transaction.
- The real cost of the transaction had probably doubled – from an estimated \$2.5 – 3 billion as of September 1, 2000 to \$5 to \$6 billion in early 2001 – due primarily

to changes in the prices of WorldCom and Intermedia stock and the plummeting value of the Intermedia assets that WorldCom planned to sell following the acquisition. The Examiner believes such a cost increase should have been cause for significant concern, particularly given WorldCom's declining results and falling stock price as of early 2001.

- By February 2001, the U.S. Department of Justice had imposed restrictions, making sale of the Intermedia assets more difficult. This should have been an additional cause for concern and have made the merger termination option all the more attractive.
- WorldCom Management was divided about whether the transaction continued to make sense. Although Mr. Ebbers favored it, and certainly his views would carry significant weight, others were not supportive. Further, those planning the prospective integration of the WorldCom and Digex sales forces already had encountered significant obstacles to unifying them into cohesive and effective marketers of managed Web hosting services.
- The 2000 operating results for Intermedia and Digex had fallen short of predictions made as of September 1, 2000, raising questions about the soundness of the transaction.
- Significantly, by February 2001, a number of WorldCom Directors had developed concerns about Mr. Ebbers' leadership, especially due to Company loans to him and guarantees on his behalf that had grown to \$225 million. These concerns should have prompted increased scrutiny of any significant WorldCom commitments, such as the Intermedia transaction.

Fourth, the evidence supports the conclusion that Messrs. Ebbers and Sullivan breached their fiduciary duties by committing WorldCom to the amended merger without Board of Director approval. Messrs. Ebbers and Sullivan knew that the transaction had changed significantly since September 1, 2000, and that they had no authority to commit the Company to the amended transaction in advance of full Board consideration and approval. Accordingly, the Examiner believes that the Company has claims against Messrs. Ebbers and Sullivan for disgorgement of compensation received during the period of their disloyalty and for compensatory damages to recover losses suffered on the Intermedia merger.

Fifth, the Examiner concludes that extensive evidence supports the view that WorldCom's Directors breached their fiduciary duties of care and loyalty in connection with

the Intermedia merger amendment. The Directors approved the initial Intermedia transaction on September 1, 2000 on the basis of scant data. The Directors subsequently approved the amended Intermedia merger agreement on March 1, 2001 on the basis of even less data. The Examiner is troubled that the Directors never questioned Messrs. Ebbers and Sullivan about committing WorldCom to the amended Intermedia merger agreement without prior Board approval and that the former Directors did not seek legal advice regarding the implications of Management's actions, including whether WorldCom could terminate the merger despite the unauthorized execution of the merger amendment. The Board also never questioned Messrs. Ebbers and Sullivan about their misrepresentations to Mr. Salsbury but the Board had authorized this merger amendment. In essence, the Board abdicated its duties by not taking these obvious actions. Such evidence supports the conclusion that WorldCom's Directors breached their fiduciary duties of care and loyalty.³⁵⁵ The Examiner believes that WorldCom has claims against former members of the Board for disgorgement of compensation received during the period of their disloyalty and for compensatory damages to recover any losses suffered on the Intermedia merger.

Sixth, in the Second Interim Report, the Examiner observed that neither in-house nor outside counsel to WorldCom appeared to take responsibility for ensuring that the Company followed proper corporate governance processes, particularly in connection with the Intermedia merger amendment. The Examiner noted that this matter merited further investigation. Second Interim Report at 80. Based upon his further investigation, the Examiner now reaches several conclusions:

³⁵⁵ See Pereira v. Cogen, 294 B.R. 449, 528-30 (S.D.N.Y. 2003) (board violated duties of loyalty and care by effectively abdicating responsibilities in approving excessive compensation to CEO). See also Appendix A, §§ C.2 and D.

- The legal function at WorldCom was decentralized, with no in-house counsel, including former General Counsel Michael Salsbury and Bruce Borghardt, former General Counsel for Corporate Development, charged with responsibility to ensure that proper corporate governance processes were followed. The Examiner concludes that an institutional and organizational defect, rather than failings by particular individuals, contributed to the Company's injuries in this area.³⁵⁶
- The Examiner does not fault Mr. Salsbury for executing the Intermedia merger amendment upon being told that WorldCom's Directors had approved the amendment. Mr. Salsbury had no basis to believe that the Directors had not approved the amendment or to know that Messrs. Ebbers and Sullivan had made false statements.
- WorldCom's outside and in-house counsel prepared a written consent by which WorldCom's Directors could approve the Intermedia merger amendment without the need for a meeting. 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 does not recommend that any claims be pursued against in-house or outside counsel. The data accumulated in the investigation suggest that Mr. Ebbers, and possibly Mr. Sullivan, were determined to proceed with the Intermedia merger. In such circumstances, the Examiner does not believe that counsel could be found to be in violation of any legal requirement that could support a claim by the Company.

It was beyond the scope of Examiner's mandate to assess in detail the damages that might be recovered if the Company were to prevail on Intermedia-related claims. On the one hand, the Company has been unable to sell many of the Intermedia assets, which would

³⁵⁶ The Examiner observes that following Mr. Ebbers' resignation in April 2002, Mr. Salsbury was given responsibility for all WorldCom's legal affairs, including corporate governance. The Examiner is not aware of any corporate governance failures thereafter, even during the difficult period following discovery of the accounting fraud and WorldCom's filing for Chapter 11 protection.

appear to have led to losses.³⁵⁷ On the other hand, WorldCom recently purchased the remainder of the Digex assets it had not owned, suggesting that the Digex portion of the acquisition may prove profitable. The Examiner suggests that the Company carefully assess possible damages, as well as whether likely defendants have recoverable assets, as part of its consideration as to whether to pursue claims.

B. The September 1, 2000 Board Approval of the Intermedia Merger

In his Second Interim Report, the Examiner expressed concerns about the WorldCom Board's approval on September 1, 2000 of the Intermedia merger agreement. The concerns focused on the estimates provided to the Board regarding the likely proceeds to be realized from sale of the non-Digex Intermedia assets, Management's failure to provide the Board with any written data before the meeting, and the failure of anyone to advise the Directors of their fiduciary duties. The Examiner reached no conclusion whether a better informed Board would have rejected the transaction. Second Interim Report at 56-57. Based on further investigation, the Examiner reaches the following further conclusions.

1. The Estimates Provided the Board as to the Value of the Intermedia Non-Digex Assets Were Incomplete

As detailed in the Second Interim Report, WorldCom's Corporate Development ("CD") Group and Chase each compiled estimates regarding the proceeds that WorldCom might realize when it sold Intermedia's non-Digex assets. CD arrived at an estimate of \$1.457 billion, based upon WorldCom's recent involvement in the sale of similar assets by another company. CD provided this estimate to Mr. Sullivan early on September 1, 2000.

³⁵⁷ One reason that the Intermedia assets could not be sold were Department of Justice restrictions. Those restrictions were in place as of February 2001 and thus should have been a factor warranting termination of the merger.

Chase provided a written valuation estimate ranging from \$2.0 to \$3.5 billion to Mr. Sullivan late in the morning on September 1, 2000.

The lead Chase investment banker recalled a telephone conference with Mr. Sullivan on September 1, 2000, some time prior to the WorldCom Board meeting. Although he was unable to recall the meeting in detail, the banker did remember that Mr. Sullivan thought that the Chase valuations of Intermedia's non-Digex assets were "way too high."

The WorldCom Board convened its telephonic meeting at 3:30 p.m. on September 1, 2000. No one interviewed by the Examiner's representatives could recall very well what was said at that meeting. As a result, Mr. Salsbury's notes from this meeting appear to contain the best "record" of what transpired. Mr. Ebbers asked Mr. Salsbury to serve as Board Secretary, and he attempted to take "very careful" notes during this meeting.

Mr. Salsbury's notes concerning the Chase presentation include the following: "3-3.5 B value for Intermedia." The Examiner interviewed the Chase investment banker who participated in the Board meeting subsequent to publication of the Second Interim Report. He thought that the estimated the value of the non-Digex Intermedia assets that he provided at the September 1, 2000 Board meeting was \$2.5 to \$3.0 billion, but concluded that he could not dispute that he might have estimated \$3.0 to \$3.5 billion, the high range of the Chase written estimate provided to Mr. Sullivan. The Chase investment banker also is recorded in Mr. Salsbury's notes as stating "we take risk of CLEC sales." The Examiner believes this buttresses the conclusion that the sale of the non-Digex assets as a means of reducing overall costs of the Intermedia merger was a part of the Chase presentation in support of Board approval of the merger, although there was no guarantee that WorldCom would realize \$3.0 to \$3.5 billion.

The Examiner has obtained additional information that further supports the conclusion that Chase told the WorldCom Board that the non-Digex Intermedia assets could be sold for between \$3.0 and \$3.5 billion. The WorldCom CD representative responsible for the \$1.457 billion estimate attended the telephonic September 1, 2000 Board meeting and recalled Chase giving the \$3.0 to \$3.5 billion estimate.³⁵⁸ The CD representative remembered telling the Chase representative that the Chase estimate “was ludicrous.”³⁵⁹ The CD representative, moreover, sent an e-mail to Mr. Sullivan on September 2, 2000, commenting on the Chase estimate:

Just Thought [sic] of something funny. When Kindler [the Chase banker] finally gets around to asking you about fees, just tell him that you will give him a \$ for every dollar [at which] he sells the Intermedia assets over \$3.5 Billion.

On the basis of the foregoing, the Examiner reaffirms his earlier conclusion that the WorldCom Board on September 1, 2000 was advised by Chase that the non-Digex Intermedia assets possibly could be sold for between \$3.0 and \$3.5 billion. Further, it seems clear that no one specifically advised WorldCom’s Directors that WorldCom CD had estimated the value of Intermedia’s non-Digex assets at \$1.457 billion.³⁶⁰

³⁵⁸ The CD representative was at outside counsel’s offices in New York during the Board meeting. Chase’s representatives were present at that location as well.

³⁵⁹ The CD representative believed that he questioned the Chase estimate during the WorldCom Board meeting. Beyond this recollection, the Examiner has found no evidence to support this belief, and Mr. Salsbury’s notes make no mention of such a statement by the CD representative. Mr. Salsbury was quite sure his notes would have reflected any contrary figure. The Examiner suspects that the CD representative may have been part of the Sullivan/Chase call prior to the Board meeting and made his comments at that time.

³⁶⁰ In the Second Interim Report, the Examiner stated that Mr. Sullivan had advised the WorldCom Board that the Intermedia non-Digex assets could be sold “for close to \$3 billion.” Second Interim Report at 55. This conclusion was based on the fact that Intermedia’s debt was about \$3 billion and Mr. Salsbury’s notes record Mr. Sullivan stating “sell [Intermedia’s] CLEC assets at close to debt values.” On further review, the Examiner observes that it is possible that the reference in Mr. Salsbury’s notes to “debt values” referred to the then current market values of the Intermedia debt, which appear to have been in the \$1.5 billion range, rather than to a \$3 billion estimate. Given Mr. Sullivan’s unavailability to be interviewed, the Examiner cannot reach a final conclusion on this issue.

2. The WorldCom Directors Probably Relied on the \$3 – 3.5 Billion Chase Valuation of Intermedia’s Non-Digex Assets as a Material Part of Their Decision

In his Second Interim Report, the Examiner expressed the preliminary view that the Chase valuation of the Intermedia assets at between \$3.0 and \$3.5 billion was material to the Board’s approval of the transaction, because a successful sale at that range of values would reduce the effective cost of the transaction from \$6 billion to between \$2.5 and \$3.0 billion. Second Interim Report at 55-56, 62. Based on his further investigation, the Examiner confirms this conclusion.

WorldCom engaged Chase to assist with the sale of the non-Digex Intermedia assets.³⁶¹ Accordingly, it is apparent that Management asked Chase to attend the September 1, 2000 Board meeting and inform the Board that the cost of the Intermedia merger would be reduced by the proceeds that Chase was predicting would be realized through the Company’s sale of Intermedia’s non-Digex assets.

Further, while the recollections of the Board members about the September 1 meeting were mostly vague, a number of the Directors advised the Examiner that the projected proceeds from the Intermedia asset sales played an important role in the Board’s initial approval of the transaction on September 1, 2000. One Director, for example, stated that the proceeds to be achieved from the asset sale were an important deal point. Similarly, another Director replied “yes” when asked whether getting \$3 billion for the Intermedia assets was an important factor in the proposed merger. Finally, another Director commented that if the Intermedia assets could not be sold for \$2-3 billion, that would be material to the deal.

³⁶¹ By the time WorldCom engaged Chase late on August 31, 2000, the basic business terms of the Intermedia deal had already been negotiated. Subsequent to September 1, 2000, Chase’s primary role was to assist WorldCom in its efforts to sell Intermedia’s non-Digex assets.

3. The Role of Outside Counsel

Cravath, Swaine & Moore (“Cravath”) served as outside counsel to WorldCom on the Intermedia transaction, and Cravath attorneys were also present at the September 1, 2000 Board meeting. At the meeting, Cravath did not advise the WorldCom Directors of their fiduciary duties. A Cravath attorney advised the Examiner that he believed that the WorldCom Directors were aware of their fiduciary duties, since the Directors had considered many prior acquisitions, and stated that if he had thought that the WorldCom Directors lacked sufficient data to make an informed decision about the Intermedia transaction, he would have viewed it as his responsibility to “say something.” The attorney acknowledged, however, that he did not know before the September 1 meeting how familiar the WorldCom Board was with Digex, Intermedia or managed Web hosting. He also stated that he would have expected that the written Chase valuation of Intermedia would have been sent to all Directors. There is no evidence, however, that Cravath attorneys took any steps to attempt to confirm that this had been done. In fact, the Examiner’s investigation confirms that the Chase valuation was never provided to WorldCom’s Directors.

The Examiner is troubled by the failure of counsel to WorldCom to advise the Company’s Directors of their fiduciary duties. However, under the totality of the circumstances, the Examiner cannot conclude that Cravath violated any obligation to the Company in not expressly advising the Directors of their duties.

The Cravath attorney advised that, in the context of an auction transaction,³⁶² the Board’s approval of the transaction after a 35-minute meeting based on oral presentations with no written data was “within the realm of acceptable practice.” That well may have been

³⁶² Mr. Ebbers advised the Board on September 1, 2000, that WorldCom was in an auction transaction, meaning that if WorldCom did not reach a deal by 5 pm Friday, September 1, 2000, Intermedia would likely be sold to another entity.

the case. However, the Examiner would have expected outside counsel to caution the Directors that in acting with haste and on the basis of limited data, they potentially rendered themselves more vulnerable to a claim that they failed to fulfill their fiduciary duty to become adequately informed. Such advice was not provided.

4. If the Board had Demanded More Data, It Probably Would Have Approved the Transaction

In the Second Interim Report, the Examiner concluded that he lacked sufficient data on which to make a finding that the WorldCom Directors had breached their fiduciary duty of care in approving the transaction on September 1, 2000 on the basis of inadequate information. After further investigation, the Examiner concludes that it is not necessary to resolve this question, which remains a close one. Even assuming that the Directors failed to fulfill their fiduciary duty as of September 1, 2000 to become adequately informed about the Intermedia merger, the Examiner concludes that they may be able to show that the transaction appeared to make sense at that time.

First, as of September 1, 2000, managed Web hosting was viewed as a promising Telecom growth area that would augment WorldCom's existing Internet platform. Further, Digex appears to have been one of the strongest managed Web hosting companies. Web hosting, moreover, was an area in which WorldCom already was exploring a joint venture and, accordingly, it was not irrational for WorldCom to seek control of Digex when it had the opportunity to do so.

Second, although WorldCom's due diligence on Digex was limited, certain members of Management had performed due diligence on other Web hosting companies, including

Global Center, and thus had a basis for its assurances to the Board that Digex appeared to be a good acquisition prospect.³⁶³

Third, although some members of WorldCom's Management disputed the Chase \$3 – 3.5 billion valuation figure, Chase's representative advised the Examiner that, as of September 1, 2000, Chase felt that this was a fair estimate. The Examiner has not discovered any evidence to suggest that Chase felt otherwise.³⁶⁴

Fourth, the Examiner's interviews suggest that, even if the Board had been told on September 1, 2000 that the value of the non-Digex Intermedia assets was much lower than Chase's estimate – even as little as \$1 billion – the Board may still have approved the transaction. As of September 1, 2000, Digex's stock was selling for approximately \$85 per share, and WorldCom and its advisors estimated that the Company would have to pay in excess of \$8.5 billion (around \$120 per share) in a direct acquisition of Digex. Accordingly, acquiring control of Digex via an Intermedia merger at a cost of approximately \$6 billion (not counting cost reductions for possible asset sales) seemed to make sense.

Fifth, although WorldCom's definitive agreement to acquire Intermedia came about in less than 48 hours, speed alone provides no basis on which to object to the transaction. Particularly during the telecommunications "boom" of several years ago, rapid transactions did occur, and several persons advised the Examiner that other deals had proceeded with similar speed. This does not excuse the failure of WorldCom Management (Messrs. Ebbers

³⁶³ According to Mr. Salsbury's September 1, 2000 notes, Messrs. Stupka, Beaumont and Briggs, senior members of WorldCom Management, made very positive comments about Digex at the September 1 Board meeting, based upon their personal meetings with Digex management the prior day. Directors are entitled to rely upon Management's analyses of this type. Second Interim Report at 22-23; see Appendix A, § D.1.

³⁶⁴ The WorldCom CD representative advised the Examiner that Chase backed off of its \$3-3.5 billion estimate of value of the Intermedia assets on or soon after September 1, 2000. That may be true, but the Chase representative advised the Examiner that as of the Board meeting on September 1, 2000, he was comfortable with the \$3-3.5 billion estimate, although Chase had been engaged on the WorldCom Intermedia engagement only since late afternoon on August 31, 2000.

and Sullivan in particular) to provide adequate data to the WorldCom Board prior to the September 1 Board meeting. However, the Examiner concludes that, on September 1, 2000, the Intermedia transaction had a reasonable business basis and if all such data had been presented to the WorldCom Board in a considered manner, the Examiner believes that the Board may have approved the transaction. Accordingly, the Examiner does not recommend that the Company pursue any claims arising from the September 1, 2000 Board meeting and approval.

C. The February 2001 Approval of the Intermedia Merger Amendment

The Examiner reaches a different conclusion regarding the February 2001 amendment to the Intermedia merger agreement. The Examiner concludes that the evidence supports a finding that WorldCom's Directors breached their fiduciary duty of care by: (1) failing to take action in the face of the February 15, 2001 press release and related news articles, which falsely stated that the WorldCom Board had approved the proposed Digex settlement and the attendant amendments to the Intermedia merger agreement; and (2) subsequently approving the amended merger agreement on March 1, 2001, without adequate information or deliberation. The Examiner also concludes that the Board unreasonably approved the Intermedia merger amendment in the face of evidence that weighed in favor of abandoning the transaction, including the precipitous decline in the value of the Intermedia non-Digex assets, and the substantial rise in the transaction costs. The Examiner believes that if the Directors had become adequately informed and had abandoned their passive role, the Board quite likely would have and should have rejected the amended Intermedia merger agreement.

The Examiner also concludes that the evidence supports a finding that Messrs. Ebbers and Sullivan breached their fiduciary duties as officers in directing Mr. Salsbury to execute

the merger amendment. Messrs. Ebbers and Sullivan had to know that no Board approval had occurred, and they also must have known that they lacked authority to bind WorldCom to the amended merger absent such Board approval.

Accordingly, the Examiner believes that the Company has claims against Messrs. Ebbers, Sullivan and the remaining Directors for those fiduciary duty breaches.

1. Numerous Problems Existed With the Intermedia Transaction as of February 2001

There were significant problems with the Intermedia merger as of February 2001, many of which have been further confirmed since the Second Interim Report was published:

- The market for Intermedia's non-Digex assets fell sharply in the fall of 2000.³⁶⁵ Efforts to sell those assets had been unsuccessful. The Board was advised of this at the November 16, 2000 Board meeting. Further, the U.S. Justice Department imposed conditions that made it difficult for WorldCom to sell the Intermedia assets.
- Digex's minority shareholders commenced litigation against WorldCom and Intermedia in September 2000 over the merger agreement and achieved an interlocutory victory in December 2000, with the possibility that significant damages (as much as \$2.5 billion by some media estimates) could be assessed against Intermedia and WorldCom if the merger went through. The Board first became aware of this litigation at the September 7, 2000 Board meeting. It received a further update during the November 16, 2000 Board meeting.
- Intermedia's financial performance declined significantly.

As a result of these factors, Messrs. Ebbers and Sullivan received advice – from Mr. Salsbury, Cravath and Chase – that WorldCom was not obligated to continue with the merger because these developments had a material adverse effect on the transaction, thus permitting withdrawal.³⁶⁶

³⁶⁵ Chase did a new valuation of Intermedia's non-Digex assets as of September 11, 2000, and valued them at \$2.0-2.7 billion, a drop of \$800 million from Chase's top valuation made just 11 days earlier. Chase never prepared a subsequent valuation of the Intermedia assets.

³⁶⁶ Section 7.1 of the initial merger agreement provided:

As discussed in the Second Interim Report, Mr. Ebbers nevertheless decided, without Board approval, to amend the Intermedia merger agreement and stick with the merger. The Examiner calculated that in mid-February 2001, the estimated cost of the merger was between \$4.974 and \$6.054 billion, as compared to an estimated cost of between \$2.5 – 3 billion for the merger as presented to the Board of Directors on September 1, 2000. Second Interim Report at 62.³⁶⁷ Thus, the price of the merger had approximately doubled as of February 2001.

The Intermedia merger appears to have been a financial failure. The Examiner understands that WorldCom succeeded in selling only about \$100 million of Intermedia's assets. The losses experienced as a result of this transaction appear to have been substantial, but the exact amounts are beyond the scope of the Examiner's assignment. The Examiner believes that WorldCom has claims against the former Directors and officers (Messrs. Ebbers and Sullivan) who breached their fiduciary duties in approving the Intermedia merger amendment. Specifically, as outlined further below, the Examiner believes that WorldCom has causes of action against: (1) the Board of Directors for breach of its duties of care and loyalty by failing to take remedial action in the face of Messrs. Ebbers' and Sullivan's unauthorized commitment of WorldCom to the amended Intermedia merger agreement and by rubber-stamping the amended merger agreement without adequately informing itself; and

Material Adverse Effect: any change or effect that individually or in the aggregate with all other changes or effects, is or is reasonably likely to be materially adverse to the business, operations, properties, financial condition, assets, liabilities or prospects of Target and its Subsidiaries, taken as a whole, when used with respect to Target, or of Wildcat and its Subsidiaries, taken as a whole, when used with respect to Wildcat; other than those relating to the economy or securities market in general or the industries in which Wildcat, Target and their respective Subsidiaries operate in general.

³⁶⁷ The value of the non-Digex Intermedia assets in February 2001 is unclear. The Examiner's estimated cost of \$4.974 to 6.054 billion must be reduced by the then-expected value of the Intermedia assets. However, by February 2001, the prospect of realizing significant value for the non-Digex Intermedia assets was remote. Second Interim Report at 62.

(2) Messrs. Ebbers and Sullivan for breaching their duties of good faith and loyalty by intentionally causing Mr. Salsbury to execute the amended Intermedia merger agreement without prior Board approval.

2. The WorldCom Directors Breached Their Fiduciary Duties

The Examiner concludes that WorldCom's former Directors breached their fiduciary duties in failing to address Messrs. Ebbers' and Sullivan's unauthorized commitment of WorldCom to the amended Intermedia merger agreement and then in ratifying the amended agreement without adequate data. The pertinent facts supporting this conclusion are as follows.³⁶⁸

- During January and early February 2001, there were negotiations to settle the Digex litigation. The negotiations tied any such settlement to an amendment to the WorldCom/Intermedia merger agreement and a WorldCom commitment to fund Digex's business plan in 2001-2002.
- By February 2001, WorldCom could have withdrawn from the Intermedia transaction due to the litigation by Digex shareholders and Intermedia's declining financial performance.
- Notwithstanding the ability to withdraw from the transaction, at a meeting on February 7, 2001, former WorldCom Management reached a tentative agreement with Intermedia to revise certain terms of the merger agreement, subject to WorldCom Board approval.
- On February 12, 2001, with most or all of the terms of the amended merger agreement and a Digex settlement apparently negotiated, Cravath sent an e-mail to Mr. Borghardt, attaching a proposed written consent by which the WorldCom Board would approve the merger agreement amendment, the Digex settlement, and certain Digex/WorldCom commercial agreements. This e-mail and its attachment reflect the understanding among legal counsel that WorldCom Board approval was required, but had not yet been obtained.
- On February 13, 2001, at 1:10 p.m., Mr. Borghardt sent Mr. Salsbury and Cravath a draft of the written consent that contained Mr. Borghardt's suggested revisions.

³⁶⁸ WorldCom's Directors may not have been personally aware of the facts recited below. However, if they had insisted that Management explain how the merger amendment came about, consistent with their fiduciary duty of care, all such facts would have been available to the Directors. See Appendix A, § D (discussing duty of care).

The cover e-mail stated that once Mr. Salsbury approved the draft, Mr. Borghardt would obtain Mr. Ebberts' approval and then "route it to other Directors." Cravath and Mr. Borghardt clearly understood that Board approval had not been obtained as of the afternoon of February 13, 2001.

- According to a February 14, 2001 e-mail to Mr. Sullivan from his secretary, Intermedia's investment bankers were pressuring Mr. Salsbury to have WorldCom execute the merger amendment.
- On February 14, 2001, or possibly February 15, 2001, Mr. Salsbury executed the amendment to the Intermedia merger agreement, after being authorized to do so by Mr. Ebberts and Mr. Sullivan. Mr. Salsbury informed the Examiner that Mr. Ebberts and Mr. Sullivan told him that the WorldCom Board had approved the amended merger agreement.
- On February 15, 2001, WorldCom issued a press release announcing the Digex settlement and the amended merger agreement. The release stated falsely that WorldCom's Board had approved the Digex settlement. Similarly, a subsequent SEC filing by WorldCom on Form S-4 stated falsely that "[t]he WorldCom board of directors approved the merger as contemplated in the amended merger agreement on February 14, 2001."
- WorldCom's execution of the Intermedia merger amendment was widely publicized. For example, an article on the merger appeared in the Wall Street Journal on February 16, 2001. When interviewed by the Examiner, a number of WorldCom's former Directors acknowledged reading the article. Yet, not a single Director questioned former Management at that time regarding why WorldCom had entered into the amendment without Board approval.
- In fact, the WorldCom Board did not actually approve the Digex settlement and the amended merger agreement until it met on March 1, 2001. No data were provided to the Directors in advance or at the March 1 meeting to justify the amended agreement and no former Director even questioned, much less voiced any disapproval of Messrs. Ebberts' and Sullivan's prior unauthorized actions. The Directors then approved the amended merger agreement on March 1, 2001 via a written consent.

Directors and officers of Georgia corporations are charged with a duty of care in conducting the affairs of their corporation.³⁶⁹ A director's or officer's actions "must be made on an informed basis, in good faith, and in the honest belief that the action taken was in the

³⁶⁹ O.C.G.A. §§ 14-2-830(a)(2) and 14-2-842(a)(2).

best interest of the Company.”³⁷⁰ Moreover, a director may not abdicate his directorial duties. If he does so, he can be held to have breached his duty of loyalty to the corporation.³⁷¹

a. Failure to Correct Senior Management’s Misrepresentations

The Directors breached their fiduciary obligation of due care and loyalty by failing to take action to address Management’s unauthorized conduct. The Directors knew that Management had committed WorldCom to the amended merger agreement without prior Board authorization. The Examiner has determined that at least some of the WorldCom Directors knew about the February 15, 2001 press release, indicating falsely that the Board had approved the amended Intermedia merger agreement. The Examiner concludes this should have caused the Directors to: (1) question Messrs. Ebbers and Sullivan about such conduct; (2) correct the false press release without waiting for the regularly scheduled Board meeting on March 1, 2001; and (3) seek legal advice whether WorldCom was able to withdraw from the transaction. None of these things happened.³⁷² Instead, the Board

³⁷⁰ In re Intercat, Inc., 247 B.R. 911, 923 (Bankr. S.D. Ga. 2000) (citation omitted). For a more complete discussion of the standards governing the conduct of directors and officers of Georgia corporations, see Appendix A.

³⁷¹ Pereira v. Cogen, 294 B.R. 449, 528 (S.D.N.Y. 2003); Cede & Co. v. Technicolor Inc., 634 A.2d 345, 363 (Del. 1993) see O.C.G.A. § 14-2-1101 (a board must approve the form of a merger agreement); cf. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (court finds directors breached fiduciary duties by failing to require written amendments to merger agreement). See Appendix A, § C.2.

³⁷² At the March 1, 2001, WorldCom Board meeting, Mr. Salsbury made a brief presentation about the settlement of the Digex minority shareholder litigation. Such a report was consistent with Mr. Salsbury’s regular practice of reporting to the Board on legal, regulatory and legislative matters. His presentation did not include information concerning Management’s decision to stick with the Intermedia merger. The Examiner does not fault Mr. Salsbury or suggest that he withheld information from or misled the Board, because Mr. Salsbury was under the false impression (from Messrs. Ebbers and Sullivan) that WorldCom’s Board previously had approved the amended merger agreement, which obviated the need to justify the transaction on March 1, 2001.

abdicated its duties and stood idly by without taking any action until March 1, when the Directors rubber-stamped the amended merger agreement with no deliberation.³⁷³

The Examiner observes that if WorldCom's Directors had acted promptly after learning of the unauthorized Intermedia amendment, they would have been in a better position to oppose arguments by Intermedia that WorldCom was estopped from contending that the execution of the amendment was never properly authorized.³⁷⁴ The failure of the Directors to act promptly (or at all) after learning of Management's unauthorized conduct was a breach of the Directors' fiduciary duty to manage WorldCom's affairs.

b. Failure to Conduct Appropriate Due Diligence

The Examiner concludes that the WorldCom Directors further abdicated their duties when they ratified the amended Intermedia merger agreement on March 1, 2001 with no deliberation or due diligence. At that time, the Directors were requested to execute the written consent, approving the Digex settlement, the amended Intermedia merger agreement, and certain WorldCom/Digex commercial transactions. The Examiner has determined that no Board member sought the information necessary to make an informed determination about whether the transaction still made economic sense for WorldCom. Indeed, the Examiner is not aware of any Board member who demanded that Messrs. Ebberts and Sullivan account for their actions in directing Mr. Salsbury to execute the amended merger agreement in the absence of Board approval. By failing to inform themselves about this

³⁷³ Pereira v. Cogen, 294 B.R. 449, 528-30 (S.D.N.Y. 2003) ("the close relationships of the Board members to [the CEO], and the complete lack of diligence in the performance of the Board's duties further suggests that a breach of the duty of loyalty exists" as well as a breach of the duty of care).

³⁷⁴ See Bresnahan v. Lighthouse Mission, Inc., 496 S.E.2d 351, 354 (Ga. App. 1998) (It was not "unjust, unfair, or inequitable" to allow corporation to repudiate contract one month after execution and one month prior to scheduled closing where corporate officer acted outside the scope of authority granted by the corporation in executing the contract and there was no evidence of any conduct by the corporation clothing the officer with apparent authority). The issue of estoppel is addressed in Section VI.C.2.d.iii, infra.

transaction or engage in other appropriate deliberations, the Examiner concludes that the Directors approved the written consent without becoming adequately informed. Accordingly, they breached their fiduciary duties of care and loyalty, which required these Directors to make decisions for WorldCom “on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the Company.”³⁷⁵ If the Directors had informed themselves, they could (and should) have repudiated the contract at that time.

Moreover, while prior to the Board meeting one Director told the Examiner that he had privately expressed his disapproval to Mr. Ebbers for misrepresenting Board approval for the transaction, neither he nor any other Board member voiced any disapproval of former Management’s prior unauthorized actions during the March 1, 2001 Board meeting.³⁷⁶ The Examiner believes this is yet another example of the former WorldCom Directors failing to exercise independent judgment and simply “rubber-stamping” Mr. Ebbers’ decisions.

c. A Properly Informed WorldCom Board Probably Would Have Rejected the Amended Intermedia Transaction

The Directors’ fiduciary duty breaches means that they are liable for disgorgement of compensation received and possibly for losses incurred by WorldCom in the merger unless the Directors can show that an active and informed Board would have approved the amended merger. See Appendix A, § F.2. The Directors would bear the burden of proof regarding

³⁷⁵ In re Intercat, Inc., 247 B.R. 911, 923 (Bankr. S.D. Ga. 2000); cf. Pereira v. Cogen, 294 B.R. 449, 529 (S.D.N.Y. 2003) (“directors shirk their duty of loyalty where there exists an abdication of directional duty”) (citations omitted). See also Appendix A, §§ C.2 and D.

³⁷⁶ The Directors’ abdication of responsibility on March 1, 2001 is all the more surprising because there was an Executive Session on that date with Mr. Ebbers excused to discuss threatened shareholder litigation about the WorldCom loans and guaranty to Mr. Ebbers. The Examiner is disappointed that no Director present at the Executive Session addressed the conduct of Management pertaining to the Intermedia merger amendment.

any such breach. Id.³⁷⁷ The Examiner believes the Directors would not be able to demonstrate that a vigilant Board in early 2001 would have approved the amended merger. Set forth below is a summary of the key factors that an active and informed WorldCom Board would have considered in determining whether to accept or reject the Intermedia merger under its new terms:

The factors favoring approval appear to be as follows:

- Mr. Ebbers is reported to have favored the amendment in the belief that managed Web hosting was still a good business for WorldCom, although the Examiner has identified no WorldCom analyses from late 2000 or early 2001 seeking to justify sticking with the merger.³⁷⁸
- Mr. Ebbers reportedly was concerned that WorldCom's withdrawal from the Intermedia merger would be harmful, because it would be the second acquisition in a row (with Sprint being the first) that the Company announced but failed to consummate.

The factors favoring withdrawal from the transaction appear to be as follows:

- The cost of the transaction had risen significantly since September 2000 – from under \$3 billion to over \$5 billion and, possibly, nearly \$6 billion. In contrast, WorldCom's financial results had been in decline for some time and WorldCom's stock price had fallen greatly.
- The amendments to the Intermedia merger agreement, which effectively doubled the cost of the transaction, made it more difficult for WorldCom to withdraw from the transaction should Intermedia's financial fortunes continue to deteriorate.
- Members of the WorldCom CD Group thought the transaction should be terminated.
- Digex's stock price had fallen from approximately \$85 per share as of September 1, 2000 to about \$27 per share in late January 2001.

³⁷⁷ Ordinarily, Directors' actions are presumed proper under the business judgment rule. However, where, as here, the Directors' have violated their fiduciary duties, they lose the protection of that rule. See Appendix A, § F.1 and 2.

³⁷⁸ The Examiner is aware that certain research analysts in February 2001 praised the amended Intermedia/WorldCom merger agreement as a good move by WorldCom. The Examiner is not prepared to accept cheerleading by analysts over hard analysis as a basis for believing that the merger continued to make sense.

Digex's operating performance in 2000 had also ended slightly behind predictions. As of September 1, 2000, Digex was predicted to have \$179.7 million in revenues and an operating loss of \$148.8 million in 2000; Digex's actual results, which were known to WorldCom Management by early February 2001, were revenues of \$168.1 million and an operating loss of \$150.6 million.

- Intermedia's results since September 1, 2000 had been poor as well. Intermedia's 2000 revenues came to \$868.7 million, which was \$24 million less than the \$891.7 million predicted as of September 1, 2000. Similarly, Intermedia's operating loss for 2000 was \$440.2 million, which was far greater than the \$383.5 million loss predicted on September 1, 2000. Finally, Chase determined by January 31, 2001 that Intermedia's revenue growth in 2000 was substantially lower than that achieved by Intermedia's competitors.
- Efforts to sell the non-Digex assets for significant value had been unsuccessful and no significant sale prospects were viable at that time. Indeed, prospects were so poor that WorldCom engaged SSB in early 2001 to seek to help with the sale.
- Early efforts to merge the Digex and WorldCom sales teams suggested that hoped for synergies would be difficult to achieve.
- WorldCom's loans to, and the guaranty on behalf of Mr. Ebbers caused doubt among WorldCom Directors as to his leadership, suggesting that an active and informed Board should have carefully scrutinized the amended transaction for which Mr. Ebbers acted as the primary proponent.

The Examiner believes that the Board's approval of the original Intermedia merger agreement on September 1, 2000 had been a close call, based in part upon the Board's understanding of the value of the non-Digex assets. By the time Messrs. Ebbers and Sullivan misrepresented to Mr. Salsbury that the Board had approved the amended agreement, the substantial decrease in the value of the non-Digex assets made this deal far less desirable, particularly when coupled with the developments in the Digex minority shareholder litigation and the decline in Intermedia's financial performance.

It is obviously difficult to predict what an informed, non-passive WorldCom Board, as of February 2001, would have decided with respect to the Intermedia merger in assessing

these and possibly other factors. The Examiner, in his Second Interim Report, concluded preliminarily that an informed Board “almost certainly” would have said no and, at a minimum, would have faced a very difficult decision. The Examiner now concludes that had the Board been active and properly informed itself on February 16, 2001 or, at the latest, March 1, 2001, by obtaining outside advice from a financial advisor, such as in the form of a fairness opinion, it should have voted against going forward with the transaction.³⁷⁹

d. Potential Defenses of the Directors

The WorldCom Directors, other than Messrs. Ebbers and Sullivan (who also face liability for this transaction as officers of WorldCom), may attempt to defend against a claim for breaches of their fiduciary duties of care and loyalty on at least five grounds: (1) the exculpatory provision contained in WorldCom’s articles of incorporation; (2) the business judgment rule; (3) principles of estoppel and ratification; (4) the September 1, 2000 Board Resolution authorizing Mr. Ebbers or his designee to execute the Intermedia merger agreement, including any amendments thereto; and (v) the indemnification provision in Article Twelve of WorldCom’s Articles of Incorporation.³⁸⁰

(i) Exculpatory Provision

Article Ten of WorldCom’s Articles of Incorporation provides:

No director of the Corporation shall be liable to the Corporation or to its shareholders for monetary damages for breach of duty of care or other duty as a director, except for liability: (i) for any appropriation, in violation of his duties, of any business opportunity of the Corporation; (ii) for acts or omissions which

³⁷⁹ Given Messrs. Ebbers’ and Sullivan’s misconduct in having Mr. Salsbury execute the amended merger agreement without prior Board approval, the Board may well have been justified in demanding their resignations at that time.

³⁸⁰ The Examiner is unaware of any releases granted to any WorldCom Directors other than Mr. Ebbers. If there were any such releases, they were not furnished to the Examiner. Moreover, if such releases exist and if they are structured along the same lines as Mr. Ebbers’ release, they possibly would not apply to these claims due to the gross negligence exception and, at a minimum, a genuine issue of material fact probably would exist on this issue.

involve intentional misconduct or a knowing violation of the law; (iii) for the types of liability set forth in Section 14-2-832 [distributions] of the Revised Georgia Business Corporation Code; or (iv) for any transaction from which the director received an improper personal benefit.

This is known as an exculpatory clause. It purports to limit sharply directors' personal liability to a company or its shareholders for most of their business decisions. At least two United States District Court decisions, however, have held that a Bankruptcy Trustee is not bound by the terms of exculpatory clauses.³⁸¹ These decisions were based upon the fact that the Trustee represents the interests of the creditors. Since the creditors were not parties to the contract, i.e., the articles of incorporation, they could not be bound by its terms. Further, the exculpatory clause on its face applies only to "the Corporation or to its shareholders," and any Trustee would act on behalf of creditors.

A debtor-in-possession is a different legal entity than the bankrupt corporation, and it has the same rights, powers and duties as a trustee. See 11 U.S.C. § 1107(a). Thus, WorldCom, as a debtor-in-possession, is most likely not barred by Article Ten from asserting fiduciary duty claims against WorldCom's former Directors.

In addition, the Examiner believes the Directors' knowing inaction in the face of the false February 15, 2001 press release and associated news articles arguably represented "intentional misconduct," against which the exculpatory clause does not offer protection. At a minimum, a genuine issue of material fact appears to exist regarding whether the Directors' inaction rose to the level of intentional misconduct, and the Examiner believes that a fact finder would ultimately have to resolve this issue.

³⁸¹ See, e.g., Pereira v. Cogan, No. 00 Civ. 619 (RWS), 2001 WL 243537, *11 (S.D.N.Y. March 8, 2001); In re Ben Franklin Retail Stores, No. 97C7934, 97C6043, 2000 WL 28266, *8 (N.D. Ill. Jan. 12, 2000).

Moreover, recklessness under the appropriate circumstance may constitute intentional misconduct, which is not protected by an exculpatory clause.³⁸² Here, substantial evidence suggests that the Directors acted in a reckless, if not an intentional fashion by: (1) not correcting the false press release and making clear that, as of February 15, 2001, the Board had not approved the amended merger agreement; (2) not challenging Messrs. Ebbers and Sullivan about their misrepresentations about prior Board approval of the amended merger agreement; and (3) failing to make an informed decision or engage in substantial deliberation over whether the Intermedia transaction continued to make economic sense.

(ii) Business Judgment Rule³⁸³

The WorldCom Directors may attempt to avail themselves of the protections afforded by the business judgment rule. Directors of Georgia corporations like WorldCom are charged with a duty of care in conducting the affairs of their corporation.³⁸⁴ Thus, a director's actions "must be made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the Company."³⁸⁵ However, to be entitled to the protections of the business judgment rule, a director must have complied with his or her fiduciary duties to the corporation.³⁸⁶ Once a director's violation of a fiduciary duty has been established, the burden then shifts to the director to prove the entire fairness of the transaction.³⁸⁷

³⁸² See Callaway v. Ryckley, 404 S.E.2d 650, 651 (Ga. App. 1991), rev'd on other grounds, 412 S.E.2d 826 (Ga. 1992); DaCosta v. Technico Constr. Corp., 344 N.Y.S.2d 967, 969-70 (N.Y. Cir. Ct. 1973).

³⁸³ The business judgment rule is discussed in more detail in Appendix A, § F.1.

³⁸⁴ See O.C.G.A. §§ 14-2-830(a)(2).

³⁸⁵ In re Intercat, Inc., 247 B.R. at 923.

³⁸⁶ Munford, Inc. v. Valuation Research Corp., 98 F.3d 604, 611 (11th Cir. (Ga.) 1996) ("The business judgment rule protects directors and officers from liability when they make good faith business decisions in an informed and deliberate manner.").

³⁸⁷ See Solomon v. Armstrong, 747 A.2d 1098, 1112 (Del. Ch. 1999). See also Appendix A, § F.2.

As outlined above, the WorldCom Directors breached their duties of care and loyalty in connection with the amended Intermedia merger agreement. They failed to seek any explanation why Messrs. Ebberts and Sullivan lied about Board approval, why the transaction as amended still made sense, or whether WorldCom could withdraw from the transaction after it was executed. As a result, they did not make a good faith business decision in an informed or deliberate manner. Thus, the Examiner believes that WorldCom's Directors are not entitled to the protections provided by the business judgment rule.

The Directors could attempt to establish the entire fairness of the transaction, which is a means of avoiding liability even when fiduciary duties are not fulfilled. But this is an exacting standard, requiring the Directors to show the fairness of both the process and the price.³⁸⁸ The Examiner believes that the WorldCom Directors would not be able to sustain their burden of proof regarding the fairness of the amended Intermedia merger agreement because, as discussed above, the substantial weight of the evidence favored withdrawal from this transaction. The only other option available to the Board would be to shift the burden back to WorldCom by proving the fairness of the process by which they approved the Intermedia amended merger agreement. The Examiner believes that the WorldCom Directors cannot establish that the process was fair because, as detailed above and in the Second Interim Report, the process itself was deficient in many respects.

(iii) Estoppel

The WorldCom Directors may attempt to argue that they were effectively estopped from taking any action in the face of Messrs. Ebberts' and Sullivan's misconduct and may rely on the following facts. First, Mr. Salsbury signed the amended Intermedia merger

³⁸⁸ See Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); Solomon v. Armstrong, 747 A.2d at 1112. See also Appendix A, § F.2.

agreement based upon Messrs. Ebberts' and Sullivan's misrepresentation that the Board had approved the amendment. Mr. Salsbury executed the amended agreement on behalf of WorldCom as "General Counsel." No one from WorldCom disputed Mr. Salsbury's authority to execute the amended agreement on WorldCom's behalf, even though without actual Board approval he lacked the authority to do so.³⁸⁹ Indeed, as noted, WorldCom issued a press release within a day after the agreement was executed. That press release stated, albeit falsely, that WorldCom's Board had approved the proposed settlement of the Digex minority shareholder litigation, which included the amendments to the Intermedia merger agreement. No further action was taken by WorldCom until March 1, 2001, at which time the WorldCom Directors ratified the unauthorized action by signing a written consent, backdated to February 15, 2001, approving the amended merger agreement.

Based on these facts, Directors, other than Messrs. Ebberts and Sullivan, might argue that WorldCom could not have withdrawn from the transaction on March 1, 2001, particularly given the terms of the amended merger agreement, which made withdrawal far more difficult. The Examiner believes that this argument likely fails because any potential estoppel resulted from the Directors' own failure to act immediately upon learning that the amended merger agreement had been executed without their authorization. At a minimum, the Board's inaction likely creates a genuine issue of material fact, requiring that a fact finder resolve the estoppel issue.

³⁸⁹ Under Georgia law, corporate officers have only the powers given to them by the corporation's by-laws, articles of incorporation, "or as may be implied by usage and acquiescence." Bresnahan v. Lighthouse Mission, Inc., 496 S.E.2d 351, 353 (Ga. App. 1998). Neither WorldCom's by-laws nor its articles of incorporation authorized the Company's General Counsel to execute merger agreements. Indeed, Georgia law provides that even a corporation's president or chief executive officer has limited authority and can bind the corporation only in matters within the scope of ordinary business. See, e.g., O.C.G.A. § 14-2-841. A \$6 billion merger is not a matter within the scope of ordinary business, even for a corporation as large as WorldCom.

The Directors may contend that they were effectively estopped to reject the Intermedia merger amendment because Mr. Salsbury executed the agreement and Intermedia would have reasonably relied on Mr. Salsbury's actions as well as on the false press release published on WorldCom's website, thereby legally binding WorldCom to this transaction no matter what the Board subsequently did.³⁹⁰ Yet, if the Board had acted quickly to reject the amended transaction and possibly to censure the misconduct of Messrs. Ebbers and Sullivan, Intermedia's case for reasonable reliance would have been substantially diminished. Indeed, there is strong evidence that the Directors' inaction created the very circumstances that led to any such reliance on Intermedia's part. Some or all of the Board members knew of the false press release and the other misstatements by February 16, 2001. Yet no one on the Board reacted to the fact that the WorldCom Board had not approved the amended merger agreement.

The Directors' inaction should not be condoned. Having failed to take any action upon learning of senior Management's false statements about the Board's approval of the amended merger agreement, the former Directors should not be allowed to argue that their hands were tied due to circumstances that resulted from their own inaction.³⁹¹

³⁹⁰ The press release stated that the WorldCom Board had approved the amended merger agreement. Mr. Ebbers was quoted in that press release, which was published on WorldCom's website, creating the appearance that the statements in the release were accurate

³⁹¹ In addition, at a minimum, genuine issues of material fact exist regarding Intermedia's purported reasonable reliance upon the amended merger agreement. Without such reliance, the estoppel defense necessarily fails. For example, in Mobile Communications Corp. v. MCI Communications, No. 8108 1985 WL 11574 (Del. Ch. Aug. 27, 1985), the court held that a corporation was not estopped from disputing the effectiveness of an asset sale based upon the failure to disclose certain information since "estoppel applies only if the party lacks any means of discovering the undisclosed information." Id. at *5. Intermedia may well have been able to discover with relative ease the fact that the WorldCom Board had not in fact approved the amendments to the merger agreement. Indeed, Intermedia knew that Mr. Ebbers had executed the original merger agreement and therefore could and should have requested written assurance that Mr. Salsbury had authority to execute the amended agreement. See Augusta Surgical Center, Inc. v. Walton & Heard Office Venture, 508 S.E.2d 666, 669 (Ga. App. 1998) ("As a general rule, where the exercise or performance of an agency is by written instrument, the agency must also be created by written instrument.") Further, had the WorldCom Board acted in a manner consistent with its fiduciary duties and quickly clarified that it had not approved the amended merger

**(iv) The September 1, 2000 Resolutions Authorizing
Former Management to Alter the Terms of the
Intermedia Agreement**

It is possible that Directors might contend that Management was authorized to execute the Intermedia merger amendment without prior Board approval, thus absolving Directors from liability. This defense, if asserted, should fail.

The Examiner is aware that the September 1, 2000 WorldCom Board resolution approving the initial Intermedia merger granted Management some authority to alter the terms of the agreement:

FURTHER RESOLVED that the President and Chief Executive Officer and/or such other officers of the Corporation as he may designate (the “Authorized Officers”) be, and each of them with full power to act without the others hereby is, authorized to execute and deliver, in the name and on behalf of the Corporation, the Merger Agreement and the Voting Agreement, including any amendments thereto, in such form, with, to the extent permitted by law, such changes as the Authorized Officer executing the same may approve, such approval to be conclusively evidenced by such Authorized Officer’s execution and deliver of such agreement.

Such authority is standard in corporate transactions and permits management to approve non-material merger amendments without board approval. Such authority, however, does not permit material amendments without further board approval.³⁹²

Further, Management’s actions make clear that Board approval was understood to be required. First, on March 1, 2001, such Board approval was belatedly obtained, albeit on the

agreement, Intermedia’s ability to assert any reasonable reliance upon Mr. Salsbury’s actions or the false press release would have been significantly diminished. See Bresnahan v. Lighthouse Mission, Inc., 496 S.E.2d at 354 (It was not “unjust, unfair, or inequitable” to allow a principal to repudiate a contract executed without authority by an agent one month after the execution and one month before the scheduled closing.); cf. Synergy Worldwide, Inc. v. Long, Haymes, Carr, Inc., 44 F. Supp. 2d 1348 (N.D. Ga. 1998) (“The conduct of the agent alone cannot bind the principal. The principal must act in such a manner as to legitimate the agent’s charade of authority.”). This might also have precluded Intermedia’s potential assertion of the specific performance provisions contained in both the initial merger agreement and the February 2001 amendment thereto. In any event, none of the Directors sought legal advice on whether they could rescind the transaction.

³⁹² See O.C.G.A. § 14-2-1101; Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

basis of no informed basis. Second, WorldCom's outside and in-house counsel, who went through various iterations of a written consent for the Board members to sign authorizing the amended Intermedia merger agreement, acknowledged the need for Board approval.

(v) The Indemnification Provision in the Articles of Incorporation

Article Twelve of WorldCom's articles of incorporation provides:

The Corporation shall indemnify a director against reasonable expenses and liability incurred by him, and shall advance expenses upon receipt from the director of the written affirmation and repayment authorization required by section 14-2-853 of the Georgia Business Corporation code, provided, however, that the Corporation shall not indemnify a director for any liability incurred by a director if he failed to act in a manner he believed in good faith to be in or not opposed to the best interests of the Corporation, or to have improperly received a personal benefit or, in the case of any criminal proceeding, if he had reasonable cause to believe his conduct was unlawful, or in the case of a proceeding by or in the right of the Corporation, in which he was adjudged liable to the Corporation, unless a court shall determine that the director is fairly and reasonably entitled to indemnification in view of all the circumstances, in which case the director shall be indemnified for reasonable expenses incurred.³⁹³

By its very terms, this provision does not apply to WorldCom's Directors in this instance. First, the Directors are not entitled to indemnification for any liability "if [they] failed to act in a manner [they] believed in good faith to be in or not opposed to the best interests of the Corporation." In other words, indemnification is unavailable in the event of a breach of a Director's fiduciary duties to WorldCom, particularly the duties of loyalty and

³⁹³ Article X, Section 2 of WorldCom's By-Laws provides that WorldCom "shall indemnify and advance expenses to its directors to the fullest extent permitted under, and in accordance with, the corporation's Articles of Incorporation and the applicable provisions of Part 5 of Article 8 of the Georgia Business Corporation Code." (Emphasis added.) Even were this provision determined to be more beneficial to WorldCom's officers and directors than Article Twelve of WorldCom's Articles of Incorporation, this would not assist the Directors. Article XII of the By-Laws provides that the Articles of Incorporation shall govern in the event of inconsistencies between the By-Laws and the Articles of Incorporation.

good faith. As set forth above, WorldCom's Directors breached their duty of loyalty in connection with the amended Intermedia merger agreement.

Moreover, the clause does not provide for indemnification "in the case of a proceeding by or in the right of the Corporation, in which he was adjudged liable to the Corporation, unless a Court shall determine that the director is fairly and reasonably entitled to indemnification in view of all the circumstances." Thus, this clause means there would be no automatic indemnification at the beginning of any lawsuit brought by WorldCom against the Directors. Rather, the issue of indemnification would have to await adjudication of WorldCom's claims against the Directors, and given the substantial evidence supporting these claims, as detailed above, the Examiner believes it unlikely that a court would indemnify the Directors "in view of all the circumstances."

3. Messrs. Ebbers and Sullivan Breached Their Fiduciary Duties

a. Messrs. Ebbers and Sullivan Lied About Board Approval of the Amended Merger Agreement.

The Examiner has no hesitation in concluding that Messrs. Ebbers and Sullivan breached their fiduciary duties of loyalty, good faith, and care in connection with the amendment to the Intermedia merger agreement. They apparently directed Mr. Salsbury to execute the Intermedia merger amendment, knowing full well that WorldCom's Board had not approved the amendment and that the Directors had not even been provided with any data to attempt to justify the amendment. Messrs. Ebbers and Sullivan had no authority to commit WorldCom to the amended Intermedia merger agreement without proper Board authorization. Further, the Examiner has identified no data suggesting that Messrs. Ebbers and Sullivan sought to inform themselves of all relevant data (pro and con) before

committing WorldCom to the amended merger. In such circumstances, it seems beyond question that these officers breached their fiduciary duties to the Company.

b. The Potential Defenses of Messrs. Ebbers and Sullivan Seem Unavailing

(i) The Exculpatory Clause

Based upon the exception in Article Ten of WorldCom's Articles of Incorporation "for liability for acts or omissions which involve intentional misconduct," Messrs. Ebbers and Sullivan cannot avail themselves of the exculpatory clause regarding claims against them for lying to Mr. Salsbury and for issuing a false press release. Furthermore, the exculpatory clause by its terms applies only to the liability of Directors, not officers. Since Messrs. Ebbers and Sullivan were both officers of WorldCom, in addition to sitting on the Board, they are not shielded from liability by Article Ten for breaches of their fiduciary duties.

(ii) Mr. Ebbers' Release

Mr. Ebbers cannot rely upon the April 29, 2002 mutual release, entered into between himself and WorldCom, as a defense to his action. The terms of that release are as follows:

As a material inducement for you to enter the Separation Agreement, the Company does hereby agree to forever release you, your heirs, successors and assigns (hereinafter collectively referred to as the "Executive Releasees"), from any and all causes of action, agreements, damages, judgments, claims, debts, covenants, executions and demands of any kind whatsoever, which the Company ever had, now has or may have against the Executive Releasees or any of them, in law or equity, whether known or unknown, for, upon, or by reason of, any matter whatsoever occurring up to the date this Release is signed by the Company, including without limitation in connection with or in relationship to your employment relationship with the Company or its affiliates or the termination of such relationship; provided that such released claims shall not include any claims (i) to enforce the Company's rights under, or with respect to, the Separation Agreement, or the Letter Agreement, Promissory Note or April 2 Letter Agreement referenced in Section 5 of the Separation Agreement, or (ii) in connection with any fraud, willful misconduct, gross negligence or criminal act on your part.

(emphasis supplied.) The Examiner concludes that Mr. Ebberts' conduct in connection with the amended Intermedia merger agreement rises to the level of "fraud, willful misconduct, gross negligence or criminal act" so as to preclude Mr. Ebberts from relying upon the terms of the release as a defense to his liability in connection with this matter. Mr. Ebberts had no basis known to the Examiner to believe that he had authority to commit WorldCom to the Intermedia amendment. Thus, a finding of willful misconduct seems well supported by the facts. Further, as detailed in Chapter VIII, *infra*, Mr. Ebberts' breach of his Separation Agreement by failing to pay WorldCom the \$25 million in loan proceeds due on April 29, 2003 may provide additional grounds to set aside the release.

(iii) The Indemnification Provision

If WorldCom's Directors are not entitled to indemnification under the terms of Article Twelve of WorldCom's Articles of Incorporation, Messrs. Ebberts and Sullivan most certainly are not. The Examiner believes that these individuals breached their fiduciary obligations to WorldCom by falsely representing to Mr. Salsbury that the Board had authorized execution of the amended Intermedia merger agreement, thus leading to WorldCom entering into the merger amendment with no proper authorization.

4. Available Remedies

As discussed in Section K of Appendix A, WorldCom's Directors and Mr. Ebberts and Mr. Sullivan may be subject to disgorgement of any compensation earned during the period of their disloyalty. In addition to this remedy, WorldCom may be entitled to pursue recovery of compensatory damages proximately caused by the Directors' and Messrs. Ebberts' and Sullivan's breaches of their fiduciary obligations to the Company. The compensatory damages would reflect those losses recorded in connection with the Intermedia

merger that could have been avoided (including presumably, some or all of the \$5 million fee paid to Chase Securities after the Intermedia closing) if Messrs. Ebbers and Sullivan had not breached their duties or if WorldCom's Directors had acted promptly after February 15, 2001, to disassociate WorldCom from the amended Intermedia merger agreement.³⁹⁴ WorldCom may also be entitled to pursue an award of punitive damages.³⁹⁵

The Directors (other than Ebbers and Sullivan) may argue that they cannot be held liable for compensatory damages since Messrs. Ebbers' and Sullivan's misrepresentation to Mr. Salsbury regarding Board approval of the amended merger agreement was the proximate cause of the damages suffered by WorldCom. Conversely, Messrs. Ebbers and Sullivan may argue that they cannot be held liable for compensatory damages since there may have been no such damages had the Directors properly exercised their fiduciary duties and determined to repudiate the amended merger agreement. The Examiner doubts that either such argument would be sustained. Georgia law suggests that the Directors probably could have avoided or minimized the damage of Messrs. Ebbers' and Sullivan's action if they had acted promptly. Further, Messrs. Ebbers and Sullivan should not be able to defend against liability for their fiduciary duty breaches by arguing that the Directors also breached their duties.

5. Role of Counsel in the Intermedia Merger Amendment

In the Second Interim Report, the Examiner reached no conclusion regarding counsel's role in facilitating the Intermedia merger amendment prior to WorldCom Board approval. The Examiner commented, however, that the role of WorldCom counsel merited

³⁹⁴ See Davis v. Ben O'Callaghan Co., 227 S.E.2d 837, 841 (Ga. App. 1976), rev'd in part, 232 S.E.2d 53 (Ga. 1977) ("There are three elements of a tort: existence of a legal duty other than contractual from defendant to plaintiff, breach of that duty, and damage as a proximate result."); cf. Holland v. Holland Heating & Air Conditioning, Inc., 423 S.E.2d 238 (Ga. App. 1993).

³⁹⁵ See Kilburn v. Young, 569 S.E.2d 879, 883 (Ga. App. 2002) ("A breach of fiduciary duties is sufficient to support an award of punitive damages." (Citations omitted.)); Caswell v. Jordan, 362 S.E.2d 769, 774 (Ga. App. 1987); Davis v. Ben O'Callaghan Co., 227 S.E.2d at 841.

further investigation and such investigation has led the Examiner to the following conclusions.

First, the Examiner's interviews and review of documents, including numerous e-mail messages, indicate that on February 14 or 15, 2001, Messrs. Ebbers and Sullivan informed Mr. Salsbury that the WorldCom Board had approved the Intermedia merger amendment and that Mr. Salsbury was authorized to execute the amendment on behalf of WorldCom.³⁹⁶ Mr. Salsbury carried out his superiors' instruction and did not inquire when the Board had provided such approval. The Examiner does not fault Mr. Salsbury in this regard, given that WorldCom's General Counsel often was not involved in matters of importance.³⁹⁷ Thus, the Examiner believes Mr. Salsbury had no basis to know that the Board, in fact, had not authorized the Intermedia merger amendment.³⁹⁸

Second, the Examiner is concerned that outside and in-house counsel appear to have agreed that WorldCom's Directors could approve the amended Intermedia merger agreement via the use of a written consent, rather than following a full Board meeting that included in-depth discussion of the ways in which the transaction had changed since September 1, 2000. In this instance, Cravath, as well as in-house counsel, worked on February 12-13, 2001 (and

³⁹⁶ It appears that Messrs. Ebbers and Sullivan were in New York at the time, which may explain why the execution of the Intermedia merger amendment was delegated to Mr. Salsbury.

³⁹⁷ For example, when Mr. Ebbers convened an informational meeting of the WorldCom Board in February 1999 to discuss the complex series of agreements involving WorldCom and EDS, Mr. Salsbury was not included on the conference call. Second Interim Report at 40-43. Similarly, when Mr. Ebbers convened a "kickoff" meeting on October 11, 2000, on Tracker-related issues involving WorldCom employees, outside counsel, SSB, J.P. Morgan and Arthur Andersen, Mr. Salsbury again was not involved. Third and Final Report § IX.B.

³⁹⁸ Mr. Salsbury informed the Examiner that he did not learn that WorldCom's Board had not approved the amended Intermedia merger agreement prior to his execution of it until just prior to his May 2003 interview with the Examiner. The Examiner has no reason to doubt Mr. Salsbury's statement. All the same, with the benefit of hindsight and the current regulatory climate, the Examiner observes that a general counsel in the future should insist on hard evidence of proper corporate approvals before executing important corporate documents.

possibly on earlier days as well) to prepare a written Board consent to the Intermedia merger amendment.

The Examiner has been unable to determine how former WorldCom Management, in-house counsel and Cravath decided that a written consent could be used to evidence the Board's approval of the Intermedia merger amendment. It is clear, however, that Cravath and two in-house WorldCom attorneys were involved in drafting the written consent and that none of these attorneys appear to have questioned the use of a written consent in this instance.³⁹⁹

Georgia law sanctions the use of written consents, and permits Board action without a formal meeting. Thus, the Georgia Code states:

Unless the articles of incorporation or bylaws provide otherwise, action required or permitted by this chapter to be taken at a board of directors' meeting may be taken without a meeting if the action is taken by all members of the Board.

Ga. Code Ann. § 14-2-821(a). The Georgia Code Commentary on this provision includes the following observation:

The power of the board of directors to act unanimously without a meeting is based on the pragmatic consideration that in many situations a formal meeting is a waste of time.

(emphasis added). Similarly, the Commentary to the Model Business Corporation Act section on written consents states as follows:

The power of the board of directors to act unanimously without a meeting is based on the pragmatic consideration that in many situations a formal meeting is a waste of time. For example, in a closely held corporation, there will often

³⁹⁹ Mr. Salsbury, one of the in-house counsel involved, did not specialize in corporate law matters and thus the Examiner is not surprised that he did not focus on the propriety of using a written consent. For reasons discussed hereafter, however, the Examiner would have expected WorldCom's outside corporate counsel, Cravath, and Mr. Borghardt, who regularly handled WorldCom Board resolutions, to have been more sensitive to this issue.

be informal discussion by the manager-owners of the venture before a decision is made. And, of course, if there is only a single director (as is permitted by section 8.03), a written Consent is the natural method of signifying director action. Consent may be signified on one or more documents if desirable.

In publicly held corporations, formal meetings of the board of directors may be appropriate for many actions. But, there will always be situations where prompt action is necessary and the decision noncontroversial so that approval without a formal meeting may be appropriate.

(emphasis supplied.)

It is clear to the Examiner that the Intermedia merger amendment was hardly a noncontroversial matter. Thus, a meeting of the entire WorldCom Board to consider carefully whether to stick with the revised Intermedia deal would hardly have been a "waste of time." Accordingly, the Examiner is troubled that counsel would have prepared a written consent for WorldCom Board approval of the Intermedia merger amendment without suggesting to former Management that a formal Board meeting (even by telephone) was the more appropriate method by which to proceed. The Examiner has found no evidence of any such suggestion.

The Examiner acknowledges that there is little law on the use of written consents and that the Georgia Commentary quoted above does not dictate that a written consent cannot be used in circumstances such as the Intermedia amendment. That said, the Examiner would have expected WorldCom's corporate counsel to have questioned the use of a written consent in the case of the Intermedia merger amendment. To the Examiner's knowledge, that did not happen, and the Examiner has received no satisfactory explanation for why it did not happen.⁴⁰⁰

⁴⁰⁰ The Directors did not actually execute the written consent until March 1, 2001, when Mr. Borghardt circulated the consent to Directors at the regularly scheduled WorldCom Board meeting. Second Interim Report at 61. The consent specified that the approval was "effective as of February 15, 2001." In fact, Georgia law does not appear to permit the backdating of written consents. Ga. Code Ann. § 14-2-821 Commentary.

IX. TRACKER STOCKS

A. Overview

In his Second Interim Report, the Examiner reported on matters related to WorldCom's creation of two Tracker stocks – the high growth WorldCom Group Tracker and the lower growth MCI Group Tracker. The Examiner concluded on a preliminary basis that WorldCom's Board failed to become adequately informed of relevant facts before the Trackers were announced on November 1, 2000. The Examiner also concluded preliminarily that the Board's actual approval of the Trackers five months later, in Board Minutes approved March 1, 2001, for an informational WorldCom Board meeting held on October 31, 2000, raised further corporate governance questions. Second Interim Report at 65-70. Finally, the Examiner observed that certain of the allocations of assets and costs between the two Trackers were difficult to understand and suggested a possible bias to enhance financial results of the WorldCom Group Tracker to the detriment of the MCI Group Tracker. The Examiner noted, however, that the allocations presented complex issues and, accordingly, he declined to make any preliminary findings and advised that he would report on allocation issues in a later report. *Id.* at 74-75.

Since publication of the Second Interim Report, the Examiner has continued his investigation of Tracker issues, including interviews of present and former WorldCom employees and outside service providers and the review of many additional documents. It must be noted at the outset of this discussion that the Examiner has not had access to former WorldCom personnel who played important roles in the design and implementation of the

This is another instance where corporate counsel appear to have failed to consider carefully the law governing WorldCom.

Trackers. There may be significant information that has not been made available to the Examiner that could change some of his observations and conclusions. With this caveat, the Examiner reaches the following conclusions.

First, the corporate governance processes followed by former Management and the WorldCom Board in the creation of the Trackers were deficient. The Examiner has determined that WorldCom's Management became well informed about the Trackers. For example, prior to the November 1, 2000 announcement of the Trackers, senior Management, assisted by others within WorldCom and by two financial advisors, one outside law firm and Arthur Andersen, conducted extensive analyses about the Trackers and considered possible alternatives.

However, the WorldCom Board received only limited data about the Trackers and never met with the financial advisors, the outside lawyers or the accountants. Further, the Examiner has failed to identify any documents that were provided to the WorldCom Board before the November 1, 2000 announcement pertaining to the Trackers and no outside Director appears ever to have requested such data. Many critical decisions, such as the assets to be allocated to each Tracker, the amount of debt to be allocated to each Tracker, and the dividend to be paid on the MCI Tracker, were decided by former WorldCom Management, with no input by or approval of the Board. The Trackers represented a major restructuring of WorldCom, which appears to be the reason why two financial advisors were engaged. The Examiner concludes that the Board violated its fiduciary duty in permitting the Trackers to proceed without becoming better informed.

Second, the Tracker stocks were never properly approved by the WorldCom Board. The Board held an informational meeting on October 31, 2000, but took no vote and

approved no resolutions recommending the Trackers to shareholders. Subsequently, in-house counsel created fictitious Board Minutes for the October 31 meeting, making it seem as if the meeting had included a vote on the Trackers and approval of resolutions and the WorldCom Tracking Stock Policy Statement. These Minutes were then approved without discussion by the Board on March 1, 2000. The Examiner concludes that under applicable law, the WorldCom Board never gave proper approval to the Trackers. The Examiner also concludes that representations in the Tracker proxy suggesting such Board approval were untrue.

Third, on June 7, 2001, WorldCom's shareholders voted to approve the Trackers. This vote ratified the Board's ineffective approval of the Trackers, provided that the vote was on an informed basis. The Examiner believes that it is a close question whether WorldCom's shareholders were properly informed regarding the Tracker proposal, given numerous misleading statements in the proxy.

Fourth, notwithstanding the Examiner's concerns about the Tracker approval process, the Examiner concludes that if the WorldCom Board had fulfilled its duty to become properly informed on Tracker issues, the Board may well have approved the Trackers in the same form as they finally were presented to shareholders in the Tracker proxy. A consensus developed in 2000 among WorldCom Management and its advisors that the Trackers were a preferable alternative to a spin-off or a sale of the consumer unit. This was consistent with choices made by other telecom companies, like AT&T and Bell South, which decided to create Trackers during the same time period. Likewise, once the Trackers were tentatively selected as WorldCom's best restructuring option, the choice of which business units would go to a particular Tracker was not controversial for the vast majority of the assets.

WorldCom's then incumbent Management had extensive data regarding these choices, all or some of which could have been used to inform the Board of choices and recommendations. Likewise, on critical issues such as debt allocation and the MCI dividend, Management sought advice from its financial advisors, which data again could have been shared with the Board. Accordingly, if the available data concerning the Tracker choices or a reasonable summary of such data had in fact been made available to the WorldCom Board before November 1, 2000, the Examiner believes that the former Directors may have agreed with Management and its financial advisors.

Fifth, the Examiner concludes that the major allocations mentioned in the Second Interim Report – \$6 billion debt to the MCI Group Tracker, no cash balances in the MCI Tracker, and the MCI trade name allocated to the WorldCom Group and then licensed back to the MCI Group for \$27.5 million a year – do not appear to violate the federal securities laws. These allocations were disclosed in the Tracker proxy. The law on Tracker stocks supports the view that such allocations are permitted, so long as they are disclosed and followed, which occurred in this instance.

Sixth, the Examiner investigated whether major cost categories, particularly line costs and selling, general and administrative ("SG&A") expenses, WorldCom's biggest cost categories were fairly allocated between the Trackers. The Examiner has discovered no conclusive evidence to suggest that such costs were not fairly allocated. The Examiner also observes that he was able to review only certain of WorldCom's cost allocations as part of his investigation. Thus, there could be instances of manipulated allocations that the Examiner did not consider. Overall, however, the data available to the Examiner appear to

reflect rational cost allocation decisions and the Examiner has not identified systematic effort to load inappropriate costs onto the MCI Group.

Finally, the Examiner investigated whether the MCI Group was unduly restricted, both in terms of expense budgets and capital budgets, from achieving sound, long-term financial results. On this issue, the evidence is unclear. It appears that from the time of the closing of the WorldCom/MCI merger in 1998, there was a reluctance within WorldCom Management to invest in the MCI businesses. It also appears that this reluctance continued after the Trackers were implemented. As a result, MCI operated in what came to be called a "harvest" mode, which was designed to result in increasing cash flow. The "harvest" mode was typified by significant pressure to control expenses, limited new investments, and raised prices, even when the long term effect of such practices might be to drive away customers. Thus, it does not appear that the "harvest" strategy was a long-term viable strategy. The Examiner is concerned that this "harvest" strategy was never properly disclosed in WorldCom's regulatory filings, nor approved by the WorldCom Board.

In all, even though the Trackers strategy turned out to be unsuccessful, the Examiner, based on the information currently available to him, does not believe that WorldCom has claims related to the Trackers against any persons. The Examiner believes that the Trackers were the result of complicated decisions and that there is evidence that such decisions were undertaken in the good faith and belief that they would better focus investors on the core strengths of WorldCom's different lines of businesses. The Examiner further recognizes that the economic downturn that started in 2000, which particularly impacted the telecommunications industry, made positive economic results all more difficult to achieve.

At the same time, the Examiner believes that certain persons involved in the Tracker processes failed to perform appropriately. WorldCom Directors were passive and let then-existing Management go forward with its plans, with virtually no Board input. In-house counsel contributed to the governance lapses by creating the fictionalized October 31, 2000 Board minutes. The financial advisors did significant work with Management, but Management never called for the advisors to address the Board on Tracker issues, even though it would be typical for the advisors to have done so. The Examiner does not conclude that these lapses led to losses by WorldCom for which claims should be pursued. But, the Examiner does conclude that the failings of WorldCom Management, the Board and the Company's professionals with respect to the Tracker stocks offer important lessons.

B. The WorldCom Board Failed To Become Adequately Informed About The Trackers Before The Trackers Were Authorized

In the Second Interim Report, the Examiner described the WorldCom Board's involvement in Tracker decision-making prior to the November 1, 2000 announcement that the Trackers had been approved by the Board. Such involvement was limited:

March 2, 2000	Brief general discussion of Trackers at the quarterly Board meeting. No documents were provided and no financial advisors or outside counsel were present. No vote was taken.
September 7, 2000	Long Executive Session discussion of Trackers at the quarterly Board meeting. No documents were provided and no financial advisors or outside counsel were present. A series of slides were utilized. ⁴⁰¹ No vote was taken but a consensus in favor of the Trackers seems to have developed at that meeting.

⁴⁰¹ The Examiner requested from WorldCom copies of the slides used at the September 7, 2000 Executive Session. Despite what appear to have been extensive searches by WorldCom personnel and its counsel, the slides have not been found. Accordingly, the exact nature of the data presented by WorldCom Management to the Board at that meeting cannot be determined. However, Mr. Borghardt, acting as secretary at that meeting, kept extensive notes, which help to make clear that there was a wide-ranging discussion, although many important details (i.e., the specific assets to be allocated to particular Trackers, amount of debt to be allocated to each Tracker, license MCI's use of the MCI tradename, etc.) do not appear to have been discussed.

October 31, 2000

Brief Tracker discussion at a telephonic informational Board meeting, which was convened on 24 hours notice with no agenda or Board package. The meeting lasted 15-30 minutes. No financial advisors or outside counsel were present. No documents were provided and no vote was taken. In fact, the meeting focused mostly on new financial guidance being announced and not on the Trackers.

Based on the foregoing, the Examiner concluded preliminarily in the Second Interim Report that the WorldCom Board had failed to become reasonably informed of relevant data before permitting former Management to announce the Tracker stocks. Second Interim Report at 69. The Examiner has discovered no new information to lead him to reconsider his preliminary conclusion. To the contrary, information obtained by the Examiner subsequent to the issuance of the Second Interim Report has only served to buttress this view. For example, financial advisors to WorldCom confirmed that the Trackers were a major restructuring, akin to a large M&A transaction,⁴⁰² and that it would be typical for the financial advisors to make presentations to the WorldCom Board. Indeed, a July 12, 2000 SSB document prepared for WorldCom Management suggested that there should be two WorldCom Board meetings on Trackers: an initial one where there would be presentations by Management and financial advisors, followed by a second meeting where WorldCom Board approval would be sought. Similarly, an October 19, 2000 SSB document suggested that a WorldCom Board meeting needed to be scheduled on Tracker issues and that SSB, J.P. Morgan and outside counsel all should be present.

The very fact that the Trackers constituted a major restructuring should have underscored the need for the WorldCom Board to have become thoroughly familiar with Tracker issues and potential alternatives before the Trackers were announced. The Examiner

⁴⁰² The fact that two financial advisors, SSB and JP Morgan Securities, were engaged on Tracker matters underscores that the Trackers were viewed as a significant transaction.

concludes that the single Executive Session on September 7, 2000, when the Trackers were discussed in detail but no documents were provided and no financial advisors appeared, was insufficient to inform adequately the Board. For example, issues such as which business units would go into a particular Tracker, how much long-term debt would be allocated to each Tracker, and how much of a dividend would be paid by the MCI Tracker, were major issues that were not discussed at all or in detail at the September 7 Board meeting.⁴⁰³ These matters were considered in detail by WorldCom's Management and financial advisors⁴⁰⁴ between September 7 and November 1, 2000 and then were publicly announced on November 1, 2000.⁴⁰⁵ However, prior to November 1, 2000, such issues were never discussed with WorldCom's former Directors, which was contrary to normal practice for most companies.

In sum, the Examiner concludes that the Board permitted WorldCom Management to commit the Company to the major Tracker restructuring, despite the fact that the Board had

⁴⁰³ On a typical Tracker restructuring, the Examiner has been informed that there are relatively standard policies that come to be adopted in virtually every instance, such as policies on how to handle corporate opportunities. However, there also are other issues that need particular focus in the context of individual Tracker decisions, such as debt allocation and dividend policies. It is typical that such decisions are made by the Board of Directors.

⁴⁰⁴ For example, both J.P. Morgan and SSB in early October made recommendations to WorldCom Management on debt allocation matters. Thus, on October 2, 2000, J.P. Morgan, in a document entitled "WorldCom Restructuring Discussions Follow-Up," made a series of recommendations, including that \$5 billion of long-term debt be allocated to the MCI Tracker and that the MCI Tracker pay \$370 million in annual dividends. Similarly, on October 5, 2000, SSB prepared a document entitled "Project Gibraltar Tracking Stock Debt Considerations," in which it also recommended that \$5 billion in long-term debt be allocated to the MCI Tracker and that the MCI Tracker pay \$500 million per year in dividends. Ultimately, Management decided to allocate \$6 billion in long-term debt to the MCI Tracker and to pay approximately \$280 million annually in dividends.

⁴⁰⁵ Other significant issues were also considered by Management but not shared with the Board. For example, outside counsel prepared a memorandum addressing Tracker stock exit alternatives, i.e., possible means to end the Trackers if they did not work as planned, including the potential financial consequences. Similarly, outside counsel advised Management of necessary changes to WorldCom's stock option plans in view of the plan to create the Tracker stocks. Such data, or reasonable summaries, would typically be made available to the Board before Board approval was obtained. The Examiner has identified no information to suggest that Management provided such data to the WorldCom Board.

been provided with virtually no data about the restructuring. In the Examiner's opinion, this was clearly contrary to the Directors' duty of care.⁴⁰⁶

The Examiner has considered who may be at fault for this lapse in basic corporate governance. First, Messrs. Ebberts and Sullivan are clearly at fault. They closely managed the Tracker process, dealing directly and frequently with the financial advisors, SSB and J.P. Morgan Securities, and outside counsel, Simpson Thacher & Bartlett ("STB"). The Examiner has determined that Messrs. Ebberts and Sullivan knew that these outside service providers had generated substantial amounts of data about the Trackers and that they should have known the WorldCom Directors needed to be informed regarding those matters. Accordingly, the Examiner concludes that Messrs. Ebberts and Sullivan breached their fiduciary duties by failing to provide WorldCom's Board with adequate data prior to the Tracker announcement.

Second, the other WorldCom Directors also bear significant fault. The former Directors should have realized that the creation of the Trackers was a significant WorldCom restructuring, including the issuance of two new classes of securities and the need for shareholder approval. These Directors should have insisted that Management provide detailed justification for the actions being taken. Instead, the Directors once again passively acquiesced in permitting Management to control the affairs of WorldCom, while making virtually no inquiries about the actions being taken.

⁴⁰⁶ Several persons interviewed by the Examiner suggested that WorldCom's Directors were generally experienced and knowledgeable about Trackers, thus excusing the failure to become better informed. The Examiner identified very little data to suggest that WorldCom's outside Directors had any significant expertise with Trackers. Further, even if they had such expertise in general, that still would not excuse their failure to become informed about the critical decisions made regarding the specific WorldCom Trackers, including the choices of assets to be allocated to particular Trackers and the various cost allocation issues, including the allocation of \$6 billion in long-term debt to the MCI Tracker and the \$27.5 million annual fee charged the MCI Tracker for use of the MCI trade name.

Third, the Examiner does not believe that WorldCom's senior in-house counsel bear responsibility for permitting the Trackers to be announced on November 1, 2000 before the Board became adequately informed.⁴⁰⁷ Messrs. Salsbury and Borghardt appear to have had no prior Tracker experience and had very little involvement with the Trackers prior to November 1, 2000.⁴⁰⁸ Further, it seems clear that Mr. Ebbers would not have welcomed any comment from Mr. Salsbury.⁴⁰⁹

Fourth, the Examiner does not believe that the financial advisors bear responsibility for failing to insist that they appear before the WorldCom Board. While such appearances are typical, the Examiner has identified no basis to suggest that such appearances are required and it was reasonable for the advisors to assume that a summary of their analyses and recommendations on matters like debt allocation and dividend policy would be shared with the WorldCom Board, even in the absence of actual Board presentations by the advisors. Further, to the Examiner's knowledge, the financial advisors had no duty to take affirmative steps to make certain that the WorldCom Directors had been provided with pertinent data.

Finally, the Examiner does not fault STB for failing to ensure that the WorldCom Board was adequately informed before the Trackers were announced. The lead STB counsel on the WorldCom Trackers informed the Examiner that he had been involved in a number of

⁴⁰⁷ STB, which had had extensive prior Tracker experience, had been engaged as WorldCom's counsel on Tracker matters. STB was first approached by WorldCom about a potential Tracker engagement in August 2000. STB started work in earnest on Tracker issues on September 27, 2000 and between then and November 1, 2000, STB timekeepers billed approximately 675 hours, almost all on Tracker matters.

⁴⁰⁸ For example, there was a "kick off" meeting in Jackson, Mississippi, on October 11, 2000, attended by senior Management (Messrs. Ebbers, Sullivan, Scott Hamilton, Blair Bingham, Wayne Huyard, Brian Brewer, Stephanie Scott, Mark Willson, Sangeve Sethi and Brad Burns), as well as representatives from SSB, J.P. Morgan and Arthur Andersen. Messrs. Salsbury and Borghardt were not among the attendees. By this time, Trackers had been decided upon by WorldCom Management and work was focused thereafter on resolving details for a November 1 announcement.

⁴⁰⁹ Indeed, a former senior member of Management stated that expressing an opinion that a transaction might not make sense or that the Board processes were not proper could cost a person his job.

prior Trackers and that he never once had been asked to address a Board of Directors on Tracker issues. Accordingly, the fact that STB was not invited to address the WorldCom Board before November 1, 2000 did not seem out of the ordinary. Prior to November 1, 2000, STB reviewed the draft WorldCom press release that would announce the Trackers, which stated that the WorldCom Board had approved the Trackers. In these circumstances, STB reasonably could assume that proper corporate authorization by the WorldCom Board had taken place prior to November 1, 2000.

C. The WorldCom Board Never Properly Approved the Tracker Stocks

The Examiner reported in the Second Interim Report that the purported WorldCom Board approval of the resolutions recommending the Trackers to WorldCom shareholders and authorizing their implementation was questionable. Second Interim Report at 70. The Board Minutes approved by the WorldCom Board on March 1, 2001, purporting to be the minutes of the October 31, 2000 Board meeting (the "October 31 Minutes"), read as follows in pertinent part:

Mr. Ebbers reviewed a proposed release by the Company regarding financial guidance for the fourth quarter of 2000 and for 2001, following which Messrs. Ebbers and Sullivan responded to questions. Mr. Ebbers then reported on the proposal being considered by the Board to create tracking stocks for the Company's WorldCom and MCI businesses, including a description of the businesses expected to be included in each and other terms and conditions. Following a discussion, upon motion duly made and seconded, the proposal was approved and the attached resolutions were adopted unanimously.

In fact, the October Minutes were fictitious insofar as the Trackers were concerned. There appears to have been minimal discussion of the Tracker proposal during the brief October 31 informational meeting, and there is no evidence that any Tracker-related questions were asked. There was no Board package circulated before the meeting, and the

Directors did not have copies of the proposed resolutions during the meeting.⁴¹⁰ Thus, even though the fictionalized October 31 Minutes contain WorldCom's Tracking Stock Policy Statement, a document repeatedly referred to in the Tracker proxy, that Policy Statement was not before the Board, even in draft, on October 31, 2000. Moreover, the critical issues addressed in it, such as debt allocation and charging the MCI Tracker \$27.5 million per year for use of the MCI tradename, were not discussed at that or any other WorldCom Board meeting. Finally, no motion was made and no vote was taken during the meeting.

Legal authority suggests that the Board's use of the March 1, 2001 approval of the WorldCom Board Minutes to convert the October 31, 2000 "informational meeting" into a full WorldCom Special Board Meeting, including approval by the Board of the Tracker Resolutions, was ineffectual. Fradkin v. Ernst,⁴¹¹ is instructive. Fradkin involved an attempt by a Board of Directors to deal with a procedural irregularity resulting from last-minute revisions to a stock option plan. In Fradkin, the Board of Directors created minutes describing events that never happened:

Those minutes outline the events of January 4, 1983, as if they had taken place in formal meetings. The minutes describe motions being made and seconded and debate taking place. While the minutes may describe the intent of the directors, they constitute a fictionalization of what might have happened had actual meetings taken place. The events of January 4, 1983, contained none of the procedures of a regular, formal meeting. To the extent therefore, that the minutes suggest that a meeting took place in which regular procedures were followed, the minutes are inaccurate.⁴¹²

⁴¹⁰ Indeed, the initial draft of Board resolutions approving the Trackers were not created until November 3, 2000.

⁴¹¹ 571 F. Supp 829 (N.D. Ohio 1983),

⁴¹² Id. at 837.

The court noted that despite a later attempt to create a written consent, “the events of January 4, 1983, do not qualify as valid corporate action in the context of this litigation.”⁴¹³

Under Georgia law, in the absence of a Board conflict of interest, when a company intends to amend its articles of incorporation to issue a new class of stock, the Board of Directors must first formally recommend such an amendment to the shareholders. GA. Code Ann. § 14-2-1003(b)(1) (2002). The shareholders then vote on the proposed amendments. Id. § 14-2-1003(b)(2) (2002). Therefore, in order to be properly approved, an amendment to a company’s articles of incorporation must be preceded by both a recommendation from the Board and approval by the shareholders.

In the case of the WorldCom Trackers, the Examiner does not believe that the Board properly recommended to the shareholders the amendments to the Company’s Articles of Incorporation that created the Trackers. Moreover, because the actual events of October 31, 2000 did not include formal Board approval of the Tracker Resolutions, the actions that took place in the following months, including the announcement of the Board’s approval of the Tracker plan, the preparation of the proxy and solicitation materials and the extensive internal planning for the Tracker structures, were taken in the absence of a proper Board mandate.

More troubling is the fact that, regardless of the form or timing of the purported approval of the Tracker Resolutions, the WorldCom Board never undertook a full discussion,

⁴¹³ Id. at 845. In Fradkin, there had been no Board meeting on January 4, 1983. Rather, a series of one-on-one calls were made to Directors to obtain consent to the action to be taken. The WorldCom situation is somewhat different, since an actual informational WorldCom Board meeting did occur on October 31, 2000. Nonetheless, Fradkin is still very much on point. The WorldCom fictionalized minutes “suggest that a meeting took place in which regular procedures were followed” Fradkin, 571 F. Supp at 837. Just as in Fradkin, the WorldCom minutes are inaccurate. Similarly, while the Fradkin court noted that the directors on January 4, 1983 did not have before them the stock option plan that they purported to approve, which was not even in final form at that time (Id. at 836), the WorldCom Board similarly was not provided on October 31, 2000 any documents pertaining to the Trackers, including the Resolutions and the Tracking Stock Policy Statement.

debate or vote on the Tracker issues. A leading treatise on corporate governance states: "The meeting requirement is based on the belief that the greatest wisdom results from conference and exchange of individual views, and it is for that reason that the law generally requires the united wisdom of a majority of the members of the board in determining the business of a corporation." William M. Fletcher, *Fletcher Cyc Corp* § 392, at 238 (Perm. Ed. 2001). The Examiner is concerned that the former WorldCom Board and Management were content to imply that a Board meeting had taken place for the purpose of discussing the Trackers, when in fact no such "conference and exchange of individual views" had taken place. Instead, the Board, with no advance warning, was told on October 31, 2000 by Management of the Company's plan to announce and implement the Trackers. On October 31, 2000 and March 1, 2001, the Board can, at best, be said to have silently acquiesced to Management's plans. The Examiner concludes that this is symptomatic of the lack of WorldCom Board oversight and proper corporate governance procedures at the Company.

The Examiner further concludes that the WorldCom Board's March 1, 2001 approval of the October 31, 2000 Minutes did not constitute an effective recommendation of the Trackers for a shareholder vote. Fradkin is again instructive. In that case, the Directors met individually, not as a group, on January 4, 1983 and orally approved the stock option plan. Subsequently, at a May 1983 Board meeting, the Directors approved a written consent approving the stock option plan signed by all persons who were Directors as of January 4, 1983, which consent "was designed to cure the Board's failure to have a formal meeting on January 4, 1983."⁴¹⁴ The Court rejected this purported approval:

Procedural regularities and interaction among board members, therefore, are critical in determining the legitimacy of board of directors' actions. Absent

⁴¹⁴ Id. at 839.

such procedural regularities, a board may not act on behalf of a corporation. Where, as here, the Board has not met and acted as a board, the individual assent of the Board will not serve as a substitute for these procedural regularities.⁴¹⁵

This reasoning has relevance to WorldCom. While the WorldCom Board did meet on October 31, 2000, the meeting was expressly noticed as “informational.” Thus, this 15-30 minute meeting had none of the procedural regularities of a formal meeting. Just as the Fradkin court ruled that subsequent action by the Board could not create valid corporate action in that case, the Examiner concludes that the WorldCom Board’s approval of the fictitious Minutes on March 1, 2001 could not create valid corporate action taken as of October 31, 2000.

It is unlikely that WorldCom could seek to avoid its faulty approval of the Trackers by taking the position that its Board never properly approved the Trackers. WorldCom would likely be estopped from seeking to invalidate its actions due to procedural defects in its own approval processes.⁴¹⁶ Further, an informed shareholder vote generally ratifies Board action in the absence of fraud.⁴¹⁷ However, for reasons discussed in the next portion of this Report, the Examiner questions whether shareholder ratification would apply in this instance due to the likelihood that the proxy that solicited shareholder approval was materially false and misleading.

The Examiner has investigated to determine who bears responsibility for the highly questionable processes followed by WorldCom in converting the October 31, 2000 meeting into something that did not exist, which may well have not complied with Georgia legal requirements. Messrs. Ebberts and Sullivan bear responsibility. They were each consulted

⁴¹⁵ Id. at 845.

⁴¹⁶ Id. at 845.

⁴¹⁷ Solomon v. Armstrong, 747 A.2d 1098, 1127 (Del. Ch. 1999), aff’d, 746 A.2d 277 (Del. 2000).

about this process and each approved. Second, the other Directors who acquiesced in this process must bear responsibility. They received the fictionalized October 31, 2000 Minutes in draft form on or about February 12, 2001. The Examiner has not identified any objection by any Director to these Minutes and they appear to have been approved, together with the Policy Statement, on March 1, 2001 with no Board discussion at all.

Third, in-house counsel, with the blessing of Messrs. Sullivan and Ebbers, apparently agreed upon this approach. This appears inconsistent with applicable law. The Examiner has identified no principled basis for counsel to have pursued this course of action.⁴¹⁸ The Examiner does not believe that counsel chose this course of action to avoid confronting any legal or factual issue. Nonetheless, the Examiner must express concern regarding the acquiescence of the Company's in-house counsel.⁴¹⁹

D. The Tracker Proxy Contained False and Misleading Statements

Consistent with the fact that the Trackers were a major WorldCom restructuring, requiring the issuance of a new class of Company stock, the Trackers required WorldCom shareholder approval. Such approval was obtained at the June 7, 2001 WorldCom annual meeting. The approval process was pursuant to a WorldCom Form S-4 Registration Statement and proxy.

As discussed in Section IX.B, above, the WorldCom Board had very limited involvement on Tracker matters. Notwithstanding that fact, the S-4 Registration Statement

⁴¹⁸ In-house counsel could not explain why it was decided that the Tracker approvals would be done through the fictionalized October 31 Board Minutes, as opposed to going through a proper approval process on March 1, 2001. One counsel stated that making the October 31 meeting into a "real" meeting was "wrong" and made the transaction "look nefarious," when that was not the case.

⁴¹⁹ The Examiner has determined that STB, outside counsel to WorldCom, was consulted in February 2001 about the Tracker resolutions and the Tracking Stock Policy Statement. However, STB was not consulted about the October 31, 2000 Board minutes and was not aware until the Examiner's investigation that the October 31, 2000 meeting had been an informational meeting.

and proxy contain a series of statements that, taken together, suggest that the WorldCom Board had been heavily involved in Tracker matters. Thus, the following representations were made:

At meetings of our board of directors on March 2, 2000 and September 7, 2000, our directors discussed the creation of tracking stock for some or all of our WorldCom group and MCI group businesses. At meetings on October 31 and November 16, 2000, our board of directors continued these discussions. On October 11, 2000, we engaged financial advisors with respect to the tracking stock. After extensive discussions with our senior management, legal counsel and financial advisors, our board of directors has determined that the recapitalization would increase market awareness of our WorldCom group and MCI group businesses and provide for more efficient valuation of all of our businesses, advance our strategic and financial objectives and create flexibility for our overall future growth.

Our board of directors adopted a tracking stock policy statement to govern the ongoing relationship between the WorldCom group and the MCI group where the holders of WorldCom group stock and MCI group stock may have potentially divergent interests. The tracking stock policy statement also sets forth the methods and assumptions for allocating our assets, liabilities, revenues and expenses between the groups.

The board chose to pursue the establishment of a tracking stock due to the relative speed with which the transaction could be executed as a result of regulatory and other factors, and the benefits realized from maintaining both operating entities within a single corporate structure with the efficiencies of a consolidated network and consolidated debt structure.

Our board of directors carefully considered the tracking stock proposal and believes that the approval of this proposal by the shareholders is advisable and in our best interests. Our board of directors unanimously recommends that you vote FOR this proposal.

The Examiner concludes that these representations about the involvement of WorldCom's Board in the Tracker approval processes, taken as a whole, are seriously misleading. They suggest, for example, that the WorldCom Board interacted directly with WorldCom's financial advisors and outside counsel on Tracker issues. That did not occur. They similarly suggest that the WorldCom Board made a number of focused decisions or determinations on WorldCom Tracker issues, including how to structure the Trackers. That

did not occur. In reality, all decisions on structuring the Trackers and what businesses would go to a particular Tracker were made by former Management, with no Board involvement except for a discussion at the September 7, 2000 Executive Session. Finally, the proxy speaks of the Board adopting the Tracking Stock Policy Statement, suggesting that the Board gave actual consideration to the Policy Statement and the matters identified in it. Indeed, the proxy makes at least 18 references to the Tracking Stock Policy Statement, thus suggesting that the Board's approval of the Policy Statement was an important part of the Tracker process. The Examiner's investigation discloses that the Board probably never actually discussed the Policy Statement at all, nor did it discuss thoroughly any of the issues mentioned in it.

The federal securities laws prohibit the making of materially false or misleading statements in a proxy statement or proxy solicitation materials.⁴²⁰ As this relates to the description of Board deliberation and recommendation of the proposals to be voted on, it is essential that "[o]nce a proxy statement purports to disclose the factors considered by an insider in evaluating. . . [a transaction], there is an obligation to portray them accurately." 4 Louis Loss & Joel Seligman, *Securities Regulation* 2079 (3d ed. 1999).

Fradkin v. Ernst, is again instructive. In Fradkin, the Court noted as follows about the proxy disclosures in that case:

[T]he proxy statement is false and misleading to the extent that it suggests that valid formal action took place [t]he disclosures warrant a reasonable investor to believe that the Board of Directors had taken formal action and

⁴²⁰ Rule 14a-9 of the Securities Exchange Act of 1934 states "No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

given deliberate consideration of the [Stock Option] Plan. To the contrary, there was very little oversight and no discussion by the Board of Directors. Given the public prominence of the Directors, a reasonable investor would consider the approval of the Board important in determining how to vote on the Plan.⁴²¹

The Court then proceeded to find the disclosures regarding purported Board actions to be materially false and misleading.⁴²²

The Fradkin court based its decision on the definition of “materiality” articulated by the Supreme Court in TSC Industries v. Northway.⁴²³ In TSC Industries, the Court stated: “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁴²⁴

In circumstances similar to WorldCom’s, in S.E.C. v Falstaff Brewing Corp.⁴²⁵ a federal appeals court held that a proxy statement was materially false and misleading because it contained reference to a board audit committee that did not actually exist. The court upheld the trial judge’s finding that such a reference “created the false impression that the board of directors was exercising careful oversight of the company’s finances” and found that the statement was materially false and misleading, holding “formal entities such as committees create at least the impression of great care and precision through detailed review

⁴²¹ Fradkin, 571 F. Supp. at 845-46.

⁴²² Id. at 846.

⁴²³ 426 U.S. 438 (1976).

⁴²⁴ Id. at 449.

⁴²⁵ 629 F.2d 62 (D.C. Cir. 1980).

and oversight. Stating that an audit committee, with its implication of careful oversight, existed when it did not . . . is misleading”⁴²⁶

The Examiner similarly concludes that WorldCom’s S-4 and proxy disclosures about the involvement of the WorldCom Board were false and misleading. There are representations to the effect that the WorldCom Board was heavily involved in the recommendation to shareholders to approve the Tracker stocks when that was not the case. The Board, inappropriately, left all such matters to former Management, yet the public filings implied that there was active and engaged oversight by the Board.

The Examiner has investigated to determine who bears responsibility for the false portrayal in the proxy of WorldCom Board involvement in the Trackers. First, members of WorldCom’s former Management bear responsibility. STB provided copies of the draft proxy to Management for review⁴²⁷ and those persons appear to have done nothing to revise the incorrect information. Messrs. Ebbers and Sullivan, of course, bear the greatest responsibility, as they had the greatest direct knowledge about how little the Board was involved in the Trackers.

⁴²⁶ Id. at 75.

⁴²⁷ For example, on October 18, 2000, STB sent the following language to WorldCom Management for review and comments:

At a meeting of our board of directors on _____, 2000, our directors discussed the creation of tracking stock for some or all of our MCI group and WorldCom group businesses. At meetings on _____, _____, _____, _____ and _____ 2000, our board of directors discussed the creation of a tracking stock for our MCI group and WorldCom group businesses. After extensive discussions with our senior management, legal counsel and financial advisors, our board of directors has determined that the recapitalization would increase market awareness of our MCI group an WorldCom group businesses and provide for more efficient valuation of all of our businesses, advance our strategic and financial objectives and create flexibility for our overall future growth.

Second, the other Directors also are to be faulted. The Directors knew that they had minimal involvement with Trackers after September 7, 2000. Yet, they approved the Tracker proxy before it was filed, without raising any concerns about its accuracy.

Third, the Examiner does not believe that in-house WorldCom counsel, such as Messrs. Salsbury and Borghardt, bear responsibility for the statements contained in the S-4 and the proxy. Neither of these persons had responsibility to review these documents.

Fourth, the Examiner investigated whether STB, which was responsible for the S-4 and the proxy, bears responsibility for the failure to correct these inaccuracies. STB, following what was then standard practice, provided drafts of the proxy to former WorldCom Management and relied on such Management to advise STB if there were any inaccuracies. STB did not undertake any due diligence on its own to gain assurance that the representations being made, as quoted above, were accurate. The Examiner finds no basis to question that this was standard practice among corporate counsel in 2000-01. Accordingly, the Examiner does not find fault in how STB performed its duties.⁴²⁸

For reasons discussed previously, the Examiner believes that WorldCom is probably estopped from taking positions to void the Trackers due to the defective processes followed on Tracker issues or due to inaccuracies in the S-4 or proxy.

E. A Properly Informed WorldCom Board May Have Approved The Trackers

The Examiner concludes that the WorldCom Directors failed to exercise that level of care required before permitting the Trackers to be announced. That means that the Board's action as to the Trackers is not protected by the business judgment rule. Rather, in such a

⁴²⁸ The Examiner is aware of no facts that should have alerted STB to the fact that the statements in the S-4 and proxy were not accurate.

circumstance, the Directors would need to demonstrate that the Trackers made good business sense, with the Directors bearing the burden of demonstrating the overall rationality of the Trackers. Second Interim Report at 17-18, 22-23; see Appendix A, § F.2.

The Examiner concludes that the Directors, if required to do so, may be able to demonstrate the total fairness of the Trackers. The Examiner also concludes that there is considerable evidence that suggests an adequately informed WorldCom Board may have approved the Trackers in the form recommended by former Management. The bases for this conclusion are set forth below.

WorldCom Management engaged in considerable study of the Trackers and alternatives to them. A brief summary of the work undertaken is set forth in the WorldCom Tracker Stock Chronology, Appendix 7 to the Examiner's Second Interim Report. Besides the work noted therein, the Examiner observes that WorldCom personnel and outside financial advisors and legal counsel, especially in September and October 2000, devoted considerable time to analyzing various Tracker-related issues, all as a means of attempting to focus issues to be considered before the November 1, 2000 Tracker announcement.⁴²⁹ By all accounts, WorldCom's former Management appears to have become well informed about Tracker issues prior to November 1, 2000.

Several conclusions have emerged from this investigation. First, former Management did consider several alternatives to the Trackers, especially a sale or spin-off of the consumer businesses. Indeed, during the summer of 2000, one financial advisor favored a sale or spin-off over the Trackers. Ultimately, however, former Management became concerned about

⁴²⁹ For example, in early October 2000, Messrs. Ebbers and Sullivan met separately with SSB and J.P. Morgan, along with outside legal counsel, to solicit their views on critical issues, including which assets would go to each Tracker, debt allocation and dividend policy. Outside counsel, who was present at these meetings, had the impression that WorldCom Management sought such separate meetings to be sure that it was getting the independent views of the financial advisors.

the regulatory hurdles that might be faced if one of those alternatives was selected, especially after the significant regulatory problems encountered with respect to the failed Sprint merger. Eventually, all financial advisors came to favor the Trackers over other alternatives.⁴³⁰

Second, with the benefit of hindsight, it is relatively easy to conclude that the WorldCom Trackers did not succeed and proved to be exceedingly time consuming and complicated endeavors. At the time they were being considered, however, it appears that former Management and its financial advisors and outside counsel had a good faith belief that it made rational sense to divide WorldCom into the high growth and lower growth sectors, thus giving investors a better opportunity to assess the values of the businesses. This was not an uncommon reason for companies to pursue tracking stock structures. Similar Trackers had previously been pursued by Sprint and AT&T and Bell South announced Trackers of their own during Fall 2000. The supporting rationale for such tracking stock structures is that investors interested in high growth companies are more likely to purchase stock associated with high growth businesses that are not also burdened with low growth businesses, and investors interested in low growth companies that pay a dividend are more likely to invest in low growth businesses that pay a dividend when they are not burdened with riskier high growth businesses. There certainly was an element of "financial engineering" involved in this process, but that was not the motivating factor. Rather, it appears that WorldCom's former Management favored the Tracker approach because it became convinced that it offered a rational means to seek to improve WorldCom's stock price. The Examiner concludes that in the totality of circumstances in the Fall of 2000, this was a rational decision.

⁴³⁰ The Examiner has determined that at the September 7, 2000 Executive Session of the WorldCom Board, Management addressed not only the potential Trackers, but also potential alternatives, including a sale or a spin-off, or Trackers followed by a sale or a spin-off.

Third, once the high growth/low growth "model" was tentatively decided upon for the WorldCom Trackers, it was a relatively straightforward process to decide which business units should be assigned to a particular Tracker. This is not to say that there was not some uncertainty about certain portions of certain businesses,⁴³¹ but, for the vast majority of the business units, the decisions were not controversial. Accordingly, while the WorldCom Board should have been involved in decision-making as to which businesses went to a particular Tracker, there is no reason to believe that Board involvement would have led to different decisions.⁴³²

The foregoing decision-making processes were ongoing in the weeks and months prior to the November 1, 2000 announcement of the Trackers. The Examiner concludes that it would have been a relatively simple task for WorldCom Management, its financial advisors and STB to have prepared a package for the WorldCom Board, setting forth the types of analyses undertaken, the alternatives considered and the recommendations being made. A Board meeting could then have been convened to consider such issues. Nonetheless, as noted, the Examiner cannot conclude that an active and informed Board of Directors would not have approved the Trackers in the form proposed by former Management.⁴³³

⁴³¹ For example, there was a fair bit of internal discussion about where portions of the SkyTel paging business should end up.

⁴³² The Examiner pursued inquiry regarding the degree to which persons from the MCI businesses were involved in decision-making on Trackers. The conclusion reached is that persons like Wayne Huyard and Victoria Harker were periodically involved in providing data about certain businesses but that they were not decision makers regarding which businesses would go to a particular Tracker. The Examiner has identified no basis, other than the failure to involve the Board in these decisions, to question the process that was followed, especially since Messrs. Ebberts and Sullivan appear to have been well acquainted with the particulars of each line of business.

⁴³³ The Examiner acknowledges that some WorldCom personnel, especially those within the MCI Tracker Group, were not pleased with the concept of grouping the low growth WorldCom assets in one group where the focus would be on generating cash as the businesses gradually declined.

F. Tracker Allocation Issues

In the Second Interim Report, the Examiner identified concerns about certain cost and asset allocation issues, including the allocation decisions set forth in the Tracker Stock Policy Statement. The Examiner expressed concern that there may have been a systematic bias to make decisions that had the effect of favoring the WorldCom Tracker to the detriment of the MCI Tracker. Second Interim Report at 74-75.

The Examiner has continued his investigation of these issues and expanded it to include line cost allocations and allocations of SG&A expenses. It is clear that some of the allocation decisions could have been made differently, and some seemed to have adversely affected the MCI Group. However, with only a few reservations, the Examiner concludes that there is no basis to second-guess the decisions that were made.⁴³⁴

1. Policy Statement Allocation Issues

The Examiner identified in the Second Interim Report three matters from the Tracker Stock Policy Statement that potentially gave him concern: allocation of \$6 billion of long term debt to the MCI Tracker, at an interest rate somewhat higher than that allocated to the WorldCom Tracker; the allocation of all cash to the WorldCom Tracker; and the allocation of the MCI trade name to the WorldCom Tracker and the licensing of the use of that trade name back to the MCI Tracker at an initial cost of \$27.5 million a year, with that amount to increase in subsequent years. Second Interim Report at 74-75.

⁴³⁴ The Examiner is aware that a former WorldCom employee, Paul Erickson, has alleged in a Department of Labor whistleblower complaint against WorldCom that some of the cost allocations to the MCI Tracker were improper and that he was fired on August 1, 2002, because he had complained about such cost allocations. The Examiner has investigated cost allocation issues but does not believe it appropriate to address the specific allegations made by Mr. Erickson regarding his whistleblower complaint pertaining to his WorldCom employment and its termination. The Examiner believes that it is prudent in such circumstances to leave issues pertaining to Mr. Erickson's employment to be addressed by others.

The Examiner has concluded that his concerns have been resolved. First, WorldCom fully disclosed the foregoing matters in the Tracker proxy and S-4. Based on further review of the "law" on Trackers,⁴³⁵ the Examiner concludes that a company such as WorldCom has substantial leeway in structuring a Tracker, so long as it discloses important issues and then proceeds in a manner consistent with the disclosures.⁴³⁶ The Examiner concludes that WorldCom did just that.

Second, with regard to the \$6 billion in debt allocated to the MCI Tracker, the Examiner has determined that quite a lot of consideration was given to this issue. For example, J.P. Morgan and SSB each prepared debt allocation analyses for Management's consideration. Management and the financial advisors did not attempt to determine the amount of long-term debt that was actually associated with the business units allocated to the MCI Tracker as opposed to the WorldCom Tracker. Rather, they prepared models and analyses to determine the amount of long term debt that the MCI Tracker businesses could retire, while still generating sufficient cash flow to sustain a reasonable dividend. The numbers varied from \$2 to \$8 billion, with Management (apparently Mr. Sullivan) making the final decision as to debt allocation. The Examiner knows of no reason why this was improper. Further, the Examiner notes that the \$6 billion of debt allocation to the MCI Tracker was fully disclosed.⁴³⁷

⁴³⁵ The Examiner notes that there is relatively little law, *per se*, pertaining to Trackers.

⁴³⁶ See U.S. Securities and Exchange Commission, Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, <http://www.sec.gov/divisions/corpfin/guidance/cfactfaq.htm> (Mar. 31, 2001); cf. Solomon v. Armstrong, 747 A.2d 1098, 1123-24 (Del. Ch. Ct. 1999).

⁴³⁷ It was also disclosed in the proxy that the debt allocated to the MCI Tracker would have an interest rate above the rate for the debt allocated to the WorldCom Tracker. The Examiner has determined that Management believed that the MCI Tracker businesses, if they were to stand alone, would have incurred somewhat higher interest rates than the WorldCom Tracker.

Third, the fact that the MCI Tracker generally would retain no cash balances, also was fully disclosed. Based upon his investigation, the Examiner believes this decision can be justified on the basis of efficiency of operations, as it was most efficient to have a single cash management plan. It was also explained that while the MCI Tracker might be allocated no cash balances, any cash transferred from the MCI Tracker to the WorldCom Tracker would have the effect of reducing debt attributed to the MCI Tracker. Accordingly, the Examiner does not find this a matter of concern.

Fourth, the allocation of the MCI trade name to the WorldCom Tracker is more difficult to understand. It seems obvious that a substantial portion of the value of the MCI trade name was created prior to the WorldCom/MCI merger. Nonetheless, 100 percent of the MCI trade name was allocated to the WorldCom Tracker, with the MCI Tracker then charged \$27.5 million in 2001 to use the trade name. A number of interviewees found this to be strange, and no one interviewed by the Examiner could provide a cogent rationale for this allocation or for the \$27.5 million charge.⁴³⁸ However, given the express disclosure of this allocation in the Policy Statement and the proxy, the Examiner does not view this as a substantial issue, except to note that this is the sort of issue about which a more inquisitive Board might have sought an explanation.

2. Cost Allocations

The Examiner has investigated to determine whether former Management developed methodologies to allocate costs fairly between the two Trackers. This is an area where any systematic effort to favor one Tracker over the other could have resulted in significant allocations of unjustified costs from one Tracker to another, particularly since MCI Group

⁴³⁸ One interviewee recalled being told by Mr. Myers that the license fee represented the market value for otherwise leveraging a brand name used in the market place.

personnel had little input into the Tracker cost allocation methodologies. This is also an area where the unavailability of certain witnesses – particularly persons who are inaccessible to the Examiner because of ongoing law enforcement efforts – limited the scope of the data reviewed by the Examiner. Nonetheless, based on the available data, the Examiner observes that with the exception of line cost capitalizations, where the fraudulent capitalizations seem to have benefited only the WorldCom Tracker, the allocation methodologies were generally fair and rational and were consistently applied over time.⁴³⁹

a. Telco Costs

Telco costs, also known as line costs, were the single biggest cost category for WorldCom. Telco costs represent costs paid by WorldCom to third parties for WorldCom to use third party networks to direct communications. Telco costs amounted to approximately \$15 billion a year, making this a large component of the WorldCom P&L statement.

The Examiner is generally satisfied that the allocation of telco costs between the two Trackers was done in a fair and rational manner. Even before the Trackers were under serious consideration, work was underway at WorldCom within the Domestic Telco Planning Group to develop a model to allocate telco costs among various business units, which allocations would help to judge the profitability of the various units. This model, called the Product Line Profitability (“PLP”) Model, was then available and used to allocate domestic telco costs once the Trackers were decided upon. The Domestic Telco Group would receive spreadsheets of the Company’s total line costs and then, using the PLP model, would allocate the costs to the WorldCom and MCI Trackers.

⁴³⁹ The Examiner observes that his representatives were able to examine only a fraction of all cost allocations made by WorldCom as the Trackers were implemented. On the basis of the data examined, the Examiner found no conclusive evidence that costs were systematically manipulated to the detriment of the MCI Tracker. That said, the Examiner notes that he does not rule out the possibility that some such manipulation may have occurred.

The Examiner interviewed a number of persons who were involved in the development of the PLP Model. The Examiner concludes that the model apparently was a well considered effort to address telco cost allocation issues and that persons from the MCI Tracker businesses had a significant opportunity to provide input regarding the model. The Examiner has identified no bases to question the general accuracy of the PLP model, which was reviewed by Arthur Andersen. Further, Mr. Huyard, COO of the MCI Group, felt that telco costs were allocated in a rational manner.⁴⁴⁰

The Examiner is somewhat concerned that certain individuals working in Mr. Sullivan's Corporate Group attempted on at least one occasion to change the PLP Model, which would have resulted in greater cost allocations to the MCI Tracker and commensurate cost reductions to the WorldCom Tracker. Thus, in August 2001, two members of the Corporate Group asked the Domestic Telco Group to adjust allocation percentages by rounding downward, so that a 12.9 percent cost allocation would be rounded to 12 percent instead of 13 percent. This change would have shifted costs to the MCI Group, although the magnitude of the costs is unclear. The Telco Group refused to do so and when an individual asked that the request be put in writing, the matter was dropped. Based on his investigation, the Examiner believes that the basic model remained unchanged and that it was utilized for domestic telco cost allocations. Accordingly, except as discussed below, the Examiner has no basis to believe that there were any improprieties in the telco cost allocations between the two Trackers.⁴⁴¹

⁴⁴⁰ Available data from Mr. Sullivan's group further support the view that a fair methodology was established for line cost allocations. For example, a January 23, 2002 memorandum from Mr. Myers to Messrs. Ebberts and Sullivan sets forth in detail line cost and SG&A expense allocation methodologies.

⁴⁴¹ The Examiner notes that the PLP Model addressed only domestic telco costs. The Examiner chose to investigate this cost category and, due to limits on resources, felt that it was not necessary to investigate other categories of telco costs, such as international costs, particularly after he determined that there appeared to be a

The foregoing notwithstanding, the Examiner has identified one telco cost allocation that was questionable. As previously discussed and reported, starting in the first quarter of 2001, WorldCom began to capitalize hundreds of millions of dollars of line costs every quarter, which was contrary to GAAP and the law. The Examiner investigated to determine whether those line cost capitalizations were spread between the Trackers or whether they benefited one over the other.

The Examiner has determined that the line cost capitalizations benefited only the WorldCom Tracker. Thus, they resulted in reduced costs for the WorldCom Tracker in each quarter, from Q1 2001 through Q1 2002. In addition, in Q3 2001, a special line cost charge in the amount of \$100 million was added to the MCI P&L, which had the effect of improving the WorldCom Tracker results by the same amount. Due to the unavailability of relevant people for interviews, the Examiner has not been able to determine precisely how these line cost allocations came about, but they do suggest an attempt to favor the WorldCom Tracker over the MCI Tracker.⁴⁴²

b. SG&A Expenses

SG&A expenses were the second large category of costs investigated by the Examiner. SG&A expenses involve a variety of items, such as costs associated with operations and technology ("O&T"), including network maintenance costs, and costs associated with the Company's various corporate offices, such as approximately \$78 million of costs associated with Mr. Sullivan's office in the third quarter of 2001 alone. In this

well considered cost allocation method for domestic telco costs and that none of the MCI personnel interviewed expressed concerns about international telco cost allocations.

⁴⁴² The Examiner has determined that the line cost data provided to the Domestic Telco Group included all line costs, i.e., there had been no subtractions for capitalized line costs. Then, after the Domestic Telco Group allocated line costs to the WorldCom and MCI Trackers, the WorldCom Group's allocated line costs were reduced by the improper capitalizations, which were carried out by Mr. Sullivan's group.

context, SG&A expenses amounted to approximately \$2.5 billion per quarter in 2001 for the entire Company and the Examiner investigated how these costs were allocated between the two Trackers. This investigation was prompted, in part, by allegations made by a former employee that the MCI Group had been allocated inappropriate expenses.

Based upon the available data, the Examiner has not identified a substantial basis to believe that there was any systematic effort to allocate unjustifiable SG&A costs to one Tracker versus another. The complexity of the allocation decisions, however, makes clear that this was a very difficult issue.⁴⁴³

The process for SG&A cost allocations appears to have been as follows. There would be an initial effort to determine if particular costs could be directly linked, in full, to one or the other Tracker. By way of example, if there were attorneys in the Law and Public Policy Department that only worked on regulatory issues related to the consumer businesses, those costs would be allocated 100 percent to the MCI Tracker. However, there then would be other persons who provided services that benefited both Trackers and whose costs would need to be allocated to both Trackers, based on headcount, revenues or some other basis.

The Examiner investigated to determine whether there was any basis to believe that there was a systematic bias to allocate extra SG&A costs to the MCI Tracker. One reason that the Examiner pursued this issue was that MCI Group personnel had very little input into

⁴⁴³ WorldCom cooperated in presenting personnel on Tracker issues. Nonetheless, since many cost allocation issues appear to have been resolved at Mr. Sullivan's level and since Mr. Sullivan was not available for interview, the Examiner must emphasize that his cost allocation conclusions are still somewhat preliminary. Further, the Examiner notes that no witness could explain cogently the reason(s) for certain of the SG&A cost allocations, such as allocating the costs of some offices (like Messrs. Ebberts and Roberts) on the basis of revenues, and costs of other offices, like Mr. Sullivan's, mostly on the basis of headcount. Similarly, the reason why the MCI Tracker appears to have received a disproportionate (57 percent) share of Human Resources costs, despite having far fewer employees, was never adequately explained.

SG&A cost allocation decisions, which were made by Mr. Sullivan's group. The Examiner has found no basis to conclude that such cost allocations were systematically biased.

On purely technical SG&A issues, the Examiner identified a willingness by former WorldCom Management to adjust cost allocations that seemed incorrect. For example, the WorldCom Group Tracker derived revenues from SkyTel but initially was allocated no related costs. When this was brought to Mr. Sullivan's attention, the matter was rectified, with \$11 million of costs shifted to the WorldCom Tracker.

Further, in terms of SG&A cost allocation methodologies, there was no effort to prevent MCI Group personnel from knowing about the basic allocation decisions. Thus, for example, a December 15, 2000 e-mail from Mr. Anderson in Mr. Sullivan's group, to a large number of people, including MCI Tracker personnel, provides a summary of SG&A allocation methodologies. MCI personnel did not think these methodologies ever were modified.

The Examiner notes that MCI Tracker Management also expressed concerns that the MCI Tracker was being allocated SG&A costs that it had no ability to control, such as legal costs and costs of Mr. Sullivan's office. In particular, the MCI Tracker in 2001 reduced SG&A costs by about 15 percent where it directly controlled costs but when SG&A costs over which it had no control were allocated to the MCI Tracker, those costs fell by only about one percent during the same period. The MCI Tracker Management unsuccessfully sought the ability to have input into how such costs outside of their control might be reduced.

The Examiner finds that this issue merits no further investigation. Mr. Huyard certainly had a rational basis to raise concerns about costs allocated to the MCI Tracker over which he had no control. At the same time, however, it appears equally rational for

Mr. Ebbers to advise MCI Tracker Management that it should focus on the revenues and costs that it controlled, leaving other costs to others to control. Mr. Ebbers had developed a reputation for being very cost conscious, and the Examiner believes that if the Corporate Group or others had unnecessary costs that could be trimmed, Mr. Ebbers may well have seen to it that such costs were cut.

G. Whether the MCI Tracker Had Sufficient Resources to Succeed

The Examiner has investigated whether the MCI Tracker was provided sufficient resources for its ongoing businesses to remain viable. WorldCom's public statements at the time the Trackers were announced suggested that each Tracker would have the necessary resources to carry out its charter. For example, in its November 1, 2000 Press Release announcing the Trackers, WorldCom included the following Question and Answer:

- Q. Will the tracking stock structures alter capital budget allocations to WorldCom and MCI in the future?
- A. WorldCom, Inc. will allocate capital appropriately to ensure that WorldCom had sufficient resources to fund its growth and MCI has sufficient resources to sustain its cash flow.

Similarly, the MCI Tracker charter was described as follows in the Tracker proxy:

Our Management's mandate is to use our existing market positions and assets opportunistically to optimize cash flow, while retiring the debt attributed to the MCI group. Available cash flow, after debt and interest repayments, will be available for dividend payments and possible shares repurchases. The businesses attributed to the MCI group have significant assets, including the nationally recognized brand, extensive customer relationships, 20 call centers with highly effective sales representatives and a tradition of developing innovative calling plans that enhance customer retention. Management believes it can leverage these strengths to deliver new services and to bundle existing services.

Accordingly, the message communicated was that the MCI Tracker would have sufficient resources to meet these goals, although expenditures would be tightly controlled.⁴⁴⁴ The Examiner has sought to determine if these assurances matched reality.

The Examiner concludes that former WorldCom Management was never particularly interested in making large investments in the MCI businesses. This view became evident soon after the closing of the MCI/WorldCom merger in 1998. When MCI was an independent company, part of its business plan was to invest extensively in its networks and infrastructure. This changed after the merger's closing and certain MCI veterans who stayed on after the merger noted that from the outset there was resistance from legacy WorldCom personnel to a continuation of this MCI mode of operation. This situation continued once the Trackers were announced.

Testimony from several of the persons we interviewed, as well as documentation produced in this investigation, support the conclusion that the MCI Tracker was operated with a so-called "harvest strategy" – i.e., that the objective was to maximize near term cash flow from the MCI Tracker, even at the risk that this strategy in the long run would harm the MCI businesses, such as because the rate increases implemented in the short term would eventually drive away customers. While the MCI managers still wanted growth, the focus was on managing cash flow. This strategy included limits on the MCI Tracker's capital budget.

Thus, for 2001, the MCI Tracker capital budget was set at \$500 million, but only \$150 million of this amount was subject to control by MCI Group Management.⁴⁴⁵ Such

⁴⁴⁴ In a November 2, 2000 communication to director-level MCI Tracker employees, Mr. Huyard stated: "We have the key strategies (maintain profitability with strong fiscal management, stabilize revenue through moderate investment and resource allocation)."

budget limits caused a MCI employee to comment in February 2001 that MCI might “have virtually nothing for product development or systems maintenance in MCI . . . which would seem to contradict the points we made in the [Tracker] S4 regarding ongoing sustainment of cash flows.” Similarly, another February 2001 document stated that “[o]ther critical initiatives have fallen, or remain beneath, the capital radar.”⁴⁴⁶

Indeed, in a document prepared for Mr. Huyard in May 2002, the following description of the MCI Group’s operations is set forth:

The primary objective assigned to the MCI Group in 2001 was maximizing cashflow, which essentially translated into a harvest strategy. Actions taken to achieve the cash objectives unquestionably had a long-term negative impact on sustaining the operation. While a number of efficiency gains were achieved, and a number of unprofitable channels and activities were terminated, other initiatives served to weaken our trajectory entering 2002. Marketing and support cutbacks weakened brand perceptions and service performance and resulted in a narrowing pipeline of new services to fuel future growth. Ongoing price increases translate into reduced sales productivity and increased revenue churn over time.

Mr. Huyard supported the accuracy of this statement. Accordingly, there is support for the conclusion that marketing initiatives were underfunded, investment opportunities were limited, service performance suffered, and price increases led to reduced sales productivity and increased revenue churn.⁴⁴⁷

⁴⁴⁵ A number of interviewees commented that managers rarely are satisfied with their budgets and always want more resources. The Examiner accepts such a view but has focused on whether the MCI Group was limited in its budgets in a more severe way than would be expected in a cost conscious company facing a business downturn.

⁴⁴⁶ Mr. Huyard recalled that WorldCom Management, especially Mr. Sullivan, put significant pressure on MCI Tracker personnel, especially Ms. Harker, the MCI CFO, to control expenses. In Mr. Huyard’s opinion, this pressure from Mr. Sullivan made Ms. Harker very risk adverse in 2001-2002, which Mr. Huyard viewed as unfortunate since he believed that the MCI Group needed to seek out initiatives.

⁴⁴⁷ Several interviewees disagreed with the assertion that the MCI Tracker was run in a harvest mode and stated that they believed that the MCI Group had sufficient resources to fund the programs that looked sufficiently promising to pursue. The Examiner believes that the COO of the MCI Tracker is more credible on this issue, given his position and his access to information and higher-ranking members of Management.

It is unclear whether the WorldCom Board was aware that this strategy was long-term detrimental to the MCI Tracker, and it does not appear that this strategy was clearly disclosed to the investing public. For example, in its 2001 10-K, WorldCom described the MCI Group's strategy as including the following:

OPTIMIZE RESOURCES: We intend to focus our strategies on enhancing margins and cash flow. We expect to be opportunistic and undertake only those initiatives that can generate cash flow without significant capital commitment.

While this disclosure hints at the restrictions imposed on the MCI Group, it is far less specific than the May 2002 statement endorsed by Mr. Huyard. According to Mr. Huyard, he indicated that his reaction to the harvest strategy was that he would try to achieve this strategy and make a viable business, and that he felt that he could "re-engineer" the company. However, the Examiner doubts whether this would have been possible. The Examiner concludes that the MCI Tracker was operated with a "harvest strategy" that proved to be detrimental to the business segments in that group in the long run.

H. Tracker Conclusions

As of the fall of 2000, Tracker stock restructurings were being considered by many telecom companies, during an increasingly difficult economic environment. The Examiner concludes that it was rational in all the circumstances for WorldCom to pursue the Tracker stocks as a preferred restructuring alternative, segregating WorldCom's low-growth lines of business with high cash flow from WorldCom's high-growth lines of business that yielded no dividends.

However, the Examiner is critical of the processes employed by former members of WorldCom's Management and Board to pursue the Tracker alternative. Even in the 2000 context, the WorldCom Board should have been far more insistent that existing Management

provide meaningful data, possibly including presentations by financial advisors and other outside service providers, as to the alternatives available to WorldCom. The evidence that the Examiner has gathered indicates, however, that the Board likely would have approved the Trackers had it fulfilled its obligation to exercise due care and become fully informed with respect to the myriad issues surrounding them.

Further, although there remains certain unresolved questions with respect to the debt and cost allocations between the WorldCom Tracker and the MCI Tracker, the evidence available to the Examiner generally reflects that such allocations appear to have been proper. The Examiner also observes that these allocations generally were properly disclosed, although the "harvest strategy" employed by the Company with respect to the MCI Tracker undermined the commitment to the long-term viability of its businesses, as articulated by WorldCom in public filings.

X. CONCLUSION

The Examiner observed in his conclusions to the First and Second Interim Reports that WorldCom's corporate governance lapses were part and parcel of the Company environment that permitted not only a massive accounting fraud but also multiple other lapses, such as the Intermedia acquisition, poorly managed and unchecked debt and credit management, and lack of due diligence pertaining to loans to Mr. Ebbers. The Examiner's further investigation has confirmed the breadth of these lapses in proper corporate governance, including the unprecedented financial favors that Mr. Ebbers traded for WorldCom's investment banking work, as well as the Company's ill-considered state tax minimization program. The further investigation also has identified contributions to the failures by certain outside service providers to WorldCom, including SSB, Arthur Andersen and KPMG. These findings have served to underscore that the failures surrounding WorldCom went far beyond the early reports of accounting fraud by a few persons and have reconfirmed the Examiner's earlier observations that virtually every level of gatekeeper and advisor, both within and outside WorldCom, was to some degree derelict in his/her/its responsibilities.

The Examiner has now completed his investigation with this Third and Final Report. The Examiner recognizes that this does not mean that the past lapses pertaining to WorldCom are no longer of current relevance. To the contrary, the Examiner recognizes that there are ongoing government investigations and prosecutions and lawsuits by former WorldCom shareholders, and the Company must decide whether to pursue certain claims pertaining to past lapses.

The Examiner's mandate from this Court was to examine allegations of fraud, etc., "by current or former management" The Examiner understood that mandate to encompass Management at WorldCom prior to and at the time of his appointment on August 6, 2002 and such Management's interactions with others, including outside service providers, who may have contributed to the corporate governance lapses and WorldCom's injuries. The Examiner did not believe that his mandate extended to any new Management that might direct WorldCom subsequent to August 6, 2002.

The Examiner observes, however, that in carrying out his mandate, he had occasion subsequent to August 6, 2002 to interact with persons who are in WorldCom Management at the time of issuance of this Third and Final Report. The Examiner observes that he has no reason, based on the investigation undertaken, to question the integrity of any person presently in WorldCom Management. Indeed, the Examiner further observes that notwithstanding the corporate governance lapses recited in his three Reports, there were many persons within WorldCom, at all levels, who appear admirably to have performed their duties to the best of the Examiner's knowledge. Accordingly, the Examiner does not want his criticism of many formerly in WorldCom Management inadvertently to tarnish the reputations of the many faithful WorldCom employees who were just as much victims of the corporate governance lapses as were shareholders and creditors.

Finally, the Examiner has acknowledged in the past, and does so again in this Third and Final Report the assistance of many persons and entities, including the SEC, the Department of Justice and the Honorable Richard C. Breeden, the Corporate Monitor appointed by the United States District Court for the Southern District of New York. The Examiner also expressly acknowledges the Executive Office for the United States Trustees

(including Director Lawrence A. Friedman, Deputy Director Clifford J. White, III and General Counsel Joseph A. Guzinski), the Office of the U.S. Trustee for Region 2 (including U.S. Trustee Carolyn Schwartz and Assistant U.S. Trustee Mary E. Tom), the Honorable Arthur J. Gonzalez of the United States Bankruptcy Court for the Southern District of New York, and the Honorable Jed S. Rakoff of the United States District Court for the Southern District of New York, who in various ways have assisted and supported the Examiner in carrying out his mandate as effectively and efficiently as possible.

Respectfully submitted
/s/ Dick Thornburgh
Dick Thornburgh
Examiner

January 26, 2004

By Examiner's Counsel:

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Salomon/MFS Chronology

Date	Event
March 1994	Mr. Grubman joins Salomon.
August 1994	Mr. Grubman introduces Mr. Ebbers to Salomon investment bankers in New York.
March 23, 1995	Mr. Grubman travels to Jackson, Mississippi, and introduces two Salomon investment bankers to Messrs. Ebbers and Sullivan.
March 1995	Salomon investment bankers send Mr. Sullivan materials on a bond offering.
July 1995	WorldCom and MFS exchange confidentiality agreements in order to exchange information.
August 14-15, 1995	WorldCom and MFS executives meet informally in Florida to discuss developing business relationships and mutual provision of network services.
November 1995	Salomon sends Mr. Myers materials about Accelerated Share Repurchasing, a proprietary common stock buyback strategy that Salomon Brothers developed and had executed for some of its clients.
January 1996	Salomon sends Mr. Sullivan additional materials on a potential debt offering and also forwards Mr. Grubman's most recent report on telecom legislation.
March 1996	In a letter following up on a meeting between WorldCom and Salomon regarding a possible convertible debt offering, Salomon refers to the potential value of "Jack's pre-marketing efforts" and suggests getting Messrs. Ebbers, Grubman and Mestre together for dinner in Jackson.
April 17, 1996	Mr. Grubman publishes a telecom Industry report in which WorldCom (the sole stock he has only had a Buy recommendation on for his entire 12 year career) and MFS ("the epitome of a high quality new entrant" and a stock he has given a Buy recommendation for approximately three years) are two of the three stocks he recommends for "aggressive growth managers."
April and May 1996	Salomon prepares analyses for WorldCom involving possible acquisition transactions.

Date	Event
May 16, 1996	Mr. Ebbers calls Mr. Crowe (MFS Chairman and CEO) to schedule a meeting to discuss possible commercial or strategic opportunities.
May 21, 1996	Messrs. Ebbers and Sullivan meet with Mr. Crowe and other MFS executives and agree to share information regarding traffic on their networks to determine if there is a basis for a business arrangement.
May 30, 1996	In a continued solicitation of WorldCom investment banking business, a Salomon investment banker sends Mr. Sullivan materials relating to Salomon-led equity offerings, which highlight Salomon's lead role on the then-pending MFS \$1 billion secondary equity offering. The same materials also mention Salomon's lead role on the upcoming McLeod IPO.
June 6, 1996	Salomon investment bankers attend a meeting with Messrs. Sullivan and Myers where they discuss a document prepared by Salomon investment bankers. The document, entitled "Project New Wave," includes an analysis of MFS and its acquisition of UUNet. It also includes an analysis of a possible WorldCom/MFS merger.
June 10, 1996	Salomon allocates 200,000 shares to Mr. Ebbers in the McLeod IPO.
July 11, 1996	Messrs. Ebbers and Sullivan again meet with Mr. Crowe and the MFS CFO, this time in Omaha, to discuss general commercial and strategic issues and market valuation methods.
August 5, 1996	Mr. Crowe meets with Mr. Ebbers in Jackson to discuss regulatory considerations, local telephone competition, the Internet and other general issues.
Between August 7 and August 9, 1996	Mr. Ebbers telephones Mr. Grubman and informs him that WorldCom might, within the next week, seek Salomon's services as financial advisor in connection with a contemplated merger with MFS. Mr. Grubman relays the substance of this conversation to Mr. Mestre, Co-Chairman of Investment Banking at Salomon.

Date	Event
August 13	Mr. Ebberts calls Mr. Grubman and asks him to arrange a meeting with Salomon investment bankers later that day on a MFS merger. Mr. Grubman makes the arrangement and the meeting later takes place.
August 14, 1996	Mr. Ebberts convenes an informal telephonic WorldCom Board meeting at which he informs the Board of the proposed transaction. Also the same day, WorldCom retains Breckenridge as an additional financial advisor on the transaction.
August 15, 1996	WorldCom formally engages Salomon as its financial advisor for the MFS transaction for fees totaling \$7.5 million
August 22, 1996	Messrs. Grubman, Mestre and other investment bankers from Salomon meet to prepare for the WorldCom Board meeting the next day.
August 23, 1996	The WorldCom Board meets at Salomon's offices in New York, and Messrs. Grubman and Mestre and other Salomon investment bankers attend to discuss the proposed transaction with the Board.
August 25, 1996	The WorldCom Board reconvenes and approves the proposed merger agreement and related documents in a telephonic meeting. The agreements are executed that day. That same day, Mr. Grubman and a Salomon investment banker assist representatives of WorldCom and MFS in the preparation of the public announcement of the transaction.
August 26, 1996	WorldCom and MFS issue a joint press release announcing the merger.
December 20, 1996	Shareholders of WorldCom and MFS approve the proposed merger.
December 31, 1996	The WorldCom/MFS merger is completed.

McLeod IPO
Institutional Investors with Indications of Interest of 1,000,000 Shares or Greater
Allocations Compared to Bernard Ebbers

Name	Indication of Interest	Allocation	Percent Allocated
Fidelity	1,200,000	250,000	20.8 %
Firststar Investment Mgmt Co.	1,500,000	215,000	14.3 %
Ebbers, Bernard	1,000,000	200,000	20.0 %
Alliance	1,200,000	200,000	16.7 %
Capital Guardian Trust	1,000,000	200,000	20.0 %
Capital Research & Mgmt	1,500,000	200,000	13.3 %
Dreyfus Corporation	1,200,000	200,000	16.7 %
Janus Fund, Inc.	1,200,000	200,000	16.7 %
Massachusetts Financial Servs.	1,500,000	200,000	13.3 %
Putnam Management Co. Inc.	1,200,000	200,000	16.7 %
State Street Research & Mgmt	1,200,000	200,000	16.7 %
Wellington Management	1,200,000	200,000	16.7 %
Strong Capital Management	1,800,000	190,000	10.6 %
Phoenix Mutual Life Ins. Co.	1,200,000	175,000	14.6 %
Warburg Pincus	1,200,000	175,000	14.6 %
Trust Co. of the West	1,200,000	165,000	13.8 %
Boston Company	1,200,000	160,000	13.3 %
John Hancock Advisors, Inc.	1,200,000	160,000	13.3 %
Ardsley Partners	2,000,000	150,000	7.5 %
College Retire, Equities	1,200,000	150,000	12.5 %
Columbia Circle Invs. (G&W)	1,200,000	150,000	12.5 %
Columbia Management Co.	1,000,000	125,000	12.5 %
Essex Investment Mgt. Co.	1,200,000	125,000	10.4 %
Keystone Company of Boston	1,200,000	125,000	10.4 %
Nicholas Applegate	1,200,000	125,000	10.4 %
Denver Investment Advisors	1,200,000	120,000	10.0 %
Invesco Trust Company	1,200,000	120,000	10.0 %
Montgomery Asset Mgmt	1,200,000	120,000	10.0 %
Seligman (J W) & Co.	1,000,000	120,000	12.0 %
Ballantine Capital Mgmnt., Inc.	1,000,000	110,000	11.0 %
Bankers Trust Co.	1,200,000	100,000	8.3 %
GT Capital Management, Inc.	1,200,000	100,000	8.3 %
IDS/American Exp Fin. Mgmt	1,000,000	100,000	10.0 %
Invista	1,200,000	100,000	8.3 %
Kaufman Fund, Inc.	1,000,000	100,000	10.0 %
Kingdon Associates	1,000,000	100,000	10.0 %
Odyssey Partners	1,200,000	100,000	8.3 %

Name	Indication of Interest	Allocation	Percent Allocated
Provident Investment Capital	1,200,000	100,000	8.3 %
Travellers	1,200,000	100,000	8.3 %
Weiss (George) Associates, Inc.	1,000,000	90,000	9.0 %
Tudor Arbit	1,200,000	70,000	5.8 %
Berger Associates, Inc.	1,200,000	50,000	4.2 %
Eaton & Howard Vance	1,000,000	50,000	5.0 %
Fleet NB Rhode Island	1,200,000	50,000	4.2 %
Westfield Capital Management	1,200,000	50,000	4.2 %
Society Asst. Management	1,200,000	50,000	4.2 %
West Highland Capital Mgmt	1,200,000	48,000	4.0 %
Hellman Jordan Mgmt Co.	1,200,000	35,000	2.9 %
Citicorp 1	1,200,000	25,000	2.1 %
Husic Capital Management	1,200,000	25,000	2.1 %
Mackay Shields Fin'l Corp.	1,000,000	25,000	2.5 %
Mitchell Hutchins Instl. Invest.	1,200,000	25,000	2.1 %
Scudder Stevens & Clark	1,200,000	25,000	2.1 %
Templeton Investment	1,000,000	25,000	2.5 %
Weiss Peck & Greer	1,000,000	25,000	2.5 %
Atlantic Richfield Corp. ARCO	1,200,000	20,000	1.7 %
Delaware Management Co.	1,200,000	15,000	1.3 %
Teachers Ins/College Ret FD	1,200,000	0	0%

Qwest IPO
Institutional Investors with Indications of Interest of 500,000 Shares or Greater
Allocations Compared to Bernard Ebbers

Name	Indication of Interest	Allocation	Percent Allocated
Fidelity Mgt & Research Equity	3,475,000	525,000	15.1 %
Putnam Mgt Co Inc	2,300,000	390,000	17.0 %
Account X*	1,000,000	300,000	30.0 %
Capital Guardian Trust	1,150,000	300,000	26.1 %
Soros Fund Management	1,150,000	300,000	26.1 %
Janus Fund Inc	1,725,000	290,000	16.8 %
Account K**	1,150,000	250,000	21.7 %
Wellington/Thorndike	2,300,000	250,000	10.9 %
Rosenberg Capital Mgt	2,000,000	225,000	11.3 %
State Street Research & Mgt Co	1,150,000	225,000	19.6 %
Bernard Ebbers	500,000	205,000	41.0 %
Alliance Capital Mgt Co NY	635,000	200,000	31.5 %
College Ret Equities FD/CREF	1,150,000	200,000	17.4 %
Columbia Management Co	1,150,000	200,000	17.4 %
Invesco Trust Co	1,150,000	200,000	17.4 %
Jennison Associates	1,150,000	200,000	17.4 %
Lynch & Mayer Inc	1,150,000	200,000	17.4 %
Montgomery Asset Mgmt	800,000	200,000	25.0 %
Oppenheimer Mgmt Corp	1,150,000	200,000	17.4 %
Miller Anderson & Sherrerd	500,000	175,000	35.0 %
Lgt Asset Mgmt	2,300,000	170,000	7.4 %
Nicholas Applegate Capital Mgt	1,150,000	170,000	14.8 %
Strong Capital Management Inc	1,150,000	165,000	14.3 %
Massachusetts Financial Svcs	1,150,000	160,000	13.9 %
State of Wisconsin Special	1,150,000	160,000	13.9 %
Aim Management Inc	740,000	150,000	20.3 %
Crabbe Huson	1,000,000	150,000	15.0 %
Essex Investment Mgt Co	1,150,000	150,000	13.0 %
Kingdon Associates	1,150,000	150,000	13.0 %
Turner Investment Partners	1,150,000	150,000	13.0 %
Account F	500,000	135,000	27.0 %
Morgan (JP) Investment Mgmt	600,000	130,000	21.7 %
Dean Witter Asset Management	540,000	125,000	23.1 %
Delaware Management Co	1,150,000	125,000	10.9 %
Dreyfus Corporation	550,000	125,000	22.7 %
Mackay Shields Finl Corp	500,000	125,000	25.0 %
Templeton Investment Counsel	1,150,000	125,000	10.9 %

Name	Indication of Interest	Allocation	Percent Allocated
Altamira	1,150,000	100,000	8.7 %
Ardsley Partners	500,000	100,000	20.0 %
Bankers Trust Co	800,000	100,000	12.5 %
Brown (Alex) & Sons	600,000	100,000	16.7 %
Federated Investors Inc	800,000	100,000	12.5 %
Kemper Financial Services Inc	1,150,000	100,000	8.7 %
Lazard Asset Mgmt. Fund	1,000,000	100,000	10.0 %
Meridian Investment Co	500,000	100,000	20.0 %
Pioneering Mgt Corp	1,000,000	100,000	10.0 %
Columbus Circle	--	90,000	--
Travelers Inc	750,000	85,000	11.3 %
Invista	800,000	80,000	10.0 %
Bank of America Corp	1,000,000	75,000	7.5 %
Firstar Investment Mgmt Co	1,150,000	75,000	6.5 %
New York Life Ins Co	500,000	75,000	15.0 %
Wells Fargo Bank	750,000	75,000	10.0 %
Palantier Capital	1,150,000	70,000	6.1 %
Peregrine Capital Management	575,000	60,000	10.4 %
American Express Finan. Adv	1,150,000	50,000	4.3 %
Berger Associates Inc	1,150,000	50,000	4.3 %
Hancock (John) Mut Life Ins	500,000	50,000	10.0 %
Manufacturers Life Ins Co	650,000	50,000	7.7 %
Northwestern Mut Lf Ins	1,000,000	50,000	5.0 %
Eaton & Howard V. Sanders	1,150,000	40,000	3.5 %
Price (T Rowe)	1,150,000	30,000	2.6 %
Denver Investment Advisors	1,150,000	25,000	2.2 %
Founders Cap Mgt Corp	1,150,000	25,000	2.2 %
Gluskin Sheff	600,000	25,000	4.2 %
Hellman Jordan Mgt Co	1,000,000	25,000	2.5 %
Mitchell Hutchins	1,150,000	25,000	2.2 %
Grantham Mayo Van Otterloo	500,000	15,000	3.0 %
Keystone Company of Boston	1,150,000	15,000	1.3 %
Hagler Mastrovita	1,000,000	10,000	1.0 %
Omega Advisors	500,000	10,000	2.0 %
Schneider Capital Mgmt	1,150,000	10,000	0.9 %
Babson (David) & Co Inc	1,000,000	5,000	0.5 %
Morgan Stanley Asset Mgt Inc	740,000	5,000	0.7 %
Northern Trust Co Chicago	638,500	5,000	0.8 %
SIT Investment Associates Inc	575,000	5,000	0.9 %
Wall Street Associates	1,150,000	5,000	0.4 %
Dewey Square Investors	615,000	0	0.0 %

* It is unclear from the documents produced to the Examiner whether this lettered account was for an individual or institution.

** This lettered account was for then WorldCom Board Member Walter Scott who received 225,000 shares from the institutional pot and 25,000 shares from the retail retention.

Nextlink IPO
Institutional Investors with Indications of Interest of 1,000,000 Shares or Greater
Allocations Compared to Bernard Ebbers

Name	Indication of Interest	Allocation	Percent Allocated
Fidelity Mgt & Research-Equity	1,216,000	400,000	32.9 %
Putnam Mgt Co Inc	1,056,000	350,000	33.1 %
Alliance Capital Mgt Co NY	1,320,000	225,000	17.0 %
Capital Research & Mgt	1,500,000	210,000	14.0 %
Bernard Ebbers	1,000,000	200,000	20.0 %
Massachusetts Financial Svcs	1,056,000	200,000	18.9 %
Wellington/Thorndike	2,432,000	200,000	8.2 %
American Express Finan. Adv	1,400,000	175,000	12.5 %
Dawson Samberg	1,056,000	175,000	16.6 %
Invesco Trust Co	1,056,000	175,000	16.6 %
Invista	1,520,000	175,000	11.5 %
Janus Fund Inc	1,216,000	175,000	14.4 %
Rosenberg Capital Mgt	1,250,000	175,000	14.0 %
Strong Capital Management Inc	1,056,000	175,000	16.6 %
State Street Research & Mgt Co	1,056,000	165,000	15.6 %
Chancellor Capital Mgt	1,056,000	150,000	14.2 %
GLG Partners	1,200,000	150,000	12.5 %
Nicholas Applegate Capital Mgt	1,056,000	150,000	14.2 %
Capital Guardian Trust	1,056,000	140,000	13.3 %
Trust Co of the West (TCW)	1,056,000	135,000	12.8 %
Aetna Variable Annuity	1,400,000	125,000	8.9 %
Ardsley Partners	1,056,000	125,000	11.8 %
Ark Asset Management	1,216,000	125,000	10.3 %
Columbus Circle Invs (G & W)	1,056,000	125,000	11.8 %
Essex Investment Mgt Co	1,056,000	125,000	11.8 %
Jennison Associates	1,200,000	125,000	10.4 %
Neuberger & Berman NY	1,020,000	125,000	12.3 %
Robertson Stephens Inv Mgt Inc	1,056,000	125,000	11.8 %
Seligman (JW) & Co	1,056,000	125,000	11.8 %
Account X	1,000,000	100,000	10.0 %
Basic Economics Assn (BEA)	1,056,000	100,000	9.5 %
Berger Associate Inc	1,056,000	100,000	9.5 %
Federated Investors Inc	1,056,000	100,000	9.5 %
Founders Cap Mgt Corp	1,056,000	100,000	9.5 %
Hancock (John) Mut Like Ins	1,056,000	100,000	9.5 %
Kingdon Assoc	1,056,000	100,000	9.5 %

Name	Indication of Interest	Allocation	Percent Allocated
Morgan (JP) Investment Mgmt	1,056,000	100,000	9.5 %
Palantier Capital	1,056,000	100,000	9.5 %
Warburg Pincus Counsellors	1,200,000	100,000	8.3 %
West Highland Capital Mgmt	1,056,000	100,000	9.5 %
Zweig Advisors	1,200,000	100,000	8.3 %
Account T	1,000,000	89,500	9.0 %
Phoenix Mutual Life Ins Co	1,056,000	75,000	7.1 %
Waddell & Reed Inc	1,056,000	75,000	7.1 %
Chase Manhattan USA	1,056,000	70,000	6.6 %
Ballentine Capital Mgmt	1,000,000	50,000	5.0 %
Templeton Investment Counsel	1,056,000	50,000	4.7 %
Vinik Asset Mgmt	1,056,000	50,000	4.7 %
Awad & Associates	1,000,000	40,000	4.0 %
Chartwell Reinsurance Co.	1,056,000	40,000	3.8 %
College Ret Equities FD/CREF	1,056,000	35,000	3.3 %
Columbia Management Co	1,216,000	35,000	2.9 %
Schneider Capital Mgmt	1,200,000	30,000	2.5 %
Account U	1,000,000	25,000	2.5 %
Boston Partner Asset	1,056,000	25,000	2.4 %
Eaton & Howard V. Sanders	1,400,000	25,000	1.8 %
Pilgrim, Baxter, Hoyt & Grieg	1,056,000	25,000	2.4 %
Ulysses Partners	1,216,000	25,000	2.1 %
Craig & Drill Capital Mgmt	1,300,000	20,000	1.5 %
Kemper Financial Services Inc	1,216,000	20,000	1.6 %
General Electric Invstmnt Corp	1,200,000	10,000	0.8 %
Cowen & Co	1,056,000	5,000	0.5 %
Morgan Stanley Asset Mgt Inc	1,320,000	5,000	0.4 %
Stein Roe & Farnham	1,500,000	5,000	0.3 %
Davis Skaggs Investment Mgmt	1,056,000	0	0.0 %

MFN IPO
Institutional Investors with Indications of Interest of 500,000 Shares or Greater
Allocations Compared to Bernard Ebbers

Name	Indication of Interest	Allocation	Percent Allocated
Fidelity Mgt & Research	673,000	250,000	37.1 %
Putnam Mgt Co Inc	561,000	210,000	37.4 %
Massachusetts Financial	561,000	180,000	32.1 %
Wellington/Thorndike	1,122,000	165,000	14.7 %
Oppenheimer Management	1,000,000	150,000	15.0 %
American Express Financial	561,000	140,000	25.0 %
Lynch & Mayer Inc	561,000	140,000	25.0 %
State Street Research	561,000	140,000	25.0 %
Hancock (John) Mut Life Inc	561,000	130,000	23.2 %
Invista	700,000	125,000	17.9 %
Zweig Advisors	673,000	125,000	18.6 %
Palantier Capital	561,000	125,000	22.3 %
Firstar Investment Mgmt	561,000	115,000	20.5 %
Miller Anderson & Sherre	660,000	115,000	17.4 %
Montgomery Asset Mgmt	561,000	115,000	20.5 %
Seligman (JW) & Co	561,000	115,000	20.5 %
Strong Capital Management	561,000	115,000	20.5 %
Aim Management Inc	561,000	110,000	19.6 %
Bernard Ebbers	500,000	100,000	20.0 %
Altamira	561,000	100,000	17.8 %
Essex Investment Mgt Co	561,000	100,000	17.8 %
Aetna Variable Annuity	600,000	90,000	15.0 %
Columbia Management Co	561,000	90,000	16.0 %
Columbus Circle Invs	561,000	90,000	16.0 %
GLG Partners	1,000,000	90,000	9.0 %
Nicholas Applegate Capital	561,000	90,000	16.0 %
Trust Co of the West (TCW)	561,000	90,000	16.0 %
Unicom Capital	561,000	90,000	16.0 %
Federated Investors Inc	561,000	80,000	14.3 %
Wall Street Associates	561,000	80,000	14.3 %
Bankers Trust Co	550,000	75,000	13.6 %
Ballentine Capital Mgmt	561,000	70,000	12.5 %
Chase Manhattan USA	561,000	70,000	12.5 %
Citicorp	561,000	70,000	12.5 %
Davis Skaggs Investment	561,000	70,000	12.5 %
Greenwich Street Advisors	561,000	70,000	12.5 %

Name	Indication of Interest	Allocation	Percent Allocated
Morgan Stanley Asset Mg	561,000	70,000	12.5 %
Ulysses Partners	561,000	70,000	12.5 %
Dean Witter Asset Management	561,000	60,000	10.7 %
Babson (David L) & Co Inc	500,000	50,000	10.0 %
Delphi Management Inc	675,000	50,000	7.4 %
Keystone Company of Boston	561,000	50,000	8.9 %
Marshall & Ilsley Corp	500,000	50,000	10.0 %
Schneider Capital Mgmt	500,000	50,000	10.0 %
Travelers Group	561,000	50,000	8.9 %
West Highland Schroder & Co	500,000	50,000	10.0 %
Loomis Sayles & Co – Boston	673,000	35,000	5.2 %
Levin John A	561,000	30,000	5.3 %
Atlantic Richfield Corp	561,000	25,000	4.5 %
Hughes Aircraft Co	561,000	25,000	4.5 %
Glickenhau & Co	561,000	10,000	1.8 %
Husic Capital Mgt	561,000	10,000	1.8 %
Mellon Bank	500,000	10,000	2.0 %
Amerindo Investment	561,000	2,500	0.4 %
First NB Chgo Personal	500,000	0	0.0 %
Vinik Asset Mgmt	561,000	0	0.0 %

<u>Earthshell IPO (3/23/98)</u>	
<u>PWM Group Client</u>	<u>Shares Allocated</u>
Customer 1 (5 family members)	28,000
Customer 2	20,000
Customer 3	15,000
Bernard Ebbers	12,500
Customer 5	12,500
Customer 6	10,000
Customer 7	10,000
Customer 8	7,500
4 PWM clients	5,000 each

<u>Rhythms Netconnections IPO (4/6/99)</u>	
<u>PWM Group Client</u>	<u>Shares Allocated</u>
Bernard Ebbers	10,000
Customer 1	10,000
Customer 2 (4 family members)	4,000
Customer 3	2,500
Customer 4	2,000
Customer 5	2,000
Customer 6	2,000
5 PWM Clients	1,500

<u>Juno Online Services IPO (5/25/99)</u>	
<u>PWM Group Client</u>	<u>Shares Allocated</u>
Customer 1	25,000
Bernard Ebbers	10,000
Customer 2	7,500
Customer 3	7,225
Customer 4 (5 family members)	6,500
Customer 5	6,550
Customer 6 (3 family members)	5,000
Customer 7	5,000
Customer 8	5,000
Customer 9	3,000

<u>Focal Communications IPO (7/27/99)</u>	
<u>PWM Group Client</u>	<u>Shares Allocated</u>
Customer 1	100,000
Customer 2	6,000
Bernard Ebbers	5,000
Customer 4	5,000
Customer 5	5,000
Customer 6 (2 family members)	4,500
Customer 7	4,000
Customer 8	3,000
Customer 9	3,000
Customer 10	2,500

<u>Williams Communications IPO (10/1/99)</u>	
<u>PWM Group Clients</u>	<u>Shares Allocated</u>
Customer 1	300,000*
Customer 2	45,000
Bernard Ebbers	35,000
Customer 4	35,000
Customer 5	35,000
Customer 6	30,000
Customer 7 (3 family members)	23,000
Customer 8	10,000

* This PWM customer was affiliated with Williams Communications.

<u>Tycom Ltd. IPO (7/26/00)</u>	
PWM Client	Shares Allocated
Customer 1 (2 family members)	37,500
Customer 2	20,500
Customer 3	15,000
Customer 4 (5 family members)	10,500
Bernard Ebbers	7,500
Customer 5	7,500
Customer 6	7,500
5 PWM clients tied	5,000

<u>SignalSoft IPO (8/2/00)</u>	
PWM Client	Shares Allocated
Customer 1 (2 family members)	15,000
Customer 2	10,000
Customer 3	7,500
Customer 4 (5 family members)	5,000
Bernard Ebbers	5,000
Customer 5	2,500
5 PWM clients tied	2,000

WorldCom Analyst Reports -- Ratings

Date	House	Rating
11/22/96	Interstate/Johnson Lane	Neutral
01/02/97	Salomon Brothers	Strong Buy
01/06/97	Argus Investment Analysis	Buy
01/07/97	Smith Barney	3H Neutral/High Risk
02/13/97	Salomon Brothers	Strong Buy
02/27/97	Salomon Brothers	Strong Buy
03/06/97	Salomon Brothers	Strong Buy
04/10/97	Smith Barney	2H Outperform/High Risk
04/18/97	Salomon Brothers	Strong Buy
04/30/97	Salomon Brothers	Strong Buy
06/02/97	Interstate/Johnson Lane	Neutral
06/06/97	Salomon Brothers	Strong Buy
06/17/97	Merrill Lynch	Neutral/Long Term Accumulate
08/97	Salomon Brothers	Strong Buy
08/05/97	Merrill Lynch	Neutral/Long Term Accumulate
09/10/97	The Robinson-Humphrey Co, Inc.	Buy/High Risk
10/02/97	The Robinson-Humphrey Co, LLC	Buy/High Risk
10/07/97	Merrill Lynch	Accumulate/Long Term Buy
10/16/97	The Robinson-Humphrey Co, LLC	Buy/High Risk
10/20/97	Argus Investment Analysis	Buy
10/31/97	The Robinson-Humphrey Co, LLC	Buy/High Risk
11/04/97	Merrill Lynch	Accumulate/Long Term Buy
11/10/97	The Robinson-Humphrey Co, LLC	Buy/High Risk
11/18/97	Interstate/Johnson Lane	Long-Term Buy
02/04/98	Merrill Lynch	Accumulate/Long Term Buy
03/17/98	Interstate/Johnson Lane	Long-Term Buy
04/09/98	SSB	1M Buy/Medium Risk
04/21/98	Merrill Lynch	Accumulate/Long Term Buy
04/24/98	SSB	1M –Buy/Medium Risk
05/01/98	SSB	1M –Buy/Medium Risk
05/04/98	SSB	1M –Buy/Medium Risk
05/28/98	SSB	1M –Buy/Medium Risk
06/04/98	CIBC Oppenheimer	Strong Buy
06/05/98	CIBC Oppenheimer	Strong Buy
06/10/98	CIBC Oppenheimer	Strong Buy
06/11/98	CIBC Oppenheimer	Strong Buy
06/15/98	CIBC Oppenheimer	Strong Buy
06/18/98	Merrill Lynch	Accumulate/Long Term Buy
06/19/98	CIBC Oppenheimer	Strong Buy
06/22/98	SSB	1M –Buy/Medium Risk
06/22/98	Argus Action Facts AM	Buy
06/25/98	CIBC Oppenheimer	Strong Buy
07/07/98	CIBC Oppenheimer	Strong Buy
07/07/98	CIBC Oppenheimer	Strong Buy
07/09/98	Merrill Lynch	Accumulate/Long Term Buy
07/16/98	Jefferies	Buy
07/20/98	CIBC Oppenheimer	Strong Buy

Date	House	Rating
07/23/98	SSB	1M –Buy/Medium Risk
07/23/98	CIBC Oppenheimer	Strong Buy
07/24/98	CIBC Oppenheimer	Strong Buy
07/24/98	Jefferies	Buy
07/28/98	Merrill Lynch	Accumulate/Long Term Buy
07/28/98	CIBC Oppenheimer	Strong Buy
07/30/98	Merrill Lynch	Accumulate/Long Term Buy
07/30/98	CIBC Oppenheimer	Strong Buy
07/31/98	CIBC Oppenheimer	Strong Buy
08/06/98	Interstate/Johnson Lane	Strong Buy
08/17/98	Argus Action Facts AM	Buy
09/15/98	Argus Action Facts AM	Buy
09/18/98	Legg Mason	Buy
10/07/98	SSB	1-M Buy/Medium Risk
10/09/98	SSB	1M Buy/Medium Risk
10/13/98	Merrill Lynch	Accumulate/Long Term Buy
10/30/98	Merrill Lynch	Accumulate/Long Term Buy
10/30/98	Jefferies	Buy
11/06/98	SSB	1M Buy/Medium Risk
11/16/98	SSB	1M Buy/Medium Risk
11/17/98	SSB	1M Buy/Medium Risk.
12/10/98	Merrill Lynch	Accumulate/Long Term Buy
12/17/98	Interstate/Johnson Lane	Strong Buy
01/21/99	Merrill Lynch	Accumulate/Long Term Buy
02/12/99	Jefferies	Buy
02/18/99	Merrill Lynch	Accumulate/Long Term Buy
02/23/99	SSB	1M Buy/Medium Risk
03/09/99	Interstate/Johnson Lane	Long-Term Buy
03/15/99	Argus Investment Analysis	Medium/High
03/19/99	Bernstein Research	Outperform
03/26/99	Bernstein Research	Outperform
04/07/99	Merrill Lynch	Accumulate/Long Term Buy
04/19/99	Jefferies	Buy
04/29/99	Legg Mason	Buy
04/30/99	Jefferies	Buy
05/03/99	Merrill Lynch	Accumulate/Long Term Buy
05/24/99	SSB	1M Buy/Medium Risk
06/03/99	Merrill Lynch	Accumulate/Long Term Buy
06/03/99	Jefferies	Buy
06/15/99	Bernstein Research	Outperform
06/30/99	Wachovia Securities, Inc.	Long-Term Buy
07/01/99	Jefferies	Buy
07/29/99	Legg Mason	Buy
07/30/99	Jefferies	Buy
08/02/99	Merrill Lynch	Accumulate/Long Term Buy
08/09/99	Legg Mason	Buy
08/19/99	Wachovia Securities, Inc.	Strong Buy

Date	House	Rating
08/20/99	SSB	1M Buy/Medium Risk
10/04/99	Legg Mason	Buy
10/06/99	Merrill Lynch	Accumulate/Long Term Buy
10/06/99	Jefferies	Buy
10/08/99	Jefferies	Buy
10/08/99	SSB	1M Buy/Medium Risk
10/15/99	Merrill Lynch	Accumulate/Long Term Buy
10/18/99	Merrill Lynch	Accumulate/Long Term Buy
10/28/99	Jefferies	Buy
11/05/99	Merrill Lynch	Accumulate/Long Term Buy
11/09/99	Wachovia Securities, Inc.	Strong Buy
12/13/99	The Robinson-Humphrey Co, LLC	Buy/High Risk
01/12/00	Jefferies	Buy
02/11/00	Bernstein Research Call	Outperform
02/11/00	Jefferies	Buy
02/15/00	SSB	1M Buy/Medium Risk
02/16/00	Merrill Lynch	Accumulate/Long Term Buy
02/22/00	The Robinson-Humphrey Co, LLC	Buy/High Risk
03/06/00	The Robinson-Humphrey Co, LLC	Buy/High Risk
03/24/00	Bernstein Research	Outperform
04/05/00	KBRO-Morning Notes	Buy
04/05/00	KBRO-Action Alert	Buy
04/09/00	Bernstein Research Call	Outperform
04/28/00	Bernstein Research Call	Outperform
05/11/00	Wachovia Securities, Inc.	Strong Buy
06/26/00	KBRO-Morning Notes	Buy
06/27/00	KBRO-Action Alert	Strong Buy
06/27/00	SSB	1M Buy/Medium Risk
07/11/00	CIBC World Markets	Buy
07/12/00	SSB	1M Buy/Medium Risk
07/27/00	CIBC World Markets	Hold
07/27/00	KBRO-Action Alert	Strong Buy
07/27/00	SSB	1M Buy/Medium Risk
08/02/00	SSB	1M Buy/Medium Risk
08/11/00	SSB	1M Buy/Medium Risk
08/24/00	Wachovia Securities, Inc.	Strong Buy
08/25/00	KBRO-Morning Notes	Strong Buy
09/05/00	SSB	1M Buy/Medium Risk
09/07/00	KBRO-Morning Notes	Strong Buy
10/04/00	SSB	1M Buy/Medium Risk
10/05/00	KBRO-Action Alert	Strong Buy
10/26/00	SSB	1M Buy/Medium Risk
10/30/00	KBRO-Action Alert	Strong Buy
11/01/00	SSB	1M Buy/Medium Risk
11/02/00	SSB	1M Buy/Medium Risk
12/05/00	SSB	1M Buy/Medium Risk
12/11/00	Argus Investment Analysis	Buy

Date	House	Rating
01/02/01	SSB	1M Buy/Medium Risk
01/09/01	SSB	1M Buy/Medium Risk
01/26/01	SSB	1M Buy/Medium Risk
02/02/01	SSB	1M Buy/Medium Risk
02/08/01	SSB	1M Buy/Medium Risk
02/15/01	SSB	1M Buy/Medium Risk
02/16/01	KBRO-The Morning Exchange	Strong Buy
02/16/01	SSB	1M Buy/Medium Risk
03/02/01	Robertson Stephens	Buy
03/02/01	Robertson Stephens	Buy
03/07/01	Wachovia Securities, Inc.	Neutral
03/13/01	SSB	1M Buy/Medium Risk
03/30/01	Thomas Weisel Partners	Buy
04/10/01	CIBC World Markets	Hold
04/26/01	Thomas Weisel Partners	Buy
04/26/01	SSB	1M Buy/Medium Risk
04/27/01	Robertson Stephens	Buy
05/09/01	Thomas Weisel Partners	Buy
05/09/01	Wachovia Securities, Inc.	Neutral
05/14/01	KBRO-The Morning Exchange	Strong Buy
05/15/01	KBRO-Action Alert	Strong Buy
05/23/01	Thomas Weisel Partners	Buy
06/01/01	SSB	1M Buy/Medium Risk
06/07/01	Thomas Weisel Partners	Buy
06/07/01	SSB	1M Buy/Medium Risk
06/08/01	Thomas Weisel Partners	Buy
07/03/01	SSB	1M Buy/Medium Risk
07/05/01	SSB	1M Buy/Medium Risk
07/06/01	Robertson Stephens	Buy
07/07/01	KBRO-Action Alert	Strong Buy
07/12/01	Thomas Weisel Partners	Buy
07/13/01	KBRO-The Morning Exchange Part II	Strong Buy
07/26/01	Thomas Weisel Partners	Buy
07/26/01	SSB	1M Buy/Medium Risk
07/27/01	KBRO-Action Alert	Strong Buy
07/27/01	Robertson Stephens	Buy
08/02/01	Thomas Weisel Partners	Buy
08/03/01	Wachovia Securities, Inc.	Neutral
08/30/01	SSB	1M Buy/Medium Risk
09/05/01	Thomas Weisel Partners	Strong Buy
09/19/01	SSB	1M Buy/Medium Risk
09/24/01	CIBC World Markets	Strong Buy
09/25/01	Robertson Stephens	Strong Buy
10/16/01	Jefferies-Initiating Coverage	Hold
10/25/01	Jefferies-Update	Hold
10/25/01	KBRO-Action Alert	Strong Buy
10/25/01	Thomas Weisel Partners	Strong Buy
10/25/01	SSB	1M Buy/Medium Risk

Date	House	Rating
10/26/01	CIBC World Markets	Strong Buy
10/26/01	Jefferies-Update	Hold
10/26/01	Robertson Stephens	Strong Buy
12/06/01	KBRO-Action Alert	Strong Buy
01/07/02	CIBC World Markets	Strong Buy
01/10/02	Jefferies-Update	Hold
01/17/02	SSB	1M Buy/Medium Risk
01/29/02	CIBC World Markets	Strong Buy
01/29/02	KBRO-Action Alert	Strong Buy
01/29/02	SSB	1M Buy/Medium Risk
01/30/02	Jefferies-Update	Hold
01/31/02	Robertson Stephens	Strong Buy
02/04/02	KBRO-Action Alert	Strong Buy
02/04/02	SSB	1M Buy/Medium Risk
02/06/02	KBRO-The Morning Exchange Part I	Strong Buy
02/06/02	KBRO-Action Alert	Strong Buy
02/07/02	CIBC World Markets	Strong Buy
02/07/02	Jefferies-Update	Hold
02/07/02	KBRO-Action Alert	Strong Buy
02/07/02	SSB	1M Buy/Medium Risk
02/08/02	CIBC World Markets	Strong Buy
02/08/02	Jefferies-Update	Hold
02/08/02	Robertson Stephens	Strong Buy
02/08/02	Thomas Weisel Partners	Buy
02/08/02	SSB	1M Buy/Medium Risk
03/05/02	Bernstein Research Call	Outperform
03/08/02	Bernstein Research	Outperform
03/12/02	Jefferies-Update	Hold
03/12/02	SSB	1M Buy/Medium Risk
03/13/02	Bernstein Research Call	Outperform
03/14/02	CIBC World Markets	Hold
03/18/02	SSB	1H Buy/High Risk
03/26/02	KBRO-The Morning Exchange Part II	Strong Buy
04/11/02	Jefferies-Update	Hold
04/15/02	KBRO-Action Alert	Strong Buy
04/21/02	SSB	3H Neutral/High Risk
04/22/02	CIBC World Markets	Hold
04/22/02	Jefferies-Update	Hold
04/22/02	KBRO-The Morning Exchange Part I	Strong Buy
04/22/02	KBRO-Action Alert	Strong Buy
04/22/02	Robertson Stephens	Strong Buy
04/22/02	Thomas Weisel Partners	Buy
04/23/02	CIBC World Markets	Hold
04/24/02	KBRO-The Morning Exchange Part II	Buy
04/25/02	CIBC World Markets	Hold
04/25/02	CIBC World Markets	Hold
04/25/02	Jefferies-Update	Hold

Date	House	Rating
04/25/02	Thomas Weisel Partners	Buy
04/25/02	SSB	3H Neutral/High Risk
04/26/02	Bernstein Research Call	Outperform
04/26/02	Jefferies-Update	Sell
04/26/02	KBRO-Action Alert	Buy
04/26/02	Robertson Stephens	Strong Buy
04/30/02	CIBC World Markets	Hold
04/30/02	Jefferies-Update	Sell
04/30/02	SSB	3H Neutral/High Risk
05/06/02	KBRO-The Morning Exchange Part I	Buy
05/07/02	KBRO-Action Alert	Buy
05/09/02	SSB	3S Neutral/Speculative
05/09/02	SSB	3S Neutral/Speculative
05/10/02	Jefferies-Update	Sell
05/10/02	KBRO-The Morning Exchange Part I	Buy
05/15/02	KBRO-Action Alert	Buy
05/22/02	Jefferies-Update	Sell
05/22/02	Robertson Stephens	Strong Buy
05/22/02	SSB	3S Neutral/Speculative
06/18/02	KBRO-The Morning Exchange Part I	Buy
06/21/02	SSB	4S Underperform/Speculative
06/25/02	KBRO-Action Alert	Buy
07/22/02	KBRO-The Morning Exchange Part I	Suspended (Previously Hold)

WorldCom Analyst Reports – EPS

House	Date	Estimated EPS for Calendar Yr.
Salomon Brothers	06/06/97	0.40
Smith Barney	09/26/97	0.42
The Robinson Humphey Co, LLC	10/02/97	0.35
Merrill Lynch	10/07/97	0.37
Argus Investment Analysis	10/20/97	0.35
Interstate/Johnson Lane	03/17/98	0.85
SSB	04/09/98	0.85
Merrill Lynch	04/21/98	0.87
SSB	04/24/98	0.87
SSB	05/01/98	0.87
SSB	05/04/98	0.87
SSB	05/28/98	0.87
CIBC Oppenheimer	06/04/98	0.85
SSB	06/22/98	0.87
SSB	07/23/98	0.87
Legg Mason	09/18/98	0.89
SSB	09/30/98	0.87
SSB	10/07/98	0.83
SSB	10/09/98	0.83
Merrill Lynch	10/13/98	0.79
Merrill Lynch	10/30/98	0.82
SSB	11/06/98	0.82
SSB	11/16/98	0.82
Jefferies	02/12/99	2.00 ¹
Merrill Lynch	02/18/99	2.00
SSB	02/23/99	2.00
Interstate/Johnson Lane	03/09/99	1.90
Argus Investment Analysis	03/15/99	1.90
Bernstein Research	03/19/99	1.95
Merrill Lynch	05/03/99	2.00
SSB	05/24/99	2.00
Jefferies	06/03/99	2.00 ²
Legg Mason	08/09/99	2.00
Wachovia Securities, Inc.	08/19/99	1.90
SSB	08/20/99	2.00
Legg Mason	10/04/99	1.97
Jefferies	10/06/99	1.97 ³

¹ Embratel Results Consolidated

² Embratel Results Consolidated

House	Date	Estimated EPS for Calendar Yr.
Legg Mason	10/06/99	1.97
Merrill Lynch	10/06/99	1.97
Jefferies	10/08/99	1.97 ⁴
SSB	10/08/99	2.00
Bernstein Research Call	02/11/00	1.90 ⁵
Jefferies	02/11/00	1.89 ⁶
SSB	02/15/00	1.90
KBRO-Action Alert	06/27/00	1.91
SSB	06/27/00	1.90
CIBC World Markets	07/11/00	1.90
SSB	07/12/00	1.90
SSB	07/27/00	1.90
SSB	08/11/00	2.24
Wachovia Securities, Inc.	08/24/00	1.87
SSB	9/05/00	2.24
SSB	10/04/00	2.24
KBRO-Action Alert	10/05/00	1.86
SSB	10/26/00	2.24
KBRO-Action Alert	10/30/00	1.85
SSB	11/01/00	2.01
SSB	12/05/00	2.01
Argus Investment Analysis	12/11/00	1.70
SSB	01/02/01	1.60
SSB	01/09/01	1.60
SSB	01/26/01	1.60
SSB	02/02/01	1.60
SSB	02/08/01	1.60
SSB	02/15/01	1.60
Wachovia Securities, Inc.	03/07/01	1.46
SSB	03/13/01	1.25
Thomas Weisel Partners	03/30/01	1.50
SSB	04/26/01	1.25
Thomas Weisel Partners	04/26/01	1.50
Robertson Stephens	04/27/01	1.49

³ Includes Sprint pro forma and Embratel

⁴ Embratel Results Excluded

⁵ Excludes 1-Time Items

⁶ Embratel Results Excluded

House	Date	Estimated EPS for Calendar Yr.
SSB	06/01/01	1.20
SSB	06/07/01	1.20
Thomas Weisel Partners	06/07/01	1.50
Thomas Weisel Partners	06/08/01	0.96
SSB	07/03/01	1.18
SSB	07/05/01	1.05
Robertson Stephens	07/06/01	1.05
KBRO-Action Alert	07/07/01	1.09
Thomas Weisel Partners	07/12/01	1.05
KBRO-The Morning Exchange Part II	07/13/01	
SSB	07/26/01	1.05
Thomas Weisel Partners	07/26/01	1.06
KBRO-Action Alert	07/27/01	1.09
SSB	08/30/01	1.05
SSB	09/19/01	1.05
Jefferies-Update	10/25/01	0.74
KBRO-Action Alert	10/25/01	1.05
SSB	10/25/01	1.05
Thomas Weisel Partners	10/25/01	1.06
CIBC World Markets	10/26/01	0.68
Jefferies-Update	01/10/02	0.65
SSB	01/17/02	0.90
SSB	01/29/02	0.90
KBRO-Action Alert	02/04/02	1.01
SSB	02/04/02	0.90
CIBC World Markets	02/07/02	0.90
SSB	02/07/02	0.70
SSB	02/08/02	0.70
Bernstein Research	03/08/02	0.75
Jefferies-Update	03/12/02	0.65
SSB	03/12/02	0.70
SSB	04/21/02	0.39
CIBC World Markets	04/22/02	0.70
Jefferies-Update	04/22/02	0.40
KBRO-Action Alert	04/22/02	0.44
SSB	04/25/02	0.33
SSB	04/30/02	0.33
SSB	05/09/02	0.33
Jefferies-Update	05/22/02	0.40

House	Date	<u>Estimated</u> <u>EPS for</u> <u>Calendar Yr.</u>
Robertson Stephens	05/22/02	0.35
SSB	05/22/02	0.24
SSB	06/21/02	0.13

WorldCom Analyst Reports – Target Price

Date	House	Target Price in \$
01/06/97	Argus Investment Analysis	32
01/07/97	Smith Barney	29
02/27/97	Salomon Brothers	38-40
03/06/97	Salomon Brothers	35-40
06/03/97	Morgan Stanley	33
06/06/97	Salomon Brothers	35-40
06/20/97	Morgan Stanley	33
08/97	Salomon Brothers	35-40
08/12/97	Morgan Stanley	40
04/09/98	Morgan Stanley	45
04/09/98	SSB	60
04/21/98	Merrill Lynch	60
04/24/98	SSB	60
04/30/98	Morgan Stanley	52
05/01/98	SSB	60
05/28/98	SSB	60
06/04/98	CIBC Oppenheimer	48
06/18/98	Merrill Lynch	63
06/22/98	SSB	70
06/25/98	CIBC Oppenheimer	55
07/07/98	CIBC Oppenheimer	55
07/09/98	Merrill Lynch	63
07/20/98	CIBC Oppenheimer	63
07/23/98	CIBC Oppenheimer	69
07/23/98	SSB	70
07/24/98	Jeffries	65
07/28/98	Merrill Lynch	70
08/06/98	Interstate/Johnson Lane	70
08/06/98	Morgan Stanley	65
10/07/98	SSB	70
10/13/98	Merrill Lynch	65
10/30/98	Merrill Lynch	70
10/30/98	Jeffries	65
11/04/98	Morgan Stanley	65
11/06/98	SSB	80
11/16/98	SSB	80-90
12/10/98	Merrill Lynch	77
12/17/98	Interstate/Johnson Lane	84
02/12/99	Jefferies	95
02/17/99	Morgan Stanley	95
02/18/99	Merrill Lynch	98
02/23/99	SSB	100

05/03/99	Merrill Lynch	98
05/24/99	SSB	130
10/04/99	Legg Mason	120
10/06/99	Merrill Lynch	86
10/06/99	Jeffries	115
10/06/99	Legg Mason	120
10/06/99	Morgan Stanley	105
10/08/99	Jeffries	115
10/08/99	SSB	(approx) 135
06/23/00	Merrill Lynch	68
06/26/00	KBRO	63
06/27/00	SSB	87
06/29/00	CSFB	69
07/10/00	Morgan Stanley	70
07/11/00	CIBC	55
07/12/00	SSB	87
07/13/00	CSFB	69
07/28/00	Merrill Lynch	57
08/01/00	CSFB	60
08/02/00	SSB	87
08/24/00	Wachovia Securities	70
09/05/00	SSB	87
09/06/00	Merrill Lynch	60
09/06/00	Morgan Stanley	70
09/07/00	KBRO	63
09/07/00	CSFB	56
10/04/00	SSB	87
10/05/00	KBRO	63
10/20/00	CSFB	47
10/26/00	Morgan Stanley	70
10/26/00	SSB	87
10/27/00	Morgan Stanley	70
10/30/00	KBRO	50
11/01/00	SSB	45
11/02/00	SSB	45
12/05/00	SSB	45
12/11/00	Argus	44
02/12/01	CSFB	25
02/15/01	SSB	45
02/15/01	CSFB	25
02/16/01	KBRO – The Morning Exchange	37
07/05/01	SSB	35
07/06/01	Robertson Stephens	18
07/07/01	KBRO – Action Alert	27

07/18/01	CSFB	19.5
10/25/01	KBRO – Action Alert	24
10/25/01	SSB	22
10/26/01	CIBC World Markets	18
10/26/01	Robertson Stephens	19
01/10/02	Jefferies-Update	24
01/17/02	SSB	20
01/29/02	KBRO – Action Alert	24
02/07/02	KBRO – Action Alert	18
02/07/02	SSB	12
02/08/02	CIBC World Markets	11
02/08/02	Robertson Stephens	14
02/08/02	Thomas Weisel Partners	20
04/21/02	SSB	5
04/22/02	KBRO – Action Alert	10
04/22/02	Robertson Stephens	8
04/25/02	CSFB	2
04/26/02	Berstein Research Call	7

APPENDIX A: LEGAL STANDARDS RELATING TO CORPORATE GOVERNANCE

This Appendix addresses the legal standards for the corporate governance claims that the Examiner recommends that WorldCom might pursue. In particular, this Appendix discusses: (1) choice of law principles; (2) the legal standards regarding the fiduciary duties of directors and officers, i.e., their duties of loyalty, good faith, and due care, as well as the usurpation of corporate opportunities and conflicting interest transactions; (3) the legal standards governing claims for aiding and abetting a breach of a fiduciary duty; (4) the business judgment rule and the entire fairness doctrine; (5) the legal issues surrounding the exculpatory clause in WorldCom's articles of incorporation; (6) legal issues pertaining to the indemnification provision in WorldCom's articles of incorporation; (7) the statute of limitations applicable to corporate governance claims; and (8) the remedies available against directors and officers who breach their fiduciary duties, including disgorgement, and against third parties who aided and abetted such conduct.

A. Choice of Law

Corporate governance claims brought against directors and officers of a corporation are governed by the laws of the state of incorporation, pursuant to the "internal affairs doctrine."¹ Thus, claims against former members of WorldCom's Board of Directors and against former officers arising out of the breach of their fiduciary duties to WorldCom will most likely be resolved under Georgia law, WorldCom's state of incorporation.

Because relatively little published case law exists regarding fiduciary duties under Georgia corporation law, this Appendix also refers to the ABA's Revised Model Business

¹ See BBS Norwalk One, Inc. v. Raccolta, Inc., 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999) (Under the "internal affairs doctrine," "issues relating to the internal affairs of a corporation are decided in accordance with the law of the state of incorporation."), aff'd, 205 F.3d 1321 (2nd Cir. 2000).

Corporation Act, upon which the Georgia Business Corporation Code is based,² and to cases decided under the laws of other states, particularly Delaware.³ In addition, because significant contacts exist with Mississippi, WorldCom's principal place of business prior to the MCI acquisition and most likely after it as well, and because the Examiner cannot predict with certainty the choice of law determination, Mississippi case law is also cited where available and appropriate.

B. Duties of Officers and Directors -- Overview

In Georgia, "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors"⁴

Directors are charged with fiduciary duties in running the business affairs of the corporation. Ga. Code Ann. § 14-2-830 sets forth those duties and charges a director with acting:

- (1) In a manner he believes in good faith to be in the best interests of the corporation; and
- (2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances.⁵

² See Ga. Code. Ann. § 14-2-101, comment.

³ Georgia courts look to case law from other states, including Delaware, in the absence of Georgia precedents. See, e.g., Southeast Consultants, Inc. v. McCrary Engineering Corp., 273 S.E.2d 112 (Ga. 1980).

⁴ Ga. Code Ann. § 14-2-801(b). See Miss. Code Ann. § 79-4-8.01(b); Boddy v. Theiling, 199 S.E.2d 379, 382 (Ga. Ct. App. 1973); Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 814 (Miss. 1956); Home Tel. Co. v. Darley, 355 F. Supp. 992, 999 (N.D. Miss. 1973) (applying Mississippi law).

⁵ Miss. Code Ann. § 79-4-8.30 is somewhat different. It provides:

- (a) Each member of the board of directors, when discharging the duties of a director, shall act:
 - (1) In good faith, and
 - (2) In a manner the director reasonably believes to be in the best interests of the corporation.
- (b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting

Officers possess the same fiduciary duties to the corporation as directors.⁶

Georgia courts have ruled that these Georgia Code sections impose on directors and officers three basic duties to the corporation -- those of good faith, loyalty and due care. The Georgia Court of Appeals has spelled out these duties under a statutory predecessor:

Directors owe three major duties. These are described in three key words: Obedience, Loyalty and Diligence. The first imposes the duty to comply with the law. The second requires “a duty of undivided good faith since they are fiduciaries and trustees of their corporation and stockholders.” The author [of a leading Georgia corporate law treatise] explains the use of the third key word in that “they owe a duty to exercise reasonable care and prudence, and not be mere ornaments and figureheads.” An individual who agrees to become a corporation director therefore undertakes to carry out the obligations of obedience to the law, loyalty as fiduciary to the stockholders, and the diligence of an ordinarily prudent man.⁷

Delaware and Mississippi recognize a similar set of fiduciary duties owed by directors and officers of corporations organized under their laws -- due care, good faith and loyalty -- although Mississippi uses a slightly different formulation of these duties.⁸

At least one distinction exists between the duties owed by directors and officers of a corporation. Because of their greater access to information and greater familiarity with the day-to-day affairs of the corporation, officers may be held to a higher standard than directors in judging their compliance with their fiduciary duties.⁹ For example, while both officers and

attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

⁶ See Ga. Code Ann. § 14-2-842; cf. Miss. Code Ann. § 79-4-8.42.

⁷ Boddy v. Theiling, 199 S.E.2d at 382 (emphasis in original.).

⁸ See Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); Omni Bank v. United Southern Bank, 607 So. 2d 76, 84 (Miss. 1992) (holding a corporate officer has “two principal duties: a duty of care and a duty of loyalty and fair dealing.”); Derouen v. Murray, 604 So. 2d 1086, 1092 (Miss. 1992) (duty of loyalty and good faith is also known as duty of fair dealing).

⁹ See, e.g., Bates v. Dresser, 251 U.S. 524, 530 (1920) (holding the president of a bank, but not a number of its outside directors, liable for negligently allowing a cashier to steal deposits, noting that “[t]he position of the president” is distinguished from the position of a director because of the president’s “responsibility, as executive officer . . . and knowledge, from long daily presence in the bank . . .”).

directors may rely on reports from various credible sources in carrying out their duties, the comments to Ga. Code Ann. § 14-2-842 note that an officer's ability to rely on such information, opinions, reports or statements may be more limited than a director's "in view of the greater obligation he may have to be familiar with the affairs of the corporation."¹⁰ In particular, an officer's ability to rely on reports from these enumerated sources is removed "if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) of this Code section unwarranted."¹¹

C. Duties of Loyalty and Good Faith

1. Duty of Good Faith

Georgia Law requires directors and officers to discharge their duties "[i]n a manner [t]he[y] believe[] in good faith to be in the best interests of the corporation"¹² Officers and directors discharge their duties in good faith when they make informed business decisions that they reasonably believe to be in the best interest of the corporation.¹³

While "[t]he requirement that a director act in good faith in pursuit of the best interest of the corporation and its shareholders is at the core of the fiduciary duty of a director,"¹⁴ the scope of this duty is not amenable to precise definition.¹⁵ However, "[a] decision made by

¹⁰ Ga. Code Ann. § 14-2-842(b) provides: "In discharging his duties an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by: (1) One or more officers or employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented; or (2) Legal counsel, public accountants, investment bankers, or other persons as to matters the officer reasonably believes are within the person's professional or expert competence."

¹¹ Ga. Code Ann. § 14-2-842(c); Cf. Miss. Code Ann. § 79-4-8.42(b).

¹² Ga. Code Ann. §§ 14-2-830 (establishing general standards of conduct for directors); Ga. Code Ann. § 14-2-842(a) (establishing general standards of conduct for directors); see also Revised Model Act §§ 8.30, 8.42.

¹³ See Matter of Munford, 98 F.3d 604 (11th Cir. 1996) (applying Georgia law).

¹⁴ Citron v. Fairchild Camera and Instrument Corp., 1988 WL 53322, at 17 (Del. Ch. May 19, 1988), the scope of this duty is not amenable to precise definition. See, e.g., Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

¹⁵ See, e.g., Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

competent directors that is not explicable on any rational ground,” may give rise to an inference that the directors violated their duty of good faith.¹⁶ Finding an absence of good faith requires an inquiry into an officer’s or director’s subjective state of mind, but in making this inquiry, inferences may be drawn from overt conduct:

While the absence of significant financial adverse interest creates a presumption of good faith, or a prima facie showing of it * * * the question of bona fides may not be finally determined on that basis alone. Rather, that question calls for an ad hoc determination of the board’s motives in this particular instance. As in other contexts, however, this inquiry into a subjective state of mind necessarily will require inferences to be drawn from overt conduct -- the quality of the decision made being one notable possible source of such an inference.¹⁷

2. Duty of Loyalty

An officer or director breaches his duty of loyalty to a corporation by placing his or her personal interests above the corporation’s interests, such as by usurping a corporate business opportunity.¹⁸ The duty of loyalty “mandate[s] [that] the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer, or controlling shareholder and not shared by the stockholders generally.”¹⁹ Thus, a corporate officer breaches the duty of loyalty by using a corporate position to further private interests at the corporation’s expense.²⁰ In particular:

[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is,

¹⁶ Citron v. Fairchild Camera and Instrument Corp., 1988 WL 53322, *16. See also Gagliardi v. TriFoods Int’l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) (“By ‘bad faith’ is meant a transaction that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law.”) (Emphasis in original).

¹⁷ Citron v. Fairchild Camera and Instrument Corp., 1988 WL 53322, *15 (citations omitted).

¹⁸ 6 Ga. Jur. Corporations §§ 5:34, 5:45.

¹⁹ Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

²⁰ Id.; In re Trim-Line Meat Products, 4 B.R. 243, 246 (D. Del. 1980).

from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.²¹

Even if an “opportunity[] is not one which is essential or desirable for [the] corporation to embrace, being an opportunity in which it has no actual or expectant interest,” an officer cannot use “the corporation's resources in order to acquire the business opportunity.”²²

In addition, directors can also breach their duty of loyalty by essentially abdicating their directorial duties.²³ One court has recently held that a board breached its duty of loyalty by ratifying excessive compensation paid to a CEO, who dominated and controlled the board.²⁴ The following facts influenced the court's decision: the CEO's great influence over the board; and the compensation committee's failure to seek outside advice or even to meet to discuss the compensation recommended by the compensation committee.²⁵ Because no evidence existed of a compensation schedule for similarly situated executives or of production or performance by the CEO commensurate with his exorbitant salary, the court held the directors, among others, liable for a breach of the duty of loyalty to the company in grossly overpaying the CEO. In doing so, the court noted that “the close relationships of the

²¹ Quinn v. Cardiovascular Physicians, P.C., 254 Ga. at 218, 326 S.E.2d at 463 (citation omitted). See also Southeast Consultants, Inc. v. McCrary Engineering Corp., 273 S.E.2d at 117.

²² Phoenix Airline Services, Inc. v. Metro Airlines, Inc., 390 S.E.2d 219, 224 (Ga. Ct. App. 1989) (applying Delaware law) (emphasis supplied), rev'd on other grounds, 397 S.E.2d 699 (1990); Equity Corp. v. Milton, 221 A.2d 494, 497 (Del. 1966); Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 815 (Miss. 1956) (“If officers or directors make a personal profit through the use of corporate assets, they must account for it to the stockholders, and it is immaterial that their dealings may not have caused a loss or been harmful to the corporation; the test of liability is whether they unjustly gained enrichment.”) (Quoting 3 Fletcher, Corporations, § 884).

²³ Pereira v. Cogan, 294 B.R. 449, 528 (S.D.N.Y. 2003).

²⁴ Id. at 528-29.

²⁵ Id. at 477-79, 528-29.

Board members to [the CEO], and the complete lack of any exercise of due diligence in the performance of the Board's duties (in ratifying [this compensation] further suggests that a breach of the duty of loyalty exists.”²⁶

3. Conflicting Interest Transactions

A “conflicting interest transaction” occurs when a corporation engages in a transaction in which a director or officer has a financial interest of such significance that the interest is likely to influence the director's judgment.²⁷ Courts may rescind or set aside a director's conflicting interest transaction unless that transaction satisfies the “safe harbor provisions” of the Georgia Business Corporation Code, which are described below.²⁸

The Georgia Business Corporations Code defines an “officer's conflicting interest transaction” as “any transaction, other than a director's conflicting interest transaction, as

²⁶ Id. at 529.

²⁷ See Ga. Code Ann. § 14-2-860. See also Miss. Code Ann. § 79-4-8.60.

²⁸ See Ga. Code Ann. § 14-2-861. A “director's conflicting interest transaction” is defined as “a transaction effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) respecting which a director of the corporation has a conflicting interest.” Ga. Code Ann. § 14-2-860(2). See also Miss. Code Ann. § 79-4-8.60(2). A “conflicting interest” is defined as a director's interest in a transaction by the corporation if:

(A) Whether or not the transaction is brought before the board of directors of the corporation for action, to the knowledge of the director at the time of commitment he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that it would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction; or

(B) The transaction is brought (or is of such character and significance to the corporation that it would in the normal course be brought) before the board of directors of the corporation for action, and to the knowledge of the director at the time of commitment any of the following persons is either a party to the transaction or has a beneficial financial interest so closely linked to the transaction and of such financial significance to that person that it would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction: (i) an entity (other than the corporation) of which the director is a director, general partner, agent, or employee; (ii) a person that controls one or more of the entities specified in division (i) or an entity that is controlled by, or is under common control with, one or more of the entities specified in division (i) of this subparagraph; or (iii) an individual who is a general partner, principal, or employer of the director.

Ga. Code Ann. § 14-2-860(1). See also Miss. Code Ann. § 79-4-8.60(1).

defined in paragraph (2) of Code Section 14-2-860, between a corporation (or a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) and one or more of its officers or between a corporation and a related person of an officer.”²⁹ According to the comments to this section, this provision “restore[d] the safe harbor for transactions between the corporation and its officers formerly provided by Ga. Code Ann. § 14-2-155 (1982), which covered both officers and directors.”³⁰

a. Cases Interpreting Standards for Conflicting Interest Transactions

Little case law exists in Georgia applying and interpreting the conflicting interest transaction provisions.³¹ Only one court has discussed whether defendants may be vulnerable to attack on grounds other than conflicting interest when conflicting interest constitutes a key element of the claim. In Fisher v. State Mutual Insurance Co.,³² plaintiffs charged the defendants with self-dealing after discovering that the defendants were directors of a corporation to which State Mutual made an apparent bargain sale of an asset. The 11th Circuit noted that the plaintiffs’ allegations of corporate waste, fraud, and breach of the fiduciary duty of good faith were “not independent of” but rather “totally interrelated” to the claim of self-dealing and thus barred by defendants’ compliance with Section 14-2-862.³³ As a result, the court upheld summary judgment in favor of the defendants, who included two board members, a shareholder, and an officer of State Mutual. In determining whether Section 14-2-862 applied to each of the additional asserted claims, the court found persuasive

²⁹ Ga. Code Ann. § 14-2-864(a)(2).

³⁰ Id., cmts.

³¹ Cf. ABA Revised Model Business Corporation Act § 8.62 (same standard for conflicting interest transactions as Georgia law).

³² 290 F.3d 1256 (11th Cir. 2002) (applying Georgia law).

³³ Id. at 1264.

the fact that only the conflicted parties were sued, not the disinterested directors who voted to approve the sale at issue.³⁴

b. Safe Harbors for Conflicting Interest Transactions

Two safe harbors exist that protect officers and directors from liability for certain conflicting interest transactions: (1) where the underlying transaction is fair to the company; and (2) where the qualified or independent directors approve the transaction after required disclosure.³⁵ A transaction is considered “fair” to the corporation if the terms are reasonable and not adverse to the corporation’s interests.³⁶ The official comments to Section 14-2-861 explain that, “fairness” for purposes of the safe harbor provisions requires that “the price and terms must be fair, and [the transaction] must also be one that the directors could have believed to be in the best interests of the corporation.”³⁷

Alternatively, approval by a corporation’s qualified or independent directors will also provide a safe harbor for a conflicting interest transaction.³⁸ To benefit from this safe harbor, the transaction must be approved by “a majority (but not less than two) of those qualified directors on the board of directors or on a duly empowered committee thereof who voted on the transaction after either required disclosure to them (to the extent the information was not known by them) or compliance with subsection (b) of this Code section.”³⁹ When this safe

³⁴ Id.

³⁵ See Ga. Code Ann. § 14-2-861. See also Miss. Code Ann. § 79-4-8.61(b).

³⁶ See Ga. Code Ann. § 14-2-861, cmts. Ga. Code Ann. § 14-2-861(b)(3) thus appears comparable to Delaware’s “entire fairness” doctrine for self-dealing transactions, which inquires into the fairness of the price associated with the transaction and the process by which the transaction was approved. Solomon v. Armstrong, 747 A.2d 1098, 1112 (Del. Ch. 1999); see also Pereira v. Cogan, 294 B.R. at 518-19.

³⁷ The comments particularly focus on loans to a director or related person.

³⁸ See Ga. Code Ann. § 14-28-861.

³⁹ Ga. Code Ann. § 14-2-862(b) provides:

harbor applies, no need exists to reach the question of the transaction's fairness to the corporation.⁴⁰

For a director's conflicting interest transaction to meet the requirements of Ga. Code Ann. § 14-2-862, the transaction must have:

received the affirmative vote of a majority (but not less than two) of those qualified directors on the board of directors or on a duly empowered committee thereof who voted on the transaction after either required disclosure to them (to the extent the information was not known by them) or compliance with subsection (b) of this Code section.⁴¹

A "qualified director" in this context means:

any director who does not have either (1) a conflicting interest respecting the transaction or (2) a familial, financial, professional, or employment relationship with a second director who does have a conflicting interest respecting the transaction, which relationship would, in the circumstances, reasonably be expected to exert an influence on the first director's judgment when voting on the transaction.⁴²

The comments to Section 14-2-862 specifically tie the qualified directors' duties back to Section 14-2-830(a). Thus, even if the qualified directors approve the transaction, this action

If a director has a conflicting interest respecting a transaction, but neither he nor a related person of the director specified in subparagraph (A) of paragraph (3) of Code Section 14-2-860 is a party thereto, and if the director has a duty under law or professional canon, or a duty of confidentiality to another person, respecting information relating to the transaction such that the director cannot, consistent with that duty, make the disclosure contemplated by subparagraph (B) of paragraph (4) of Code Section 14-2-860, then disclosure is sufficient for purposes of subsection (a) of this Code section if the director:

Discloses to the directors voting on the transaction the existence and nature of his conflicting interest and informs them of the character of and limitations imposed by that duty prior to their vote on the transaction; and

(2) Plays no part, directly or indirectly, in their deliberations or vote.

See also Miss. Code Ann. § 79-4-8.62(b).

⁴⁰ See Ga. Code Ann. § 14-2-861; Miss. Code Ann. § 79-4-8.62(a).

⁴¹ Ga. Code Ann. § 14-2-862(a). See also Miss. Code Ann. § 79-4-8.62(a) (language is substantially similar to Ga. Code Ann. § 14-2-862(a)).

⁴² Ga. Code Ann. § 14-2-862(d).

will not protect the director with the conflicting interest if the qualified directors fail to discharge their duties “in a manner they believe[s] in good faith to be in the best interests of the corporation,” and “with the care an ordinarily prudent person in a like position would exercise under similar circumstances,” as required by section 14-2-830.

If, for example, “qualified directors” vote in favor of a transaction, as an accommodation to the director who has a conflicting interest, without complying with the requirements of Section 14-2-830(a), the board action would not be given effect under Section 14-2-861(b).⁴³

With respect to what constitutes “required disclosure” to the qualified directors assessing the transaction, the comments to Section 14-2-861 exclude from the definition of required disclosure:

personal or subjective information that bears upon [the director’s] negotiating position (such as, for example, his urgent need for cash, or the lowest price he would be willing to accept), despite the fact that such information would be relevant to the corporation’s decision-making in the sense that, if known to the corporation, it would improve the corporation’s negotiating position.

At least one Georgia case has addressed the issue of what constitutes required disclosure. Dunaway v. Parker⁴⁴ involved a shareholder action against the corporation’s CEO in connection with the sale of virtually all of the corporation’s assets to the Jack Eckerd Corporation.⁴⁵ Among other things, defendant did not disclose that, in contemplation of the deal with Eckerd, he had secretly amended leases on property he owned and rented to the corporation such that the terms were “favorable to his own interests, thereby devaluing the corporation’s leasehold estates.”⁴⁶ While a committee of the Board of Directors approved the lease amendments, they were never presented to the entire Board. Under the circumstances,

⁴³ Comments to Ga. Code Ann. § 14-2-862.

⁴⁴ 453 S.E.2d 43 (1994).

⁴⁵ Id. at 45.

⁴⁶ Id. at 47.

the court affirmed the jury's rejection of the safe harbor defense asserted by the defendant.⁴⁷ The court found that the CEO had not made the required disclosure because "he never directly informed the Parkers or the other corporate directors of the existence, extent and nature of his conflicting interests while acting as the corporation's negotiator during his secret talks with Eckerd Drugs. . . ."⁴⁸

D. Duty of Care

A breach of the duty of care arises in two circumstances: where the directors or officers take action without generally sufficient information before acting; and where the directors or officers fail to act, despite knowing of data suggesting a need for action. Each of these circumstances is discussed below.

1. Liability for Unreasonable Actions

Directors and officers of Georgia corporations are charged with a duty of care in conducting the affairs of their corporation.⁴⁹ Their actions "must be made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the Company."⁵⁰

If directors or officers satisfy these duties, they may rely upon the protection of the business judgment rule.⁵¹ Conversely:

⁴⁷ Id. at 50.

⁴⁸ Id.

⁴⁹ Ga. Code Ann. §§ 14-2-830(a)(2) and 14-2-842(a)(2).

⁵⁰ In re Intercat, Inc., 247 B.R. 911, 923 (S.D. Ga. 2000), quoting Aronson v. Lewis, 473 A.2d at 812. See also Derouen v. Murray, 604 So. 2d at 1092 ("[A]n officer or director owes the corporation a duty of care, a duty to perform the officer's or director's functions in good faith, in a manner that he or she reasonably believe to be in the best interest of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.").

⁵¹ Millsap v. American Family Corp., 430 S.E.2d 385, 388 (1993); Munford, Inc. v. Valuation Research Corp., 98 F.3d 604, 611 (11th Cir. 1996) ("The business judgment rule protects directors and officers from liability

[u]nder the business judgment rule there is no protection for directors who have made “an unintelligent or unadvised judgment.” . . . A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. . . . Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.⁵²

Consultation with and reliance upon experts is one factor that courts will consider in assessing the business judgment rule's application.⁵³ In discharging their duties, officers and directors also are entitled to rely on information, opinions, reports, or statements prepared or presented by:

- One or more officers or employees of the corporation whom the [officer or director] reasonably believes to be reliable and competent in the matters presented; or
- Legal counsel, public accountants, investment bankers, or other persons as to matters the officer reasonably believes are within the person's professional or expert competence.⁵⁴

A director also may rely on information provided by “[a] committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.”⁵⁵ As discussed above, based upon the comments to Section 14-2-842, an

when they make good faith business decisions in an informed and deliberate manner.”). See also Kaplan's Nadler, Ga. Corps., Lim. Parts. and Lim. Liab. Cos. (2000 Ed.), § 10-11.

⁵² Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (citations omitted). See also Miss. Code Ann. § 79-4-8.31(a)(2)(iv) (imposing liability for conduct that “consisted or was the result of *** [a] sustained failure of the director to be informed about the business and affairs of the corporation, or other material failure of the director to discharge the oversight function.”).

⁵³ See, e.g., Munford, 98 F.3d at 611; Boddy v. Theiling, 199 S.E.2d at 382.

⁵⁴ Ga. Code Ann. §§ 14-2-830(b)(1)&(2) and 14-2-842(b)(1)&(2). See also Miss. Code Ann. §§ 79-4-8.30(c)-(e) and 79-4-8.42(b).

⁵⁵ Ga. Code Ann. § 14-2-830(b)(3). See also Miss. Code Ann. § 79-4-8.30(e)(3). This rule does not absolve directors for actions taken by a committee on which they do not sit. See Ga. Code Ann. § 14-2-825(e) (“The

officer's ability to rely on information, opinions, reports or statements may be more limited than a director's "in view of the greater obligation he may have to be familiar with the affairs of the corporation." However, notwithstanding their reliance on advisors, directors cannot delegate their fundamental duty of care to management or an advisor.⁵⁶ Further, directors or officers may not rely on outside consultants where the facts and circumstances establish the unreasonableness of such reliance.

2. Liability for Inaction

A board of directors may also breach the duty of care by its inaction.⁵⁷ A director may not insulate himself from liability by failure actively to participate in the management of the corporation by the board of directors.⁵⁸ This is consistent with case law in other jurisdictions, such as Delaware. For example, in Pereira v. Cogan, the director defendants argued that unless they played a direct role in approving the CEO's excessive compensation, no liability could exist against them. The court disagreed, noting that:

Such a rule would insulate from liability directors who purposefully prevented a vote yet did not take part in formulating the challenged transactions, as well as directors who purposefully remained ignorant of issues of which they, as directors, should have been aware in order to fulfill their fiduciary duties to the corporation. Indeed, under this rule, the safest position would be for a director to hold his or her nose, close his or her eyes, and avoid attending Board meetings at all cost. Such actions surely do not satisfy that director's fiduciary duties to the corporation.⁵⁹

creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in Code Section 14-2-830." The comments to Section 14-2-825 make it clear that a noncommittee director's liability "will depend upon whether he failed to comply with Section 14-2-830(3)."

⁵⁶ See ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 103 (Del. Ch. 1999).

⁵⁷ See, e.g., Pereira v. Cogan, 294 B.R. 449, 529-30 (S.D.N.Y. 2003); In re Caremark International Inc. Derivative Litigation, 698 A.2d 959, 968-70 (Del. Ch. 1996).

⁵⁸ Boddy v. Theiling, 199 S.E.2d at 382.

⁵⁹ 294 B.R. at 525-26 (footnote omitted).

Indeed, the director defendants admitted that “even under the gross negligence standard . . . a director or board may be held liable for a ‘complete lack of monitoring by the board,’ * * * or ‘an utter failure to attempt to assure [that] a reasonable information and reporting system exists.’”⁶⁰ The business judgment rule does not apply where a board violates its duty of care through inaction.⁶¹

To satisfy the duty of care, directors must inform themselves adequately to perform their duties to the corporation.⁶² As a corollary, “[d]irectors that . . . fail to inform themselves of all material information reasonably available to them, will not receive [the] protection” of the business judgment rule.⁶³ Thus:

[I]t is important that the board exercise a good faith judgment that the corporation’s information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.⁶⁴

Therefore, a director may breach a duty of care by “an ‘unconsidered failure’ to act in situations in which due attention would, arguably, have prevented the loss,” *i.e.*, by failing to monitor.⁶⁵ Liability is appropriate in such circumstances.

Otherwise, a Board could avoid the higher judicial scrutiny of the entire fairness standard merely by ignoring or not addressing any potentially harmful transactions. Such is not good corporate governance and should not be encouraged by the law.⁶⁶

⁶⁰ Id. at 526 n.71 (citations omitted).

⁶¹ See, e.g., Aronson v. Lewis, 473 A.2d at 813; Pereira v. Cogan, 294 B.R. at 531.

⁶² In re Caremark, 698 A.2d at 970.

⁶³ Aronson v. Lewis, 473 A.2d at 813.

⁶⁴ In re Caremark, 698 A.2d at 970.

⁶⁵ Pereira v. Cogan, 294 B.R. at 530.

⁶⁶ Pereira v. Cogan, 294 B.R. at 532.

This accords with Section 14-2-801(b) of the Georgia Code, which provides that “[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors. . . .” (emphasis added).

A seminal failure-to-monitor case, In re Caremark, articulated the legal standard as requiring “a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists.”⁶⁷ Of course, a party asserting a claim for failure to monitor must also prove proximate cause, “i.e., that the absence of the adequate information system caused the losses.”⁶⁸

3. Special Considerations for Officer Liability

While Ga. Code Ann. § 14-2-830 applies to all directors, Section 14-2-842 clarifies that its provisions do not apply to individuals who are officers in name only. Rather, the duties set forth in this Section are limited to “[a]n officer with discretionary authority.”⁶⁹ Similar limitations have been placed on officer liability under Delaware law.⁷⁰

In Pereira v. Cogan, one set of transactions at issue included loans made to Cogan, who was the CEO, chairman of the board and controlling shareholder of the corporation. The court held that two non-director officers, Smith and Winters, could be liable for the loans to Cogan. Smith served as general counsel, vice president and secretary of the corporation. Winters served as a vice president of the corporation and, at some point, assumed most of the

⁶⁷ 698 A.2d at 971.

⁶⁸ Pereira v. Cogan, 294 B.R. at 530.

⁶⁹ The Georgia Business Corporations Code does not define “discretionary authority,” and the Examiner is unaware of any Georgia cases defining that phrase in this context.

⁷⁰ See, e.g., Pereira v. Cogan, 294 B.R. at 522 (“A defendant may be classified as a corporate officer for liability purposes if he had discretionary authority in the relevant functional area and the ability to cause or prevent the complained-of action.”). Miss. Code Ann. § 79-4-8.42 used to include this same limitation regarding officers with discretionary authority. However, that Section was amended in 1999 to remove that limitation.

CFO duties without being named CFO. The court noted that once Smith became aware of the loans, he held a duty to advise the board of its fiduciary obligations in connection with those loans.⁷¹ This duty arose out of “his obligation to discuss with the Board its duty to establish compliance and monitoring programs or an audit committee, the obligation to supervise and evaluate Cogan as CEO and to inform themselves as to transactions between Cogan and Trace.”⁷² The court further noted that Smith, as general counsel, could have prevented the loans by advising the Board that Delaware law barred loans of this type.⁷³ With respect to Winters, the court found that he knew of the loans, discussed the loans with the corporation’s outside auditors, and knew that the loans were at “extremely generous interest rates.”⁷⁴ The Board did not know the details of the loans until after the compensation committee had approved them and the CEO had received the loan proceeds.⁷⁵ The court thus found Winters liable, noting that he had discretionary authority and could possibly have prevented the loans by informing the board of the terms of the loans.⁷⁶

E. Aiding and Abetting Breaches of Fiduciary Duty

1. General Overview of the Law

To establish a claim for aiding and abetting the breach of a fiduciary duty, the plaintiff must prove the existence of a fiduciary duty relationship, breach of the fiduciary’s duty and that the defendant knowingly induced or participated in the breach.⁷⁷ Damages are

⁷¹ 294 B.R. at 524.

⁷² Id.

⁷³ Id.

⁷⁴ Id.

⁷⁵ See Pereira v. Cogan, 294 B.R. at 449, 476-77 (S.D.N.Y. 2003)

⁷⁶ Id. at 185.

⁷⁷ See Wight v. BankAmerica Corp., 219 F.3d 79, 91 (2d Cir. 2000) (applying New York law); Whitney v. Citibank, N.A., 782 F.2d 1106, 1115 (2d Cir. 1986); In re Trump Hotels Shareholder Derivative Litigation,

not always an essential element of this claim, such as in an action to recover fees charged for a wrongdoer's services to prevent the wrongdoer from profiting.⁷⁸

Similarly, a person who aids and abets a corporate officer's breaches of fiduciary duties is jointly and severally liable with the officer, even if that person owes no independent duty to the corporation..⁷⁹ In addition, the person who aids and abets any breaches may be required in equity to disgorge any fees paid to it by the corporation.⁸⁰

2. Choice of Law Analysis

State law supplies the rule of decision on the question of which state law should apply to aiding and abetting claims such as the potential aiding and abetting claim against SSB relating to the "spinning" activities with Mr. Ebberts.⁸¹ Assuming that the United States Bankruptcy Court for the Southern District of New York would be the forum in which the

2000 WL 1371317, at *19 (S.D.N.Y. Sept. 21, 2000); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ct. Ch. 1972).

⁷⁸ See, e.g., City of Findlay v. Pertz, 66 F. 427, 429 (6th Cir. 1896); Continental Mgmt., Inc. v. United States, 527 F.2d 613, 616 (Ct. Cl. 1975); Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 770-71 (Miss. 1956), cert. denied, 353 U.S. 977 (1957). On the other hand, some cases hold that a plaintiff must prove damages as an element of a claim for aiding and abetting a breach of a fiduciary duty. See, e.g., Whitney v. Citibank, N.A., 782 F.2d at 1115; Gilbert v. El Paso Co., 490 A.2d 1050, 1057 (Del. Ct. Ch. 1984). Whether or not a prima facie aiding and abetting case requires damages depends on the facts and circumstances of the case. Where a wrongdoer would gain unjust enrichment, damages do not represent an essential element of the claim. Under general equitable principles, where a wrongdoer is unjustly enriched, the amount of the enrichment is the measure of recovery.

⁷⁹ See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 172-73 (Del. 2002); see also Ga. Code Ann. § 51-12-30; Jackson v. Smith, 254 U.S. 586, 589 (1921); Irving Trust Co. v. Deutsch, 73 F.2d 121, 125 (2d Cir. 1934); United States v. Kenealy, 646 F.2d 699, 705-06 (1st Cir. 1981); Miller v. Steinbach, 268 F. Supp. 255, 281 (S.D.N.Y. 1967); cf. In re Albion Disposal, Inc., 152 B.R. 794, 824-25 (W.D.N.Y. 1993) (that others who participate in another's breach of fiduciary duty are jointly and severally liable is a "theme [that] recurs throughout the cases of high authority").

⁸⁰ See Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d at 770-71; see also Continental Mgmt., Inc. v. United States, 527 F.2d at 616 ("courts have declared that victimized principals may obtain non-statutory remedies against outsiders who have knowingly participated in or induced an agent's breach of duty"); City of Findlay v. Pertz, 66 F. at 434.

⁸¹ See O'Melveny & Myers v. FDIC, 512 U.S. 79, 83-85 (1994) (rejecting the argument that federal common law applied to determine whether the knowledge of corporate officers of a federally insured bank should be imputed to the corporation and instead holding that state law applied); Bennett Funding Group, 336 F.3d at 100 ("State law determines whether a right to sue belongs to the debtor in a bankruptcy proceeding."); Mediators, 105 F.3d at 826 (same).

Company would pursue claims against outside parties, New York choice of law principles would control the determination of which state law applies.⁸²

a. Most Significant Contacts Analysis

One line of cases holds that the “most significant contacts” test applies to claims for aiding and abetting a breach of a fiduciary duty (even though the internal affairs doctrine governs the underlying claim for breach of fiduciary duty).⁸³ These cases reason that aiding and abetting claims present “garden-variety tort issues,” rather than corporate governance issues, and, therefore, should be governed by the law of the state with the most significant contacts to the aiding and abetting claim.⁸⁴ If a court applies the test to an aiding and abetting claim against SSB, as the Examiner believes a court likely would, either New York or Mississippi law likely would apply because those states had the most significant contacts with the “spinning” activities.

b. Internal Affairs Doctrine

Another line of cases, however, holds that the “internal affairs doctrine” requires application of the law of the state of incorporation to claims based on a breach of fiduciary

⁸² See Klaxon Co. v. Stentor Electric Mfg. Co., 313 U.S. 487, 496-97 (1941) (forum state’s choice of law rules apply).

⁸³ See Solow v. Stone, 994 F. Supp. 173, 177 (S.D.N.Y. 1998) (“the facts giving rise to the aiding and abetting . . . claims took place, in significant part, in New York”; therefore, New York had the most significant contacts with the claim and New York law applied); Granite Partners L.P. v. Bear, Stearns & Co., 17 F. Supp. 2d 275, 306 n.16 (S.D.N.Y. 1998) (New York law applied where the claim “was brought in a New York federal court by and against entities and individuals located in New York and based on facts alleged to have occurred in New York”).

⁸⁴ See Solow, 994 F. Supp. at 177; Granite Partners, 17 F. Supp. 2d at 306 n.16. The Examiner believe that likely that a court would apply the most significant contacts analysis to determine the applicable law governing in aiding and abetting claim. Nonetheless, because the question of which choice of law test applies is not entirely free from doubt, the Examiner has analyzed the viability of aiding and abetting claims under laws of Mississippi and New York (states where significant contacts took place regarding some of the potential claims) and also under Georgia law (the state of incorporation).

duty and for aiding and abetting the breach (and defenses to such claims).⁸⁵ These cases conclude that, because claims for breach of a fiduciary duty are governed by the law of the state of incorporation, claims for aiding and abetting a breach of fiduciary duty are also governed by the law of the state of incorporation.⁸⁶ If a court applies the test to the SSB aiding and abetting claim, Georgia law would apply because WorldCom was incorporated in Georgia.

3. New York Law

New York law expressly recognizes a cause of action for aiding and abetting the breach of a fiduciary duty.⁸⁷ To prove such a claim, the plaintiff must establish: (1) the breach of a fiduciary duty by another; (2) that the defendant knowingly induced or participated in the breach; and (3) that the plaintiff suffered damages as a result of the breach.⁸⁸ As to whether proof of damages represents an essential element of a claim for aiding and abetting a breach of fiduciary duty, none of the cases applying New York law researched by the Examiner addresses the circumstances in this case where a third-party wrongdoer like Salomon/SSB benefits from a corporate fiduciary's breach of duty, but that breach of duty may not actually have damaged the company. Under these unique circumstances, the Examiner believes the possibility exists that a court applying New York

⁸⁵ See, e.g., BBS Norwalk One, Inc. v. Raccolta, Inc., 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999) (under New York law, issues relating to the internal affairs of a corporation are decided in accordance with the law of the state of incorporation); Lou v. Belzberg, 728 F. Supp. 1010, 1023 (S.D.N.Y. 1990) ("claims of aiding and abetting a breach of a fiduciary duty relates to the internal affairs of a corporation, and are governed by the law of the state of incorporation.").

⁸⁶ See BBS Norwalk One, Inc., 60 F. Supp. 2d at 129; Lou, 728 F. Supp. at 1023.

⁸⁷ See Whitney v. Citibank, N.A., 782 F.2d 1106, 1115 (2d Cir. 1986); S&K Sales Co. v. Nike, Inc., 816 F.2d 843, 847-48 (2d Cir. 1987).

⁸⁸ Whitney, 782 F.2d at 1115; S&K Sales Co., 816 F.2d at 847-48.

law may still require disgorgement on equitable grounds to prevent the wrongdoer from profiting from misconduct.⁸⁹

4. Mississippi Law

While the elements of an aiding-and-abetting claim under Mississippi law are somewhat undefined, Mississippi courts have recognized that a third party who knowingly participates with a corporate officer in a breach of a fiduciary duty may be liable for participating or assisting in that breach.⁹⁰ In Knox Glass, a corporation sued a third party who knowingly participated with the corporation's former president (and other officers and directors of the corporation) in breaching the president's fiduciary duties.⁹¹ Specifically, the third party (a personal friend of the corporation's former president) "actively participated" in a scheme pursuant to which the president usurped corporate opportunities in connection with certain truck leases.⁹² The record established that the third party participated in and profited from this scheme and possessed actual knowledge of the then-president's breach of his fiduciary duties.⁹³ Based on these facts, the court held that the third party came "clearly within the universally accepted rule that one who participates with a fiduciary in a breach of his duties, with knowledge that he is violating his obligations, is liable for the profits received thereby from the corporation."⁹⁴

⁸⁹ See, e.g., Crites, Inc. v. Prudential Ins. Co., 322 U.S. 408, 414 (1944) ("Any profits that might have resulted from a breach of these high standards, including the profits of others who knowingly joined him in pursuing an illegal course of action, would have to be disgorged and applied to the estate."); Curtis v. George J. Meyer Malt & Grain Corp., 6 F.R.D. 444, 448 (W.D.N.Y. 1947) (citing Crites for this proposition).

⁹⁰ Knox Glass Bottle Company v. C.R. Underwood, 89 So. 2d 799 (Miss. 1956).

⁹¹ 89 So. 2d at 823-24.

⁹² Id. at 824.

⁹³ Id.

⁹⁴ Id. at 762. See also Cheatham v. Kem Manufacturing Corp., 372 So. 2d 1085 (Miss. 1978), (affirming holding that defendants aided and abetted the breach of a fiduciary duty by co-defendant who sold products in competition with employer).

5. Georgia Law

No reported Georgia decision has expressly recognized a cause of action for aiding and abetting the breach of a fiduciary duty. In the most recent case to address this issue, however, the Georgia Court of Appeals, in Time Warner Entertainment Company v. Six Flags Over Georgia, LLC, explained:

Although this court has never explicitly recognized a cause of action for aiding and abetting a breach of fiduciary duty, see Munford v. Valuation Research Corp., 98 F.3d 604, 613 (11th Cir. 1996), we have at least twice implicitly acknowledged that such claims are viable. See Williams v. Svs. Corp., 218 Ga. App. 10, 459 S.E.2d 621 (1995), and U3S Corp. v. Parker, 202 Ga. App. 374, 380(4), 414 S.E.2d 513 (1991) (“issues remain to be tried” on the count alleging two defendants “aided and abetted the other two defendants’ breach of fiduciary duty”). We have explicitly “acknowledged an aiding and abetting cause of action in torts involving violence, the sale of unregistered securities, breaches of covenants with employment contracts, and fraudulent conveyances.” Munford v. Valuation Research Corp., 98 F.3d at 613. And, we have also recognized an aiding and abetting cause of action in many cases involving the misapplication of trust funds. See, e.g., Adams v. McGehee, 211 Ga. 498, 500(4), 86 S.E.2d 525 (1955). Further, other jurisdictions have specifically found that such a cause of action is implicit in their existing case law governing the liability of persons acting in concert. See, e.g., Granewich v. Harding, 329 Or. 47, 54-58, 985 P.2d 788 (1999); Holmes v. Young, 885 P.2d 305 (Colo. App. 1994). Were we required to address this issue, we could follow suit, finding that such a basis for liability is implicit in OCGA § 51-12-30, pertaining to the joint liability of one who procures an actionable wrong.⁹⁵

On the other hand, in a ruling that preceded the decision in Time Warner, the United States Court of Appeals for the Eleventh Circuit predicted that Georgia courts would not recognize a claim for aiding and abetting a breach of a fiduciary duty.⁹⁶ In Munford, the Eleventh Circuit opined that “Georgia courts would not recognize such a cause of action”

⁹⁵ 537 S.E.2d 397, 408 (Ga. Ct. App. 2000), vacated on other grounds, 534 U.S. 801 (2001), opinion reinstated, in part, 563 S.E.2d 178 (Ga. Ct. App. 2002).

⁹⁶ Munford, Inc. v. Valuation Research Corporation, 98 F.3d 604, 613 (11th Cir. 1996).

because [t]o hold otherwise . . . would enlarge the fiduciary obligations beyond the scope of a confidential or special relationship.”⁹⁷

Thus, there is no controlling Georgia case or statute on point and the elements of such a claim under Georgia law remain undefined. Nonetheless, as noted in Time Warner, several Georgia courts have implicitly recognized a cause of action for aiding and abetting a breach of a fiduciary duty.

F. The Business Judgment Rule and Entire Fairness Doctrine

1. Business Judgment Rule

Georgia courts apply the business judgment rule in determining whether directors and officers have complied with their fiduciary obligations to the corporation. The business judgment rule shields directors and officers from liability “when they make good faith business decisions in an informed and deliberate manner.”⁹⁸ Thus, “courts will not interfere

⁹⁷ 98 F.3d at 613.

⁹⁸ Munford, Inc. v. Valuation Research Corp., 98 F.3d at 611; see also Aronson v. Lewis, 473 A.2d at 812 (“It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”). See Omni Bank v. United Southern Bank, 607 So. 2d at 85 (discussing Mississippi business judgment rule); see also ABA Model Business Corporation Act § 8.42 requiring officers to discharge duties in “good faith” with the care of an “ordinarily prudent person” but permitting the officer to rely on “information, opinions, reports, or statements” prepared by officers or employees whom the officer reasonably believes to be competent or by providing professional services if the officer believes that the services are within the professional competence of that person); ALI Principles of Corporate Governance § 4.01 (officer whose business judgment is “in good faith” does not breach his duty if he is informed with respect to the business judgment and actually believes the judgment is in the best interest of the corporation).

A leading treatise on Delaware corporate law sets forth a cogent explanation of the business judgment rule: “A decision by a board of directors (i) in which the directors possess no direct or indirect personal interest, (ii) which is made (a) with reasonable awareness of all reasonably available material information, and (b) after prudent consideration of the alternatives, and (iii) which is in good faith furtherance of a rational corporate purpose, will not be interfered with by the courts . . . even if the decision appears to have been unwise or have caused loss to the corporation or its stockholders.” David A. Drexler, Lewis S. Black, Jr., A. Gilchrist Sparks, III, DELAWARE CORPORATION LAW AND PRACTICE, § 15.03 (2002). Omni Bank v. United Southern Bank, 607 So. 2d at 85.

in matters involving merely the judgment of the majority in exercising control over corporate affairs.”⁹⁹

Once a plaintiff proves that a director or officer has breached any of his or her fiduciary duties to the corporation, be it the duty of care, the duty of loyalty or the duty of good faith, the director or officer loses the presumption of the business judgment rule.¹⁰⁰ Rather, at this point, the director or officer bears the burden of proving the entire fairness of the transaction.¹⁰¹

2. Entire Fairness Doctrine

“Entire fairness” involves a two-prong analysis that looks at the fairness of both the process and price of the transaction.¹⁰² As the court noted in Weinberger:

The former embraces the questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.¹⁰³

⁹⁹ Tallant v. Executive Equities, Inc., 209 S.E.2d 159, 161 (Ga. 1974).

¹⁰⁰ See Munford, Inc. v. Valuation Research Corp., 98 F.3d at 611 (“The business judgment rule protects directors and officers from liability when they make good faith business decisions in an informed and deliberate manner.”); Millsap v. American Family Corp., 430 S.E.2d at 388; Orman v. Cullman, 794 A.2d at 20. This does not mean that liability exists. See Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

¹⁰¹ Solomon v. Armstrong, 747 A.2d at 1112. This is an exacting standard, the application of which is sometimes thought to be determinative of whether liability will be imposed. Pereira v. Cogan, 294 B.R. at 519; Solomon v. Armstrong, 747 A.2d at 1113; Nixon v. Blackwell, 626 A.2d at 1376.

¹⁰² See Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); Solomon v. Armstrong, 747 A.2d at 1112.

¹⁰³ Weinberger v. UOP, Inc., 457 A.2d at 711 (citations omitted).

If the defendant director or officer can prove that the process was fair, such as “through the board’s use of a well-functioning committee of independent directors,” the burden shifts back to the plaintiff to prove that the transaction at issue was not entirely fair.¹⁰⁴

In Pereira v. Cogan, the court held that both directors and officers breached the duty of care, among other fiduciary duties that they breached, by allowing loans to the CEO without putting a process in place to ensure Board approval of the loans. Specifically, the court stated that:

There was no process in place for the loans to be approved and, in fact, the officers and directors for the most part could only determine the existence of the loans by reading the daily cash reports. At no time did any of the Defendants attempt to (1) set up a procedure by which loans would be approved; (2) seek to insure that Cogan had put up collateral or was otherwise able to pay back the loans; (3) investigate the loans to insure that they were fair to the company; or (4) even discuss whether such measures should be put into place. As a result, there was not fair process.

The Defendants have also failed to establish fair price. The terms of the loans were set by Cogan, rather than Trace, at extremely favorable rates to him. Thus, all the Defendants are liable for the Cogan loans.¹⁰⁵

G. The Exculpatory Clause

Georgia’s Corporation Code authorizes the inclusion in articles of incorporation of so-called exculpatory provisions:

eliminating or limiting the liability of a director to the corporation or its shareholders for monetary damages for any action taken, or any failure to take any action, as a director, except liability:

- (A) For any appropriation, in violation of his or her duties, of any business opportunity of the corporation;
- (B) For acts or omissions which involve intentional misconduct or a knowing violation of law;

¹⁰⁴ Solomon v. Armstrong, 747 A.2d at 1113.

¹⁰⁵ Id. at 537.

- (C) For the types of liability set forth in Code Section 14-2-832; or
- (D) For any transaction from which the director received an improper personal benefit,

provided that no such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.¹⁰⁶

WorldCom's articles of incorporation contain such a provision in Article Ten, which provides:

No director of the Corporation shall be liable to the Corporation or to its shareholders for monetary damages for breach of duty of care or other duty as a director, except for liability (i) for any appropriation, in violation of his duties, of any business opportunity of the Corporation; (ii) for acts or omissions which involve intentional misconduct or a knowing violation of the law; (iii) for the types of liability set forth in Section 14-2-832 [distributions] of the Revised Georgia Business Corporation Code; or (iv) for any transaction from which the director received an improper personal benefit.

By its plain language, this provision protects only directors, not officers, from liability to the corporation or its shareholders. Further this exculpatory clause does not protect directors against claims alleging usurpation of corporate opportunities or intentional misconduct, among other exceptions.

Some cases suggest that Article Ten may not bind the Company because of its status as a debtor-in-possession. A debtor-in-possession is a different legal entity than the bankrupt corporation, and it has the same rights, powers and duties as a trustee.¹⁰⁷ While a bankruptcy trustee stands in the shoes of the debtor, the trustee also represents the interests of the

¹⁰⁶ Ga. Code Ann. § 14-2-202(b)(4).

¹⁰⁷ 11 U.S.C. § 1107(a); Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 560 (3d Cir. 2003); In re Vienna Park Properties, 976 F.2d 106, 110 (2d Cir. 1992).

debtor's creditors.¹⁰⁸ The U.S. District Court for the Southern District of New York has held that a bankruptcy trustee was not barred by a similar exculpatory provision in a Delaware corporation's articles of incorporation from pursuing breach of fiduciary duty claims against the corporation's directors.¹⁰⁹ The court noted that the suit by the bankruptcy trustee benefited the corporation's creditors. Because those creditors were not parties to the articles of incorporation, the court ruled that they could not be bound by the terms of that contract.¹¹⁰

H. The Plan of Reorganization

The Company's Plan of Reorganization preserves claims and causes of action after the Company emerges from bankruptcy. Pursuant to the Plan of Reorganization, all causes of action (with one exception, unrelated to any corporate governance claims) are reserved:

10.07. Avoidance Actions. From and after the Effective Date, the Reorganized Debtors shall have the right to prosecute any avoidance or recovery actions under sections 510, 542 through 551, and 553 of the Bankruptcy Code that belong to the Debtors or Debtors in Possession other than the Intermedia Avoidance Claims, which shall be extinguished pursuant to Section 5.06(a) of the Plan.

10.08. Retention of Causes of Action/Reservation of Rights.

(a) Nothing contained in the Plan or the Confirmation Order shall be deemed to be a waiver or the relinquishment of any rights or Causes of Action that the Debtors or the Reorganized Debtors may have or which the Reorganized Debtors may choose to assert on behalf of their respective estates under any provision of the Bankruptcy Code or any applicable nonbankruptcy

¹⁰⁸ See Henry Ansbacher & Co. v. Klebanow, 362 F.2d 569, 570 (2d Cir. 1966); In re Martin Custom Made Tires Corp., 108 F.2d 172, 173 (2d Cir. 1939); Pereira v. Cogan, 294 B.R. at 514; In re Ben Franklin Retail Stores, 2000 WL 28266, *7 (N.D. Ill. Jan. 12, 2000).

¹⁰⁹ See Pereira v. Cogan, 2001 WL 243537, *11 (S.D.N.Y. March 8, 2001) (applying Delaware law). In Pereira, the court agreed with the bankruptcy trustee's argument "that the Exculpatory Clause only shields the Defendants from liability to the corporation or its shareholders and . . . that the clause is inapplicable by its own terms because he has brought this action for the benefit of . . . creditors." Id. at 9. The court further concluded that "the Exculpatory Clause, both by its terms and in accordance with the underlying policy rationale allocates the risk of loss between the parties to the articles of incorporation, i.e., the shareholders and directors. The clause does not allocate the risk with respect to third parties, such as the creditors in whose benefit the Trustee has brought the instant suit." Id. at *11.

¹¹⁰ Id. at *10.

law, including, without limitation, (i) any and all Claims against any person or entity, to the extent such person or entity asserts a crossclaim, counterclaim, and/or Claim for setoff which seeks affirmative relief against the Debtors, the Reorganized Debtors, their officers, directors, or representatives, and (ii) the turnover of any property of the Debtors' estates.

(b) Nothing contained in the Plan or the Confirmation Order shall be deemed to be a waiver or relinquishment of any Claim, Cause of Action, right of setoff, or other legal or equitable defense which the Debtors had immediately prior to the Commencement Date, against or with respect to any Claim left unimpaired by the Plan. The Reorganized Debtors shall have, retain, reserve, and be entitled to assert all such Claims, Causes of Action, rights of setoff, and other legal or equitable defenses which they had immediately prior to the Commencement Date fully as if the Chapter 11 Cases had not been commenced, and all of the Reorganized Debtors' legal and equitable rights respecting any Claim left unimpaired by the Plan may be asserted after the Confirmation Date to the same extent as if the Chapter 11 Cases had not been commenced.

Debtors' Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, dated April 14, 2003. Thus, the reorganized Company will retain the right to assert corporate governance claims when it emerges from bankruptcy.

I. The Indemnification Provision in the WorldCom Articles of Incorporation

Article Twelve of WorldCom's articles of incorporation sets forth an indemnification provision for directors (but not officers), stating in pertinent part that:

The Corporation shall indemnify a director against reasonable expenses and liability incurred by him, and shall advance expenses upon receipt from the director of the written affirmation and repayment authorization required by section 14-2-853 of the Georgia Business Corporation code, provided, however, that the Corporation shall not indemnify a director for any liability incurred by a director if he failed to act in a manner he believed in good faith to be in or not opposed to the best interests of the Corporation, or to have improperly received a personal benefit or, in the case of any criminal proceeding, if he had reasonable cause to believe his conduct was unlawful, or in the case of a proceeding by or in the right of the Corporation, in which he was adjudged liable to the Corporation, unless a court shall determine that the director is fairly and reasonably entitled to

indemnification in view of all the circumstances, in which case the director shall be indemnified for reasonable expenses incurred.¹¹¹

(emphasis supplied.) By its terms, this provision does not protect a Director from liability “if [he or she] failed to act in a manner . . . believed in good faith to be in or not opposed to the best interests of the Corporation.” In other words, no right to indemnification exists in the event of a breach of a Director’s fiduciary duties of loyalty or good faith.

Moreover, the clause does not provide for indemnification “in the case of a proceeding by or in the right of the Corporation, in which [a director] was adjudged liable to the Corporation, unless a Court shall determine that the director is fairly and reasonably entitled to indemnification in view of all the circumstances.” This clause indicates that Directors would not receive automatic indemnification at the beginning of any lawsuit brought by the Company against them. Rather, the issue of indemnification would have to await adjudication of WorldCom’s claims against the Directors, and given the substantial evidence supporting these claims, the Examiner believes it unlikely that a court would determine that the Directors had a right to indemnification “in view of all the circumstances.”

J. Statute of Limitations

Under Georgia law, there is a four-year statute of limitations for claims arising out of breaches of fiduciary duties.¹¹² However, this limitations period may be tolled until the breach is discovered. For example, in General Information Processing Systems, Inc. v.

¹¹¹ Article X, Section 2 of WorldCom’s By-Laws provides that WorldCom “shall indemnify and advance expenses to its directors to the fullest extent permitted under, and in accordance with, the corporation’s Articles of Incorporation and the applicable provisions of Part 5 of Article 8 of the Georgia Business Corporation Code.” (Emphasis added.) Even were this provision determined to be more beneficial to WorldCom’s directors than Article Twelve of WorldCom’s Articles of Incorporation, this would not assist the Directors. Article XII of the By-Laws provides that the Articles of Incorporation shall govern in the event of inconsistencies between the By-Laws and the Articles of Incorporation.

¹¹² Ga. Code Ann. § 14-2-831(b).

Sweeney,¹¹³ the deceased husband of a corporation's president assigned the patent rights of a computer program to the corporation.¹¹⁴ During the settlement of the patent litigation, the president assigned the patent rights, for which she received money as an individual, as the executrix of her husband's estate, and on behalf of the corporation.¹¹⁵ In the shareholders' derivative action, which was filed for an accounting, the president asserted that the claims were barred by the four-year statute of limitation under Section 14-2-831(b).¹¹⁶ The court reversed an order granting the president's motion for partial summary judgment because the president failed to comply with her fiduciary duty, as an officer, to the corporation and its shareholders by remaining silent as to the litigation settlement and any misappropriation.¹¹⁷ Further, some evidence suggested that this breach of fiduciary duty was not discovered until less than four years preceding the filing of the action.¹¹⁸ Under these circumstances, the court found that a genuine issue of material fact existed as to the tolling of the statute of limitations.¹¹⁹ Accordingly, it appears the statute of limitations pertaining to corporate governance claims in Georgia may be tolled if the corporation does not discover the breach of fiduciary duty or similar wrongdoing due to concealment by the officer or director in question.

Furthermore, the Bankruptcy Code provides that where "applicable non-bankruptcy law" establishes a time "within which the debtor may commence an action," and the period did not expire before the filing of the bankruptcy petition, the Company "may commence

¹¹³ 335 S.E.2d 722 (1985).

¹¹⁴ Id. at 723.

¹¹⁵ Id.

¹¹⁶ Id.

¹¹⁷ Id. at 724.

¹¹⁸ Id.

¹¹⁹ Id.

such action only before the later of: (1) the end of such period, including any suspension of any such period occurring on or after the commencement of the case; or (2) two years after the Order for Relief.”¹²⁰ In other words, to the extent claims are not time-barred prior to bankruptcy, those claims will be preserved for at least two years.

K. Available Remedies

1. Disgorgement

Directors or officers of a Georgia corporation who violate their fiduciary duties to the corporation may be compelled to forfeit any compensation earned during the period in which the violations occurred.¹²¹ Should the agent prove to be faithless, the employer is entitled to recover the compensation paid to the faithless agent during the period of the breach.¹²² “It does not ‘make any difference that the services were beneficial to the principal, or that the principal suffered no provable damage as a result of the breach of fidelity by the agent.’”¹²³

¹²⁰ 11 U.S.C. § 108(a).

¹²¹ See, e.g., Ga. Code Ann. § 10-6-31 (“an agent who shall have discharged his duty shall be entitled to his commission and all necessary expenses incurred about the business of his principal. If he shall have violated his engagement, he shall be entitled to no commission.”); E.H. Crump Co. v. Millar, 391 S.E.2d 775, 776-77 (Ga. Ct. App. 1990); Vinson v. E.W. Buschman Co., 323 S.E.2d 204, 207 (Ga. Ct. App. 1984). See also Phansalkar v. Andersen Weinroth & Co., L.P., 344 F.3d 184, 209 (2d Cir. 2003) (interpreting New York law); Riggs Inv. Management Corp. v. Columbia Partners, LLC, 966 F. Supp. 1250 (D.D.C. 1997) (principal entitled to return of compensation paid to former CEO during period that CEO breached duty of loyalty); Royal Carbo Corp. v. Flameguard, Inc., 645 N.Y.S.2d 18 (App. Div. 1996) (affirming forfeiture of fees paid during period of disloyalty); Short v. Columbus Rubber and Casket Co., Inc., 535 So. 2d 61, 68 (Miss. 1988); accord Restatement (Second) of Agency § 469. An employee is an agent of his employer and, as such, “is at all times bound to exercise the utmost good faith and loyalty in the performance of his duties.” Phansalkar v. Andersen Weinroth & Co., L.P., 344 F.3d 184, 200 (2d Cir. 2003) (citation omitted).

¹²² Id.

¹²³ Id. (citation omitted).

2. Constructive Trust

Another remedy for breach of fiduciary duties is the imposition of a constructive trust.¹²⁴ The purpose of a constructive trust is to prevent unjust enrichment.¹²⁵ A constructive trust is available only where no adequate remedy exists at law and where the property at issue is traceable.¹²⁶ In instances where funds potentially subject to a constructive trust have been commingled with other funds of the wrongdoer, “the beneficiary of the trust may recover to the extent of the lowest balance that the account reached after the commingling.”¹²⁷

3. Other Equitable Remedies

Equity provides additional relief for breaches of fiduciary duty by a corporate officer or director, including disgorgement.¹²⁸ For example, in Vinson v. E.W. Buschman, Corp., a jury awarded the plaintiff relief equal to the profits earned by the disloyal employee’s competing business, plus all commissions earned during the period that the competing business existed. The court upheld the trial court’s denial of the defendant’s motion for a

¹²⁴ See, e.g., Voest-Alpine Trading USA Corp. v. Vantage Steel Corp., 919 F.2d 206, 218 (3d Cir. 1990 (applying Pennsylvania law)); Schneidman v. Tollman, 593 N.Y.S.2d 23, 24 (App. Div. 1993). Georgia law expressly recognizes constructive trusts. Ga. Code Ann. § 53-12-93(a) (defining) a constructive trust as “a trust implied whenever the circumstances are such that the person holding legal title to the property, either from fraud or otherwise, cannot enjoy the beneficial interest in the property without violating some established principle of equity.”); see also Lathem v. Hestley, 514 S.E.2d 440, 442 (Ga. 1999); Edwards v. Edwards, 482 S.E.2d 701, 702 (Ga. 1997).

¹²⁵ Voest-Alpine Trading USA Corp. v. Vantage Steel Corp., 919 F.2d at 218; Ragsdale v. South Fulton Machine Works, Inc., 211 B.R. 411, 418 (N.D. Ga. 1997); Phoenix Airline Services, Inc. v. Metro Airlines, Inc., 390 S.E.2d at 225; Nash v. Schock, 1998 WL 474161, *2 (Del. Ch. July 23, 1998); Schneidman v. Tollman, 593 N.Y.S.2d at 24 (applying New York law).

¹²⁶ For example, in Simonds v. Simonds, 408 N.Y.S.2d 359 (N.Y. 1978), the separation agreement between the plaintiff and the decedent required the decedent to maintain in effect, with the plaintiff as the beneficiary, life insurance policies then in existence or, if those policies were canceled or allowed to lapse, policies of equal value. The decedent subsequently remarried and replaced those policies with three new life insurance policies. The New York Court of Appeals permitted imposition of a constructive trust on the proceeds from the latter policies, noting “[t]he separation agreement provides nexus between plaintiff’s rights and the later acquired policies.” 408 N.Y.S.2d at 362; see also Ragsdale v. South Fulton Machine Works, Inc., 211 B.R. at 418.

¹²⁷ Id.

¹²⁸ See Vinson v. E.W. Buschman Corp., 323 S.E.2d at 309-10. See also Gomez v. Bicknell, 756 N.Y.S.2d 209 (2002); Pepe & Hazard v. Jones, 2002 Conn. Super. LEXIS 3146, *5 (Sept. 26, 2002).

directed verdict.¹²⁹ “[T]he remedy for breach of fiduciary duty is not only to compensate for the wrongs but to prevent them.”¹³⁰ In the event a director breaches a fiduciary duty by usurping a corporation opportunity, another measure of relief for such breach may include the profits the corporation would have earned absent the diverted corporate opportunity.¹³¹ The difficulty of calculating these profits does not foreclose their availability. Specifically, “[m]ere difficulty in fixing their exact amount, where proximately flowing from the alleged injury, does not constitute a legal obstacle in the way of their allowance, when the amount of the recovery comes within that authorized with reasonable certainty by the legal evidence submitted.”¹³²

4. Legal Damages

A corporation may also be entitled to compensatory damages for a director’s or officer’s breach of fiduciary duties.¹³³ Punitive damages may also be available.¹³⁴

5. Particular Remedies Against Aiders and Abettors

One who aids and abets the breach of a fiduciary duty is generally jointly and severally liable with the party who breached that duty.¹³⁵ Thus, the corporation entitled to the

¹²⁹ Id. at 310.

¹³⁰ Gomez v. Bicknell, 756 N.Y.S.2d at 214.

¹³¹ See, e.g., id.

¹³² Georgia Ports Authority v. Servac International, 415 S.E.2d 516, 519 (1992).

¹³³ Caswell v. Jordan, 362 S.E.2d 769, 774 (1987); Davis v. Ben O’Callaghan Co., 227 S.E.2d 837, 841 (1976), rev’d in part, 232 S.E.2d 53 (1977) (“There are three elements of a tort: existence of a legal duty other than contractual from defendant to plaintiff, breach of that duty, and damage as a proximate result.”); Omni Bank v. United Southern Bank, 607 So. 2d at 84 (“An agent is liable to his principal for losses proximately caused when the agent substantially deviates from his principal’s instructions.”); cf. Holland v. Holland Heating & Air Conditioning, Inc., 423 S.E.2d 238 (1993).

¹³⁴ See Kilburn v. Young, 569 S.E.2d 879, 883 (2002) (“A breach of fiduciary duties is sufficient to support an award of punitive damages” (citations omitted.)).

¹³⁵ See Ga. Code Ann. § 51-12-30; Jackson v. Smith, 254 U.S. 586, 589 (1921); Irving Trust Co. v. Deutsch, 73 F.2d 121, 125 (2d Cir. 1934); United States v. Kenealy, 646 F.2d 699, 705-06 (1st Cir. 1981); Miller v. Steinbach, 268 F. Supp. 255, 281 (S.D.N.Y. 1967); cf. In re Albion Disposal, Inc., 152 B.R. 794, 824-25

loyalty and good faith of its directors and officers generally may seek the same damages and remedies from the aider and abettor as it may seek from the director or officer who breached those duties. Thus, under principles of equity, a court may require the aider and abettor to forfeit the fees or other monetary benefits it received in connection with the underlying breach of fiduciary duty.¹³⁶ At least in some jurisdictions, that the principal may not have suffered monetary damage is of no moment.¹³⁷ The injury is that “it necessarily creates a conflict of interest and tends to subvert the agent’s loyalty.”¹³⁸

(W.D.N.Y. 1993) (that others who participate in another’s breach of fiduciary duty are jointly and severally liable is a “theme [that] recurs throughout the cases of high authority”).

¹³⁶ See Crites, Inc. v. Prudential Ins. Co., 322 U.S. 408, 414 (1944) (“Any profits that might have resulted from a breach of these high standards, including the profits of others who knowingly joined him in pursuing an illegal course of action, would have to be disgorged and applied to the estate.”); Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d at 819-24 (third party who assisted corporate officer in breaching fiduciary duty “comes clearly within the universally accepted rule that one who participates with a fiduciary in a breach of his duties, with knowledge that he is violating his obligations, is liable for the profits received thereby from the corporation.”); Continental Mgmt., Inc. v. United States, 527 F.2d at 616 (“courts have declared that victimized principals may obtain non-statutory remedies against outsiders who have knowingly participated in or induced an agent’s breach of duty”); City of Findlay v. Pertz, 66 F. 427(6th Cir. 1896); cf. Curiale v. Capolino, 1995 WL 150033 at *21.

¹³⁷ Continental Mgmt., Inc. v. United States, 527 F.2d at 617; City of Findlay, 66 F. at 434.

¹³⁸ Continental Mgmt., Inc. v. United States, 527 F.2d at 617; see also City of Findlay, 66 F. at 435 (“The conflict created between duty and interest is utterly vicious, unspeakably pernicious, and an unmixed evil.”).

APPENDIX B: IMPUTATION -- STANDING AND IN PARI DELICTO

A. Introduction

Under the doctrine of imputation, the unlawful conduct of a corporate agent (such as a corporate officer) acting within the scope of employment may be imputed to the corporate principal.¹ Where an outside party has aided and abetted the breach of a fiduciary duty by a corporate agent, the imputation of the agent's misconduct to the corporation may, under certain circumstances, give rise to a defense on behalf of the outside party.² In addition, the imputation defense, may also apply under certain circumstances to a claim by a corporation that a provider of professional services committed malpractice or negligence.³ This defense is substantially weaker in the context of malpractice and/or negligence claims, and has even been rejected as a complete defense in comparative negligence jurisdictions.⁴ Because the imputation defense attempts to shift responsibility from third-party wrongdoers to corporate fiduciaries engaged in misconduct, it has no application to claims against directors or officers who breached their fiduciary duties to the corporation.⁵ SSB, Arthur Andersen, and KPMG potentially may assert imputation as a defense to WorldCom's potential claims against them.

In the bankruptcy context, courts have applied the imputation defense under two legal theories: (1) lack of standing (under the theory that the claim actually belongs to the

¹ See, e.g., Wight v. BankAmerica Corp., 219 F.3d 79, 86 (2d Cir. 2000); Shearson Lehman Hutton v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991); accord Restatement (Second) Agency, § 9 (principal is considered to have knowledge of facts of which his agent has knowledge).

² Wight, 219 F.3d at 86; In re Bennett Funding Group, Inc., 336 F.3d 94, 99-100 (2d Cir. 2003).

³ See Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995); Bennett Funding Group, 336 F.3d 94, 99-100 (2d Cir. 2003).

⁴ See Allard v. Arthur Andersen LLP, 924 F. Supp. 488, 495 (S.D.N.Y. 1996) (applying New York and Michigan law).

⁵ See In re Walnut Leasing Co., No. 99-526, 1999 WL 729267 (E.D. Pa., Sept 08, 1999) (the "in pari delicto [defense] will not preclude the claims against corporate insiders."); In re Granite Partners L.P., 194 B.R.318, 332 (S.D.N.Y. 1996) (same).

creditors of the bankrupt corporation rather than to the corporation that participated in the wrongdoing); or (2) the affirmative defense of in pari delicto (under the theory that the corporation, through its agent, is equally culpable for the wrongdoing).⁶ Thus, some jurisdictions treat imputation as a standing question, while others treat the issue in the context of the affirmative defense of in pari delicto.⁷

Whether treated as a standing issue or as an affirmative defense, two recognized exceptions exist to the imputation doctrine:⁸ (1) the “adverse interest” exception, applicable where corporate agents acted adversely to the interests of the corporation, in such a manner that they “have totally abandoned the principal’s interest;”⁹ and (2) the “innocent decisionmaker” exception, applicable where there existed within the corporation an officer or director who could have prevented the wrongdoing had he or she been aware of the misconduct.¹⁰ In addition, some courts have concluded that the in pari delicto defense does

⁶ See Bennett Funding Group, 336 F.3d at 99-100 (bankruptcy trustee, who stands in the shoes of the debtor corporation, has no standing to pursue claims against third-parties); Official Committee of the Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand LLP, 322 F.3d 147, 156 (2d Cir. 2003) (concluding that the in pari delicto defense prevented the corporation from pursuing claims against certain third-parties).

⁷ In the Second Circuit, these imputation principles are known as the Wagoner Rule, derived from the decision in Shearson Lehman Hutton v. Wagoner, 944 F.2d 144 (2d Cir. 1991). In Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., the court explained that whether the equitable defense of in pari delicto applies or whether standing to sue exists are properly treated as two separate questions. The standing inquiry revolves around whether a “case or controversy” exists under Article III of the Constitution; whether the defense of in pari delicto bars a claim is a separate question that goes to the merits of the case. See Official Committee of Unsecured Creditors v. RF Lafferty & Co., Inc., 267 F.3d 340, 346-47 (3d Cir. 2001).

⁸ Wight, 219 F.3d at 87; Bennett Funding Group, 336 F.3d at 100.

⁹ Bennett Funding Group, 336 F.3d at 100 (the act of the agent will not be charged to the corporation if the agent is actually “committing a fraud for his own benefit.”); Wight, 219 F.3d at 87 (allegations that bank was adversely dominated by corrupt management who acted in their own interest and not in the interest of the bank were sufficient at the pleading stage to trigger the adverse interest exception); Bankr. Services, Inc. v. Ernst & Young (In re CBI Holding Co.), 247 B.R. 341, 365 (Bankr. S.D.N.Y. 2000).

¹⁰ Bennett Funding Group, 336 F.3d at 101 (exception applies where there existed an innocent decisionmaker who had the power to correct or stop the fraud had he known of it); Securities Investor Protection Corp. v. BDO Seidman, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999) (exception did not apply where complaint failed to allege existence of an innocent decisionmaker who could have stopped the unlawful conduct). Stated alternatively, this exception requires that “all relevant decisionmakers” must be involved in the fraud for the imputation to occur. See Bennett Funding Group, 336 F.3d 94, 101.

not apply to a claim brought by a bankruptcy trustee because “the defense of in pari delicto loses its sting when the person who was in pari delicto is eliminated.”¹¹ Even where the defense could apply, courts often reject resolving an imputation defense as a matter of law because, generally, genuine issues of material fact exist that the fact finder must resolve.¹²

The existence of standing to sue may also turn on the identity of the plaintiff and the nature of the allegations in the complaint. In some jurisdictions, a bankruptcy trustee or debtor-in-possession has standing to assert just those claims held by the bankrupt corporation and not claims on behalf of the estate’s creditors.¹³ Likewise, some courts have held that an Official Creditors Committee stands “in the shoes of the bankrupt [company].”¹⁴ In other jurisdictions, however, a bankruptcy trustee or debtor-in-possession has standing to pursue claims based on injuries that occurred to creditors generally, rather than to any particular creditors of the bankrupt corporation.¹⁵ In addition, some courts have adopted the position that imputation of a corporate agent’s wrongdoing should not prohibit a bankruptcy trustee or debtor-in-possession from suing based on the theory that the persons who committed the wrong have been removed from the corporation.¹⁶

¹¹ Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1996).

¹² See Smith v. Arthur Andersen LLP, 175 F. Supp. 2d 1180, 1199-1200 (D. Az. 2001).

¹³ Bennett Funding Group, 336 F.3d at 99-100.

¹⁴ Color Tile, 322 F.3d at 156.

¹⁵ See Feltman, 122 B.R. 466 (S.D. Fla. 1990).

¹⁶ See Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995) (“The defense of in pari delicto loses its sting when the person who is in pari delicto is eliminated.”). Furthermore, some courts also distinguish, for purposes of an in pari delicto defense, between a receiver of an insolvent company and a trustee appointed under the Bankruptcy Code. While a receiver may be an “innocent successor” to the in pari delicto corporation because he did not engage in the wrongdoing that caused the corporation harm, the bankruptcy trustee, under Section 541 of the Bankruptcy Code, merely succeeds to the debtor’s interest in the bankruptcy estate as of the time of the commencement of the bankruptcy case and, thus, the trustee’s interest can be no greater than the debtor’s interest. See Lafferty, 267 F.3d at 358.

B. Choice of Law

State law governs whether the wrongful conduct of corporate agents should be imputed to the corporate principal.¹⁷ The strength of the imputation defense varies among jurisdictions, making the choice of law issue important in determining the potential merits of this defense. Assuming that the United States Bankruptcy Court for the Southern District of New York would be the forum in which such claims on behalf of WorldCom against outside parties would proceed, New York choice-of-law principles would control the determination of which state's law applies to the imputation defense.¹⁸ Federal cases are divided as to the appropriate choice-of-law test to apply to an imputation defense under New York law.

1. Most Significant Contacts Analysis

One line of cases holds that the “most significant contacts” test applies to aiding and abetting claims and defenses to such claims (even though the internal affairs doctrine, which is discussed below, governs the underlying claim for breach of fiduciary duty).¹⁹ These cases reason that aiding-and-abetting claims present “garden-variety tort issues,” rather than corporate governance issues, and therefore should be governed by the law of the state with the most significant contacts to the aiding-and-abetting claim.²⁰

¹⁷ See O’Melveny & Myers v. FDIC, 512 U.S. 79, 84-85 (1994) (rejecting the argument that federal common law applied to determine whether the knowledge of corporate officers of a federally insured bank should be imputed to the corporation and instead holding that state law applied); Bennett Funding Group, 336 F.3d at 100 (“State law determines whether a right to sue belongs to the debtor in a bankruptcy proceeding.”); In re Mediators, Inc., 105 F.3d 822, 826 (2d Cir. 1997) (same).

¹⁸ See Klaxon Co. v. Stentor Electric Mfg. Co., 313 U.S. 487, 496-97 (1941) (forum state’s choice-of-law rules apply).

¹⁹ See Solow v. Stone, 994 F. Supp. 173, 177 (S.D.N.Y. 1998) (“the facts giving rise to the aiding-and-abetting . . . claims took place, in significant part, in New York;” therefore, New York had the most significant contacts with the claim and New York law therefore applied); Granite Partners L.P. v. Bear, Stearns & Co., 17 F. Supp. 2d 275, 306 n.16 (S.D.N.Y. 1998) (New York law applied where the claim “was brought in a New York federal court by and against entities and individuals located in New York and based on facts alleged to have occurred in New York”).

²⁰ See Solow, 994 F. Supp. at 177; Granite Partners, 17 F. Supp. 2d at 306 n.16.

2. Internal Affairs Doctrine

Another line of cases holds that the “internal affairs doctrine” requires application of the law of the state of incorporation to claims based on a breach of fiduciary duty and for aiding-and-abetting the breach and to defenses against such claims.²¹ These cases conclude that, because the law of the state of incorporation governs claims for breach of a fiduciary duty, claims for aiding-and-abetting a breach of fiduciary duty are also governed by the law of the state of incorporation.²²

3. Choice of Law Analysis Regarding Imputation Defense

a. The SSB “Spinning” Claims

Either Georgia law, New York law, or Mississippi law would likely apply to a claim against SSB for aiding-and-abetting Mr. Ebbers’ breaches of his fiduciary duties in connection with the IPO allocations and other financial favors provided to Mr. Ebbers. If the cases applying the internal affairs doctrine correctly predict New York law as to the applicable choice-of-law test, then Georgia law would govern claims against SSB for aiding-and-abetting Mr. Ebbers’ breach of his fiduciary duty because WorldCom was incorporated under Georgia law.²³

Under the “most significant contacts” analysis, however, “the law of the jurisdiction having the greatest interest in the litigation will be applied” and “the facts or contacts which

²¹ See, e.g., BBS Norwalk One, Inc. v. Raccolta, Inc., 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999) (under New York law, issues relating to the internal affairs of a corporation are decided in accordance with the law of the state of incorporation); Lou v. Belzberg, 728 F. Supp. 1010, 1023 (S.D.N.Y. 1990) (“Claims of aiding-and-abetting a breach of a fiduciary duty relates [sic] to the internal affairs of a corporation, and are governed by the law of the state of incorporation.”)

²² See BBS Norwalk One, 60 F. Supp. 2d at 129; Lou, 728 F. Supp. at 1023.

²³ See BBS Norwalk One, 60 F. Supp. 2d at 129; Lou, 728 F. Supp. at 1023.

obtain significance in defining State interests are those which relate to the purpose of the particular law.”²⁴ To determine the state with the greatest interest,

"[t]wo separate inquiries are . . . required . . . (1) what are the significant contacts and in which jurisdiction are they located; and, (2) whether the purpose of the law is to regulate conduct or allocate loss.”²⁵

Typically, "the significant contacts are, almost exclusively, the parties' domiciles and the locus of the tort."²⁶ “The respective importance of each of those contacts is determined by the nature of the law in question. Where the parties are domiciled in different states, the locus of the tort will almost always be determinative in cases involving conduct-regulating laws.”²⁷

Either New York law or Mississippi law likely would apply under the “most significant contacts” analysis. First, the parties are domiciled in different states. SSB is domiciled in New York; WorldCom, on the other hand, was domiciled in Mississippi. Second, the law governing aiding-and-abetting breach of a fiduciary duty relates to the regulation of conduct, rather than the allocation of a loss. The locus of the tort, therefore, likely would be the most significant factor.²⁸ Thus, it appears that whether New York law or Mississippi law would apply will depend, in large part, upon whether the aiding-and-abetting is deemed to have occurred in New York (where SSB presumably issued many of the

²⁴ Wells Fargo Asia Ltd. v. Citibank, N.A., 936 F.2d 723, 728 (2d Cir. 1991) (internal quotation marks omitted).

²⁵ Krock v. Lipsay, 97 F.3d 640, 645-46 (2d Cir. 1996) (quoting Padula v. Lilarn Properties Corp., 644 N.E.2d 1001, 1002 (N.Y. 1994)).

²⁶ Krock, 97 F.3d at 646 (quoting AroChem Int’l, Inc. v. Buirkle, 968 F.2d 266, 270 (2d Cir. 1992)).

²⁷ Id.

²⁸ See Krock, 97 F.3d at 646.

financial favors)²⁹ or Mississippi (where, presumably, Mr. Ebbers received many communications from SSB relating to the financial favors).

Although the choice-of-law determination represents a close question, the Examiner believes it probable that a court would apply the most significant contacts analysis, and, therefore, either Mississippi or New York law likely would govern an aiding and abetting claim against SSB. The Examiner reaches this conclusion because most of the contacts relevant to WorldCom's potential spinning claims against SSB occurred in Mississippi and New York.

b. The Arthur Andersen Claims

Arthur Andersen also may raise an imputation defense to negligence/malpractice claims asserted by WorldCom. Because those claims will be based primarily upon Arthur Andersen's failure to discover accounting fraud in the course of its auditing work for WorldCom (rather than aiding and abetting a breach of fiduciary duty), the "significant contacts" test is more likely to apply. Since Andersen performed its auditing work for WorldCom primarily in Mississippi, and thus the alleged tort would have occurred in Mississippi, Mississippi law likely applies to such claims. Nevertheless, because the choice of law decision is not free from doubt, the Examiner has analyzed the law on imputation in New York, Mississippi, and Georgia.

c. The KPMG Claims

Although the ideas behind the transfer pricing program originated with KPMG and the Company pursued it at KPMG's recommendation and with that firm's assistance, KPMG may raise an imputation defense to any negligence/malpractice claims asserted by the

²⁹ Certain of the financial favors in terms of IPO allocations also had a nexus to California, where the PWM Group was located for much of the relevant period.

Company. As with the Arthur Andersen claims, the negligence/malpractice claims against KPMG sound in tort rather than equity and, therefore, a court would likely apply the “most significant contacts” test. Applying this test, the Examiner believes that Mississippi law would govern these claims because: (1) KPMG performed a substantial part of its work in Mississippi, both at the Company’s Mississippi headquarters and the KPMG offices in Mississippi; (2) Lisa Abernethy and other members of the transfer pricing task force, worked in Mississippi; and, (3) under the transfer pricing program, both before and after the MCI merger, WorldCom possessed a tax nexus in Mississippi.

C. New York Law on Imputation

1. Imputation and Standing: The Wagoner Rule

Federal courts have interpreted New York law on the imputation defense as implicating a standing issue, rather than an affirmative defense.³⁰ The Second Circuit has held, under its interpretation of New York law, that where a corporation’s officers breach a fiduciary duty and are aided-and-abetted in that breach by a third-party, the wrongful conduct of the officer is imputed to the corporation.³¹ Likewise, where a corporation alleges that an outside provider of professional services committed malpractice by failing to detect fraud

³⁰ See, e.g., Bennett Funding Group, 336 F.3d at 100; Wagoner, 944 F.2d at 119. Under well-established principles, standing “is a threshold issue in all cases since putative plaintiffs lacking standing are not entitled to have their claims litigated in federal court.” Wagoner, 944 F.2d at 117; Bennett Funding Group, 336 F.3d at 99 (standing is “a threshold question in every federal case.”). As the Second Circuit has explained:

The Constitution confines the judicial power federal courts to decide in cases or controversies. U.S. Const. art. III. § 2, cl. 1. The doctrine of standing is derived directly from this constitutional provision. It focuses upon the party seeking to invoke federal jurisdiction, rather than just justiciability of the issue at stake in the litigation. We have held that the Article III “case or controversy” requirement coincides with the scope of the powers of the Bankruptcy Code gives a trustee.”

Bennett Funding Group, 336 F.3d at 99 (quoting Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1091 (2d Cir. 1995)).

³¹ Bennett Funding Group, 336 F.3d at 99-100; Wagoner, 944 F.2d at 118-19; Mediators, 105 F.3d at 827.

committed by officers or directors of the corporation, the unlawful conduct of the officer or director may be imputed to the corporation.³²

Thus, under the Wagoner Rule, “a claim against a third-party for defrauding a corporation with the cooperation of management generally accrues to creditors, not to the guilty corporation.”³³ This rule flows from the principle that “a bankruptcy trustee has no standing to sue third-parties on behalf of the estate’s creditors, but may assert only claims held by the bankrupt corporation itself.”³⁴ In other words, where “a bankrupt corporation has joined with a third-party in defrauding its creditors, the trustee cannot recover against the third-party for the damages to the creditors.”³⁵

The key issue, therefore, in determining whether a trustee (or a debtor-in-possession) has standing to sue is whether the claim belongs to the estate, in which case “the trustee [or the debtor-in-possession] has exclusive standing to assert it” or whether the claim belongs to the creditors, in which case “a trustee [or the debtor-in-possession] has no standing” to assert the claim.³⁶ In other words, the court must inquire whether the third-party could have been held “liable on a legal theory in a proceeding other than the bankruptcy.”³⁷

For example, in Wagoner, the trustee sued the debtor’s stockbroker on behalf of the debtor’s estate, alleging that the broker aided-and-abetted fraudulent conduct committed by

³² Bennett Funding Group, 336 F.3d at 99-100; Hirsch, 72 F.3d at 1094; In re Complete Management, Inc., No. 02 Civ. 1736, 2003 WL 21750178 (S.D.N.Y. July 29, 2003).

³³ Wagoner, 944 F.2d at 120.

³⁴ Wagoner, 944 F.2d at 118 (citing Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429 (1972)).

³⁵ Bennett Funding Group, 336 F.3d at 100 (quoting Wagoner, 944 F.2d at 118. The Wagoner Rule applies regardless whether a claim is brought by a debtor-in-possession, a bankruptcy trustee, or a creditors committee. See American Tissue Inc. v. Arthur Andersen, 2003 WL 21036233 (S.D.N.Y. May 6, 2003); Color Tile, 322 F.3d at 156.

³⁶ Bennett Funding Group, 336 F.3d at 99-100 (quoting Wagoner, 944 F.2d at 118).

³⁷ Wagoner, 944 F.2d at 118-19.

the debtor's principal.³⁸ The broker argued that the trustee lacked standing because the claims actually belonged to the debtor's creditors.³⁹ The court explained that, under the Bankruptcy Code, "the trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that it could have instituted had it not petitioned for bankruptcy."⁴⁰ Thus, "a bankruptcy trustee has no standing generally to sue third-parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself."⁴¹ The court held that "a claim against a third-party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation."⁴²

2. Exceptions to the Wagoner Rule

The imputation principles embodied in the Wagoner Rule are not, however, absolute. Rather, there are two primary exceptions to the Wagoner Rule: (1) the "adverse interest" doctrine; and (2) the "innocent decisionmaker" exception.⁴³

a. Adverse Interest Doctrine

The adverse interest doctrine is "an exception to the general rule in New York that knowledge acquired by an agent acting within the scope of his agency is imputed to the principal and the latter is bound by such knowledge."⁴⁴ Under the "adverse interest"

³⁸ See id. at 117.

³⁹ Id. at 117-18.

⁴⁰ Id.

⁴¹ Id. at 118.

⁴² Id.; see also Bennett Funding Group, 336 F.3d at 101-02 (trustee lacked standing to assert malpractice claim against accountants and attorneys who failed to report fraud of management because the fraudulent conduct was imputed to the debtor); In re The Mediators, Inc., 105 F.3d 822, 826 (2d Cir., 1997) (creditors' committee lacked standing to sue third-party on aiding-and-abetting claim because debtor's president and sole shareholder participated in the allege scheme with the defendant and therefore his unlawful conduct was imputed to the debtor).

⁴³ See Bennett Funding Group, 336 F.3d at 100.

⁴⁴ Securities Investor Protection Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999).

doctrine, a corporate debtor-in-possession (or a trustee) will be permitted to pursue claims against third parties who acted in conjunction with officers or managers of the corporation if “the agents have totally abandoned the principal’s interest.”⁴⁵ Thus, the wrongdoing of a corporate officer will not be imputed to a corporation where the officer “is really committing a fraud for his own benefit, [and therefore] he is acting outside the scope of his agency, and it would therefore be most unjust to charge the principal with knowledge of it.”⁴⁶ To prove that this exception applies, a defendant must establish that:

The agent must have totally abandoned his principal’s interests and be acting entirely for his own or another’s purposes. It cannot be invoked merely because he has a conflict of interest⁴⁷

The adverse interest exception applies where the agent acts in his own interest and thus does not generally apply where “the agent acts both for himself and for the principal, though the primary motivation for the acts is inimical to the principal.”⁴⁸

For example, in *Wight v. Bankamerica Corporation*, the liquidator of an insolvent bank, BCCI, sued BCCI’s correspondent bank, claiming that the correspondent bank aided and abetted breaches of fiduciary duty committed by BCCI’s senior management.⁴⁹ The correspondent bank moved to dismiss the case, arguing that the liquidator lacked standing to pursue the aiding-and-abetting claims because the fraud and breaches of fiduciary duty by BCCI’s officers were imputed to BCCI.⁵⁰ Because the liquidator stood in the same shoes as

⁴⁵ *Bennett Funding Group*, 336 F.3d at 100; *Wight v. Bank America Corporation*, 219 F.3d 79 (2d Cir. 2000).

⁴⁶ *Wight*, 219 F.3d at 87.

⁴⁷ *Sepa Consulting, Ltd. v. King Main Hurdman*, 138 B.R. 5, 9 (S.D.N.Y. 1992).

⁴⁸ *BDO Seidman, LLP*, 49 F. Supp. 2d at 650.

⁴⁹ *Wight*, 219 F.3d at 83.

⁵⁰ *Id.*

the insolvent bank, the defendant argued that the liquidator lacked standing to sue and that the aiding-and-abetting claims actually belonged to BCCI's creditors.⁵¹

The court rejected defendant's argument and held that the officers' wrongdoing was not imputed to the corporation, based on the adverse interest exception.⁵² The court explained that because the complaint alleged that BCCI "was adversely dominated by corrupt [management], who [acted] in their own interests and not in the interest of the BCCI," these allegations were sufficient to trigger the adverse interest exception.⁵³ Thus, the court held that the liquidator had standing to pursue the aiding-and-abetting claims.⁵⁴

Courts have applied a "sole actor" exception to the adverse interest exception in a situation where a sole shareholder (or a group of shareholders with similar interests, such as familial ties) controls the corporation or where a tortfeasor agent "dominates" the corporation.⁵⁵ The Examiner believes that the sole actor exception will not apply in WorldCom's case because the Company operated with an independent Board of Directors and its shares were publicly traded without any one person owning a controlling share. Although Mr. Ebbers "dominated" WorldCom in many respects, the Examiner thinks that it is unlikely that the sole actor exception will apply to the possible imputation defenses that Arthur Andersen and SSB may assert, because of the Company's Board that, at least in some instances, acted as a check on Mr. Ebbers. Furthermore, in response to Cynthia Cooper's warning about the accounting fraud, the Board acted quickly to investigate and terminate Mr. Sullivan. These facts highlight that, at least in some respects, the Board served as a check on

⁵¹ Id. at 87.

⁵² See Wight, 219 F.3d at 87.

⁵³ Id.

⁵⁴ Id.

⁵⁵ See Lafferty, 267 F.3d at 359-60.

management excess. At a minimum, the Examiner believes that an issue of fact exists about the applicability of the “sole actor” exception on this evidentiary record.

b. Innocent Decisionmaker Exception

The second exception to the Wagoner Rule is the so-called “innocent decisionmaker” exception.⁵⁶ This rule requires “all relevant decisionmakers” to be involved in the fraud for imputation to occur.⁵⁷ Thus, a defendant cannot invoke this exception if the evidence proves that the corporation had at least one decision-maker in management or among its stockholders who was innocent of the fraud and likely could have stopped it.⁵⁸ In other words, the Wagoner Rule applies only where all relevant decisionmakers are involved in the fraud.⁵⁹ This exception substantially narrows the imputation defense in New York.

The innocent decisionmaker can be either a board member or a member of the corporation’s management.⁶⁰ To be “relevant,” however, the decisionmaker must have been in a position to have stopped the unlawful conduct had he or she been aware of it.⁶¹ For example, in In re CBI Holding Corp., evidence established that a board member and a major shareholder of the corporation were innocent of accounting-related fraud and would have taken steps to stop the fraud had they know it occurred.⁶² Accordingly, the court held that the

⁵⁶ See Bennett Funding Group, 336 F.3d at 101.

⁵⁷ See id.; In re CBI Holding Corp., 247 B.R. 341, 364-65 (Bankr. S.D.N.Y. 2000).

⁵⁸ CBI Holding Corp., 247 B.R. at 364-65.

⁵⁹ See id.

⁶⁰ See id.

⁶¹ Id.

⁶² See id. at 365.

unlawful conduct of the corporation's majority shareholder was not imputed to the corporation.⁶³

The "sole actor" exception, discussed above,⁶⁴ also likely applies as an exception to the innocent decisionmaker exception when a sole decisionmaker governs the corporation. In these circumstances, courts likely will not apply the innocent decisionmaker exception and will impute the sole decisionmaker's wrongdoing to the corporation.⁶⁵

D. Mississippi Law On Imputation

Mississippi courts have not addressed whether a corporate officer's breach of his fiduciary duty must be imputed to the corporate principal in an action against a third party for aiding-and-abetting that breach. Thus, there is no Mississippi decision that directly addresses the issue whether an imputation defense would prohibit a corporation from suing a third-party for aiding-and-abetting a corporate officer's breach of his fiduciary duty.⁶⁶

At least one Mississippi Supreme Court decision, however, implies that Mississippi law would not impute the unlawful conduct of a fiduciary to his corporate principal under circumstances where an outside tortfeasor, seeking protection under the imputation defense, either occupied a fiduciary relationship with the corporation or knowingly colluded in the

⁶³ Id., As set forth above, WorldCom's Board served as a check on at least some management excess and reacted quickly when apprised of the accounting fraud.

⁶⁴ See p. B-12, supra.

⁶⁵ The exception to the exception does not apply to WorldCom's situation because although Mr. Ebbers dominated the Company's officers, others on the WorldCom Board could serve as a check on him. While they did this infrequently, as detailed in the Examiner's First, Second, and Final Reports, the Board apparently did so in isolated circumstances, such as when the Compensation Committee denied at least one request by Mr. Ebbers for an additional loan in September 2000.

⁶⁶ The Mississippi Supreme Court, has, however, explained in dicta, in a different factual context, that "a trustee in bankruptcy represents both the bankrupt and his creditors, and has the same rights and may pursue the same remedies on behalf of creditors as it would have been entitled to if there had been no adjudication in bankruptcy." Frazier v. Zachariah, 164 So. 893, 895 (Miss. 1936). Thus, it appears that there is some support under Mississippi law for the proposition that a bankruptcy trustee can pursue claims that belong to creditors. The validity of this decision in light of subsequent United States Supreme Court authority, and subsequent amendments to the Bankruptcy Code, is questionable. See Caplin, 406 U.S. at 429, 432.

wrongdoing. In Knox Glass Bottle Co. v. C.R. Underwood,⁶⁷ a corporation sued a third party who allegedly knowingly participated with the corporation's former president (and other officers and directors of the corporation) in breaching the president's fiduciary duties.⁶⁸ Specifically, the third party (a personal friend of the corporation's former president) "actively participated" in a scheme pursuant to which the president usurped corporate opportunities in connection with certain truck leases.⁶⁹ The record established that the third party profited from this scheme and possessed actual knowledge of the then-president's breach of his fiduciary duties.⁷⁰ Thus, the court held that the third-party came "clearly within the universally accepted rule that one who participates with a fiduciary in a breach of his duties, with knowledge that he is violating his obligations, is liable for the profits received thereby from the corporation."⁷¹ On the other hand, this court treated differently an outside party who did not occupy a fiduciary relationship (or any other relationship) with the corporation and did not knowingly collude in any wrongdoing, holding that the company possessed "no right of recovery" against this person.⁷² The case leaves open the question of how the court would treat the liability of an outsider providing professional services, who failed to detect wrongdoing, but did not knowingly participate in the wrongdoing.⁷³

⁶⁷ 89 So. 2d 799 (Miss. 1956).

⁶⁸ Knox Glass Bottle Co. v. C.R. Underwood, 89 So. 2d 799, 823-24 (Miss. 1956).

⁶⁹ Id. at 824.

⁷⁰ Id.

⁷¹ Id.

⁷² Id. at 824.

⁷³ No federal decision has interpreted Mississippi law in connection with these imputation issues.

E. Georgia Law On Imputation

No Georgia court has decided whether a defendant's claim that a debtor corporation participated (through its agents) in the misconduct for which it seeks recovery requires imputation of the officer's conduct to the corporation. Georgia law does, however, recognize the defense of in pari delicto.⁷⁴ No Georgia court, however, has applied that defense in any context similar to WorldCom's situation.

Nor has any federal court expressly interpreted Georgia law on these imputation issues. However, the United States Bankruptcy Court for the Northern District of Georgia addressed imputation, standing, and in pari delicto issues in In re Plaza Mortgage and Finance Corporation.⁷⁵ In Plaza Mortgage, a bankruptcy trustee sued the debtor's former accounting firm, alleging that the accounting firm aided and abetted the debtor's former president in breaching his fiduciary duty to the debtor.⁷⁶ The accounting firm argued that the trustee lacked standing to sue because the claim actually belonged to the creditors of the debtor, rather than to the trustee.⁷⁷ Alternatively, the accounting firm argued that the doctrine of in pari delicto barred the trustee from asserting such claims as a matter of law.⁷⁸

The court rejected the accounting firm's argument that the trustee lacked standing to sue.⁷⁹ Instead, the court explained that because the trustee pleaded damages to the debtor corporation, rather than damages to the corporation's investors, the trustee had alleged facts

⁷⁴ See Laxton v. Laxton, 507 S.E.2d 146 (Ga. App. 1998); Alliance Auto Acceptance Lease, Inc. v. Chuck Clancy Ford, Inc., 355 S.E.2d 112 (Ga. App. 1987).

⁷⁵ 187 B.R. 37 (Bkrcy. N.D. Ga. 1995) (requesting parties to file supplemental briefs addressing which state law should apply to the imputation defense).

⁷⁶ Plaza Mortgage, 187 B.R. at 38-39.

⁷⁷ Id. at 39.

⁷⁸ Id. at 39-40.

⁷⁹ Plaza Mortgage, 187 B.R. at 44.

sufficient to establish his standing in the suit.⁸⁰ In other words, damages were properly measured based on funds improperly paid to the accounting firm rather than based on any diminution in value to the shareholders.⁸¹

The court separately analyzed the in pari delicto defense. The court framed the issue as whether the doctrine of in pari delicto would bar the debtor from suing the accountants outside the bankruptcy context.⁸² The court indicated that “the answer to this question depends on whether the acts and knowledge of [the former officer] are imputed to the debtor.”⁸³ The court noted that the parties had failed to brief the question of which state’s law applied on this issue, and therefore declined to rule on the issue.⁸⁴ Importantly, however, the court raised the question whether the application of the in pari delicto defense would bar the trustee (or a debtor-in-possession) from suing. The court explained that there was significant authority supporting the conclusion that “the defense of in pari delicto loses its sting when the person who was in pari delicto is eliminated.”⁸⁵

⁸⁰ Id. at 44-45.

⁸¹ Id. at 44-45.

⁸² Id. at 45.

⁸³ Id. at 45.

⁸⁴ Id. at 46.

⁸⁵ Plaza Mortgage, 187 B.R. at 47 (quoting Scholes v. Lehmann, 56 F.3d at 754). In Scholes, the court explained that when corporations that were created and controlled by a wrongdoer are “controlled by a receiver whose only object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver’s bringing suit to recover corporate assets unlawfully dissipated by [the officer who engaged in unlawful conduct].” Scholes, 56 F.3d at 755.