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## Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance - Restoration of Active Virture in the Corpaorate Sturcture to Curb the YeeHaw Culture in Organizations

Marianne M. Jennings

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## RESTORING ETHICAL GUMPTION IN THE CORPORATION: A FEDERALIST PAPER ON CORPORATE GOVERNANCE – RESTORATION OF ACTIVE VIRTUE IN THE CORPORATE STRUCTURE TO CURB THE “YEEHAW CULTURE” IN ORGANIZATIONS

*Marianne M. Jennings\**

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*And further, the life of active virtue is essentially pleasant.<sup>1</sup>*

– Aristotle

## INTRODUCTION

The Sarbanes-Oxley Act of 2002<sup>2</sup>, variously known, as it swept through Congress, as the Public Company Accounting Reform and Investor Protection Act of 2002, Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, Corporate Responsibility Act, the Corporate Fraud and Accountability Act, Justice for Victims of Corporate Fraud Act, the Corporate and Criminal Fraud Accountability Act, the Public Company Accountability Act, and just generally as “What on earth were you people thinking when you decided to engage in this kind of financial reporting and analysis? Act.”<sup>3</sup> Sarbanes-Oxley marks the third great regulatory reform for publicly held companies during the span of my 25-year career in the academy. First, there were the new laws and reforms on insider trading and junk bonds following the Ivan Boesky and Michael Milken debacles.<sup>4</sup>

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1. ARISTOTLE, NICOMACHEAN ETHICS 41(H. Rackham trans., Harvard Univ. Press 1992), *hereinafter* ARISTOTLE, NIC. Note for non-philosophical types, “Nic” was not Aristotle’s first name. The “hereinafter” citation method with “Nic” distinguishes Ari’s ethical discussions that are explained further. *See infra* note 6 and accompanying text.

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

3. The various names are found throughout sections of the Act, the result of different versions of the bill being floated in the House and Senate, with the last name listed herein, admittedly, a commentary by the author. There were six versions of the Act, including the one finally passed. For complete details on the names of the bills and the history of its final passage, *see* <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR03763:TOM:/bss/d107query.html> (last visited April 8, 2003). A more accurate name would be the, “Where were your minds when you decided to try and hide \$9 billion or so in expenses? Act.” The latter refers to the WorldCom collapse in which the CFO and underlings in the company decided to boost revenues by reporting expenses in a creative accounting fashion, i.e., they took current expenses and capitalized them, or they took reserves and tossed them into earnings. By the time all was said and done, WorldCom’s book looked as if a “D” student from a 7:00 AM Accounting 101 class had done them, to wit, “Debit, credit – what’s the difference?” For more information on the WorldCom accounting, *see* Jared Sandberg & Susan Pulliam, *WorldCom Revision Tops \$7 Billion*, WALL ST. J., August 9, 2002, at A3, and *infra* notes 140-63 and accompanying text.

4. Those who lived through the Boesky and Milken eras would take judicial notice of these scoundrels and their market activity. However, there are those who are reading who may not have been born at the time Boesky and Milken were dominating Wall Street and developing what would become the script for Michael Douglas’s Oscar-winning role as

Then there were the reforms that came about as a result of the collapse of savings and loans. "Never again," those responsible for these reforms and legislation muttered.<sup>5</sup> With new requirements, new sanctions, new penalties, new public disgrace, no one would ever be so bold as to perpetrate schemes and artifices on the market ever again.

Yet, here we are again. And we are tackling the same sort of task: How do we prevent corporations from trotting down these temporarily lucrative paths of fraud? What types of checks and balances could we create that would prevent such frauds, or, if fraud cannot always be prevented, human nature being what it is, what could we implement to insure that someone within the corporation raises the flag of fraud before the corporation hits Chapter 11? What type of governance creates the gumption needed in employees to step up and signal that there is fraud in the air and/or books? Indeed, why have we not been able to preserve in the corporate structure the fundamental ethical values of honesty and fair play? How was it possible to have corporations fully committed to values such as preservation of the environment, promotion of diversity, philanthropic contributions, and commu-

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Gordon Gekko in the film *WALL STREET* (Twentieth Century Fox 1987). Mr. Boesky is the man who said in his commencement address at Berkeley in 1986, "Greed is all right . . . Greed is healthy. You can be greedy and still feel good about yourself." As quoted in Christopher R. Brauchli, *From the Wool-Sack*, CO. LAW. Aug. 2002, at 43 (quoting Ivan Boesky, Commencement Address, Berkeley, May 1986). Michael Milken was known as the "junk bond king," a man who would sell bonds collateralized by the companies he was proposing to acquire with the funds the bonds buyers were giving him. For those of you attempting to follow, the bondholders were fronting the money that would be used to buy their collateral, if they could see the deal through and if the target company didn't resist and if nothing went wrong with the company during the whole process. If the buy-out worked or the company paid Milken to go away (the classic greenmail defense), the bondholders did well. If the buy-outs failed, and they did, then the bonds were worthless. Hence, the term "junk bonds." It was pretty much an either/or proposition. You didn't see slow and steady growth in the junk bond market. However, in addition to the bond sales, these two rogues and other rogues-in-training, or rogues who reported to these main rogues, and occasionally even the relatives of rogues and subservient rogues, and perhaps even the servants of the rogues, were able to enjoy hefty returns on the side of the bond scheme by trading in advance of the acquisition announcements. A little short selling in advance of their moves to acquire gave them sure-fire returns. And where there are sure-fire returns, can the SEC be far behind? Mr. Boesky entered a guilty plea to a single felony count in 1987 and Mr. Milken entered a guilty plea to more felony counts in 1991. For background on Milken, Boesky and junk bonds, see, Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1 (1997). See also JAMES B. STEWART, *DEN OF THIEVES* (1991).

5. The reforms from the Boesky/Milken era included the Insider Trading Sanctions Act, 15 U.S.C. § 78u-1 (2002), which made it possible for the government to recover as a penalty three times the amount of profit made or loss avoided from the inside deal. Also, there was the Insider Trading and Securities Fraud Enforcement Act, 15 U.S.C. § 78ff (2002) that upped the penalties for insider trading to 20 years and \$25,000,000. The savings and loan collapse reforms are largely found in Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), 12 U.S.C. § 191 *et seq.*, which required new minimum capital requirements for loans and put the big kibosh on savings and loans holding junk bonds. One sees now how inextricably intertwined these market players and their subsequent collapses were. Jailbirds of a feather flock together.

nity service even as they were fully derelict in honoring Aristotelian values?<sup>6</sup> A paraphrase of Dr. Stanley Milgram's work on delivering shocks as a group to individuals is in order, "What is it about corporations that allows them to slip the restraints of human conscience?"<sup>7</sup>

Answering these questions requires an exploration of the debacles of this era.<sup>8</sup> That exploration zeroes in on the vulnerable areas of the corporation and what factors contribute to employees', officers', directors', and auditors' disregard of virtue. Those areas of vulnerability are then addressed in a proposal for changing corporate governance so as to restore active virtue of ethical gumption in employees, officers, directors and auditors, or that rare ability to speak up when debits become credits, losses become earnings, margins become inexplicable, bubbles become busts, and dreams turn to dust.

When the problems at Enron emerged and that company had to restate earnings in an amount one-sixth that of WorldCom's restatement, the *Wall Street Journal's* Holman Jenkins, Jr., wrote an analysis piece about the Enron officers entitled, "How Could They Have Done It?"<sup>9</sup> The piece ties the poor decisions in terms of accounting in that company to the psychology of decision-making.<sup>10</sup> The psychology described, includes "erroneous confi-

6. By Aristotelian values, the author employs a highfalutin philosophical term to summarize the basic virtues of honesty, fairness, and treating others as you want to be treated. You know, the stuff we all believe and certainly resent when others violate, but seem to have a great deal of difficulty doing ourselves, particularly in the financial operations and reporting of a corporation. For a discussion of these values in what will surely be the greatest esoteric reading of a lifetime, see ARISTOTLE, *NIC*, *supra* note 1, and ARISTOTLE, *THE ATHENIAN CONSTITUTION* (H. Rackham trans., Harvard Univ. Press 1981). Note: author's advice: skip right over the Athenian Constitution and head right into Eudemian. The Nicomachean ethics are easier on the eyes and soul than the Eudemian ethics.

7. Milgram said, "A substantial proportion of people do what they are told to do, irrespective of the content of the act and without limitations of conscience, so long as they perceive that the command comes from a legitimate authority." See <http://www.stanleymilgram.com/quotes.html> (last visited April 8, 2003). Dr. Milgram was the scientist who found that 65% of his subjects would inflict pain on other human beings if told to do so by someone they perceived to be an authority figure. For a summary of his work, go to <http://www.stanleymilgram.com> (last visited April 8, 2003). The figure was actually 61% in the United States and 66% in other countries.

8. They are always called "debacles." For without a debacle, you cannot have major reform legislation. Show me a good debacle and I'll show you major reforms sailing through Congress in a matter of weeks. There was the savings and loan debacle, the junk bond debacle, and now the dot-com debacle, Enron debacle, and WorldCom debacle. Well, you get the idea on debacles. This time around we are awash in debacles, a situation which sounds terribly maritime and seaworthy, being awash in debacles, with debacles being some form of barnacle, the author believes, although she concedes she is no marine biologist.

9. Holman W. Jenkins Jr., *How Could They Have Done It?*, WALL ST. J., Aug. 28, 2002, at A15.

10. *Id.* The piece is based on the work of Professors Max Bazerman and David Messick. See Max Bazerman & David Messick, *Ethical Leadership and the Psychology of Decision Making*, SLOAN MGMT. REV., Jan. 1, 1996.

dence,” “exaggerated sense of control,” and experience with “good future events.”<sup>11</sup> Translated into lay terms, the psychology behind the Enron, WorldCom, Tyco and Adelphia staggering inflation of company numbers was the result of cultures that were arrogant, high-pressure and, up to the point of collapse, highly successful.<sup>12</sup>

Enron, WorldCom, Tyco and Adelphia had what the author has coined as a descriptor for these particular types of companies, a Yeehaw Culture.<sup>13</sup> The Yeehaw Culture is appropriately named for the gunslinger swagger that enveloped these firms as they wowed Wall Street for fairly sustained periods, enjoying a near immunity from inquiry as they continued to defy all odds in terms of earnings, growth and margins.<sup>14</sup> No one inside or outside these companies dare draw a weapon, a whistle or a law to halt the march of the unbeaten and indefatigable conquerors.<sup>15</sup> There are several clear components to such a culture, from which the bizarre psychology of poor decisions springs, and these components are common to Enron, WorldCom, Tyco, Adelphia and other companies mentioned as examples in subsequent sections.<sup>16</sup> There are seven components of the Yeehaw Culture,

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11. Bazerman, *supra* note 10, at 11-13.

12. Creative and not-so-creative accounting, as well as management shortcomings, are generally the types of things that catch someone's attention such as internal auditors, external auditors, boards, shareholders, and analysts. But in the cases of Enron, WorldCom, Tyco, and Adelphia, those groups failed to catch the evolving and growing problems at the companies. These were companies where, both internally and externally, systems failed. Richard Thornburgh, a former attorney general, has phrased the WorldCom problems as follows, “The checks didn't balance, and the balances didn't check.” Seth Schiesel, *WorldCom Sees More Revisions Of Its Figures*, N.Y. TIMES, Nov. 11, 2002, at C1.

13. The term “yeehaw” was borrowed from Billy Crystal who used it in his movie, *City Slickers*, when the city slickers themselves were saddled up and ready to depart on their cattle drive for a dude ranch. These participants, clearly in over their heads and blissfully unaware of the dangers and challenges ahead, all let out a loud, “YEEHAW!” to symbolize their virility (except for Helen Slater who enjoyed that quality vicariously as much as possible through the milquetoast Daniel Stern) as they departed on their Wild West journey. CITY SLICKERS (Columbia/TriStar 1991).

14. So arrogant and far gone, in terms of propriety, was Mr. Scott Sullivan, CFO of WorldCom, until its initial restatement of \$3 billion or so in earnings, that on the eve of his termination by the WorldCom audit committee following documented malfeasance offered by the head of internal audit and the company's new auditor, KPMG, he wrote a memo to the board defending his accounting practices in an attempt to keep his job. Kurt Eichenwald & Simon Romero, *Inquiry Finds Effort at Delay At WorldCom*, N.Y. TIMES, July 4, 2002, C1.

15. The “Yeehaw Culture” defies the traditional sociological and business ethics literature on deviant behavior because the assumptions in that work include one that individuals within the organization are departing from the norms of behavior established for the company. In reality, the norms of behavior for the company have changed implicitly, if not tacitly. The behavior is not deviant, but over time has become accepted and expected. For a summary of the work on deviant behavior, see Randi L. Stone, *Ethical Rule Breaking by Employees: A Test of Social Bonding Theory*, 40 J. OF BUS. ETHICS 101 (2002).

16. One factor unique to the Yeehaw Culture, and one that distinguishes it from traditional types of frauds, is that there appears to be a belief, to the end, and at least on the part of the founders, that they really could pull it all out of a hat and keep their companies going. Mr. Lay of Enron, Mr. Ebbers of WorldCom, and Mr. Rigas of Adelphia, all founders of their

a culture that puts an organization at risk of ethical collapse.<sup>17</sup> The seven factors are:

- Pressure to Maintain Those Numbers and That Performance
- Fear and Silence
- The Young 'Uns and Bigger-than-Life CEO
- Weak Board
- Culture of Conflicts
- Culture of Innovation Like No Other
- Culture of Social Responsibility

The following sections examine those seven factors in detail in the context of the stories surrounding the Enron, WorldCom, Tyco, and Adelphia collapses. The stories and the eerie presence of the seven factors in them set the stage for proposals in corporate governance to curb the Yeehaw Culture.

#### *Debacle One – Enron*

How the mighty art fallen. Enron was the premier energy company of the 1990s.<sup>18</sup> But, it ended the decade with nicknames such as “Investment Pirates of the Caribbean” and “Crooked E.”<sup>19</sup> Enron’s stock went from \$85 per share in December 2000 to \$0.40 per share on December 3, 2001.<sup>20</sup> The

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fallen companies, were all heavily invested in them right to the end. Kurt Eichenwald, *Company Man to the End, After All*, N.Y. TIMES, Feb. 9, 2003, Section 3, at 1, (Money & Business). The Yeehaw Culture is not one of criminal insiders, but “hubris and financial recklessness.” *Id.* See also, Edward Iwata, *Ken Lay’s Lawyer Says Trades Were Legal*, USA TODAY, Feb 11, 2003, at B3.

17. The author is not clear whether Dr. Stephen Covey, author of *The Seven Habits of Highly Effective People*, would want to embrace “The Seven Habits of the Yeehaw Culture,” but nonetheless, the seven factors of the Yeehaw Culture are universal, easy to remember and difficult to fix. See *infra* notes 22-97, 202-332, 382-478 and accompanying text for a discussion of the components of the Yeehaw Culture in Enron, WorldCom, Tyco and Adelphia. For a discussion of fixing the Yeehaw Culture, see *infra* notes 498-571 and accompanying text.

18. John Schwartz & Richard A. Oppel Jr., *Foundation Gives Way on Big Chief’s Dream*, N.Y. TIMES, Nov. 29, 2001, at C1. See also, Greg Farrell & Del Jones, *How Did Enron Come Unplugged?*, USA TODAY, Jan. 14, 2002, at B1.

19. Robin Williams coined the phrase on the pirates. *The Crooked E* was a made-for-television-movie about Enron that aired on CBS in January 2003. *The Crooked E*, (CBS television broadcast, January 5, 2003).

20. Richard A. Oppel Jr. & Riva D. Atlas, *Hobbled Enron Tries to Stay On Its Feet*, N.Y. TIMES, Dec. 4, 2001, at C1.



author has already documented the rise and fall of Enron in significant detail in another work.<sup>21</sup> However, presently, it is important to place the story of Enron in the context of the seven factors of the Yeehaw Culture.

*Cultural Factor 1 – Pressure to Maintain Those Numbers and That Performance*

Like each company analyzed in this work, Enron was, at its inception, a first mover in a new market and able to capitalize on that critical strategic position to experience double-digit growth in revenue, earnings and share price.<sup>22</sup> However, once others began dabbling in energy trading, and once the dot-coms and their phenomenal, albeit temporary, market performance hit, Enron managers felt the pressure to maintain what were truly unrealistic goals. To maintain their phenomenal growth, Enron engaged in several types of “creative accounting,” aka “aggressive accounting,” aka “accounting mumbo jumbo.”<sup>23</sup> Enron’s total of accounting errors was about \$1 billion.<sup>24</sup>

21. Marianne M. Jennings, *A Primer on Enron: Lessons From a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, Cal. W. L. Rev. (forthcoming 2003).

22. Between mid-1998 and the end of 1999, Enron’s stock price tripled from \$20 to over \$60 per share. Richard A. Oppel Jr. & Andrew R. Sorkin, *Enron Collapses as Suitor Cancels Plan for Merger*, N.Y. Times, Nov. 29, 2001, at A1 (see chart within cited article). By January 2001, its share price was at \$83 and it had over \$1 billion in revenues.

23. For more information on Enron accounting mumbo jumbo, see *infra* notes 25-31 and accompanying text, and for information on WorldCom, Tyco and Adelphia accounting mumbo jumbo, see *infra* 140-85, 352-68, and 489, 497, respectively, and accompanying text. All of the companies involved in ethical and financial collapse had the type of accounting that makes accounting professors, regulators, the public and everyone not involved in the accounting say, “What on earth good is accounting and auditing if you’re just going to make stuff up?”

A partial list of companies with pending or resolved questionable accounting issues follows: AOL TimeWarner (investigation for accounting on its advertising revenues); Aura-Systems (booking \$27 million in artificial sales); Computer Associates International (overstating results to inflate revenues); Dollar General Merchandise (overstated profits by about \$100 million, again, who knows?); Dynegy Energy (sham trades to inflate revenues); Elan Pharmaceuticals (funny numbers on 55 joint ventures); Global Crossing (inflating revenues through network capacity swaps); Halliburton Oil (revenue overstatements and expenses understatements); HPL Technologies (fabricating 80% of its sales revenues); I&J (inflated worth with false sales receipts); Kmart (overstated loss one year and understated loss the next year – unfortunately, only a blue light, not a red light, went off for the auditors); Kroger (padded sales by managers in order to meet sales quotas); Nesco (overstating earnings); Network Associates (overstating earnings); Peregrine Systems (overstating revenue by about \$100 million – again, who knows?); Qwest (overstating revenues and swaps issues); Reliant Energy (overstating earnings with sham energy trades); Rite-Aid (restatement of earnings for 1997-99 that lopped off \$1.6 billion from earnings); Safety-Kleen (overstatement of \$534 million); and Xerox (restating \$6.4 billion in revenue over 5 years, give or take a billion here and there). Gary Stoller, *Funny Numbers: Regulators and Prosecutors Target Corporate Fraud, Accounting Lies and Executive-Suite Greed*, USA TODAY, Oct. 21, 2002, at B3. See *infra* notes

Enron's pressure to meet numbers caused those in the company to employ two creative accounting methodologies. There were two FASB rules Enron used to preserve its stellar and nearly exponential performance growth that allowed it to function as a hedge fund with minimal disclosure about the risk and exposure to its shareholders. The first FASB rule that Enron exploited was the rule on special purpose entities (SPEs).<sup>25</sup> SPEs allowed Enron to create entities off-the-books for absorbing the debt of the company, but, under accounting rules, it would not be required to disclose their existence on Enron's financial reports if Enron held a 49% or less interest in the SPE.<sup>26</sup> Enron was able to create thousands of SPEs and spin off the lion's share of its debt so that the financial statements of Enron looked fabulous because of low debt.<sup>27</sup> The accounting disclosures were perfectly proper under accounting rules, but the issue of materiality as well as the role of the officers in the SPEs was kept from investors or disclosed only in the most veiled fashion.<sup>28</sup>

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140-185, 352-368, and 489 and 497 and accompanying text for information and specifics on accounting practices at WorldCom, Tyco and Adelphia.

24. Stoller, *supra* note 23, at B3. At the time, Enron shocked the world with the sheer magnitude of its restatements of its financials. However, WorldCom and Adelphia were not yet unveiled, and Enron now looks like small potatoes. See *infra* notes 140-85, 352-68, and 489, 497 and accompanying text. Earnings restatements between 1997 and 2000 doubled. Microstrategy, a dot-comer, lost 85% of its market value four days after its restatement of earnings was announced. Holman W. Jenkins Jr., *Accounting for When Dreams Become Reality*, WALL ST. J., June 13, 2001, at A21. Even General Electric, the icon of earners and the solid investment of Wall Street, had to issue corrections to its financials. Gretchen Morgenson, *Wait a Second: What Devils Lurk In the Details?* N.Y. TIMES, Apr. 14, 2002, Section 3, at 1 (Money and Business). See also, Justin Fox, *What's So Great about GE?*, FORTUNE, Mar. 4, 2002, at 64.

25. Financial Accounting Standards Board (FASB) statement 140, a reiteration of FASB statement 125, governs the consolidation of financial statements with regard to SPEs. The rule provides that until the company owns 50% or more of the voting shares, consolidation reporting with the parent is not required.

26. Mr. Andrew Fastow, the CFO of Enron, was so arrogant in his abuse of the FASB 125 rule that he named some of these off the book entities as, for example, Raptor 125, in honor of the FASB rules he was abusing.

27. Worse, Mr. Fastow named himself a principal in these off-the-books entities and even earned financier's fees when the SPE did business with Enron, i.e., took over the debt. Such a role does require disclosure under the SEC's mandatory disclosures on "Related Party Transactions." Enron's 1999 10-K included the following, "A senior officer of Enron is the managing member of LJM's general partner." Enron's 1999 10-K, as quoted in Jonathan Weil, *What Enron's Financial Reports Did - And Didn't - Reveal*, WALL ST. J., Nov. 5, 2001, at C1.

28. Mr. Fastow had created such a labyrinth-like network of SPEs and off-the-books transactions that he was dipping down into family names and trusts for souls to serve as the primary owners in these entities. Andersen drew a line at that idea, but did permit Mr. Fastow to use Michael Kopper, a mid-level employee, who reported to Mr. Fastow and whose interests in the SPEs did not have to be disclosed under SEC rules. David Barboza and John Schwartz, *The Financial Wizard Tied to Enron's Fall*, N.Y. TIMES, Feb. 6, 2002, at A1. Mr. Kopper was not a Section "16-b" officer, referring to Section 16 of the Securities Exchange Act of 1934, which requires officers, directors and 10% or more shareholders to disclose

Enron also used the flexibility FASB provided on the booking of revenues for contracts that will be performed in the future, known as “mark-to-market accounting.” Under FASB rules, management was charged with the duty and discretion of valuing those contracts and Enron management used that discretion liberally. So, in essence, management was given the authority to determine how much it was going to report on these contracts and when it was going to report it. This kind of discretion opens the door for all manner of accounting shenanigans.<sup>29</sup> Valuing these contracts meant that the officers at Enron pushed the envelope, including as much as possible for these contracts that were the right to sell energy at some time in the future, maybe.<sup>30</sup> An example from the author’s previous work illustrates the absolute confusion that surrounds mark-to-market valuation and how an investor or analyst might have a tough time getting a grip on how the company has done in the past in terms of earnings, how it is currently doing, or how it will do in the future:

*Suppose that an energy company has a contract to sell gas for \$1.00 per gallon, with the contract to begin in 2004 and run through 2014. If the price of gas in 2002 is \$0.80 per gallon, then the value of that contract can be booked accordingly and handsomely, with a showing of a 20 percent*

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certain types of information about them and their dealings with the company and in company stock in the company’s disclosure forms required by the SEC. See 15 U.S.C. §78(p)(a)(1) (2001). Mr. Kopper was charged with several felonies and entered a guilty plea. Kurt Eichenwald, *Ex-Enron Official Admits Payments to Finance Chief*, N.Y. TIMES, August 22, 2002, at A1. The guilty plea was to money laundering and conspiracy to commit fraud. Mr. Kopper surrendered \$12 million and agreed to cooperate fully with investigators with great hope for a reduced sentence. *Id.* See also Jonathan Weil, Alexei Barrionuevo, Anita Raghavan, and Kathryn Kranhold, *Guilty Plea By Enron’s Kopper Increases Scrutiny of Ex-CFO*, WALL ST. J., Aug. 22, 2002, at A1.

29. Although, at least these shenanigans were somewhat imaginative and not just a violation of accounting rules, as the reader will see *infra* at notes 130-85 when we discuss the WorldCom mumbo jumbo. Nor did the Enron execs just loot the companies. They created SPEs to do business with the company and then they looted the SPEs. Big difference. See *infra* notes 482-97 and accompanying discussion on Adelpia and looting. And, let’s not forget, looting via loans shows some dignity. Embezzlement is so tawdry and mundane. See *infra* notes 482-97 and 395-407 for discussions on the art of obtaining loans from the company for purposes of looting.

30. ABN Amro Analyst Paul Patterson, a specialist in energy trading firms, notes the problems of discretion, “Whenever there’s a considerable amount of discretion that companies have in reporting their earnings, one gets concerned that some companies may overstate those earnings in certain situations where they feel pressure to make earnings goals.” Jonathan Weil, *After Enron, ‘Mark to Market’ Accounting Gets Scrutiny*, WALL ST. J., Dec. 4, 2001, at C1. Enron’s officers carried the values of its futures contracts beyond chutzpah, or at least well beyond GAAP. Some of the revenues booked at Enron were for contracts in states that had not yet deregulated electricity. Those contracts could not be performed until deregulation occurred, if it ever occurred. In fairness to the Enron boys, Enron did factor in the additional risk of no deregulation in the valuation of those contracts. Note they who value the contract also determine the risk. Floyd Norris and Kurt Eichenwald, *Fuzzy Rules of Accounting and Enron*, N.Y. TIMES, Jan. 30, 2002, at C1.

*profit margin. However, suppose that the price of gasoline then climbs to \$1.20 per gallon during 2003. What is the manager's resolution and reconciliation in the financial statement of this change in price? The company has a ten-year commitment to sell gas at a price that will produce losses. Likewise, suppose that the price of gas declines further to \$0.50 per gallon in 2003. How is this change reflected in the financial statements, or does the company leave the value as it was originally booked in 2002?*<sup>31</sup>

### *Cultural Factor 2 – Fear and Silence*

Sherron Watkins was the vice president for corporate development at Enron. Ms. Watkins' was a former Andersen employee who had been hired into the executive ranks by Enron and was, therefore, possessed of some fairly good accounting instincts. She realized very quickly, after assuming her position as a vice president and gaining access to the company's complete financials, that something was amiss with Enron's books and decisions on financial reporting.<sup>32</sup> Fearful about what she called, the "fuzzy" accounting of the off-the-books entities, she was in the process of looking for another job as she planned to write a memo objecting to the company's accounting.<sup>33</sup> She was, however, even more fearful that she would lose her job for raising the issue and began looking in earnest so that she had something to turn to when she voiced her concerns and was quite possibly sacked as a result.<sup>34</sup>

When CEO Jeffrey Skilling left abruptly, Ms. Watkins felt it was time to act. She sent an anonymous memo to Ken Lay, Enron's then-CEO.<sup>35</sup> The memo gives a glimpse of the Enron culture and explains her fears with words such as "arrogance" and "intimidating." She described a culture very similar to those of companies that have experienced the same ethical collapse as Enron, such as Lincoln Savings & Loan when it was led by Charles Keating and the meltdown of Finova Capital with its autocratic CEO.<sup>36</sup> En-

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31. Jennings, *supra* note 21.

32. Jodie Morse and Amanda Bower, *The Party Crasher*, TIME, Dec. 30, 2002, at 52.

33. *Id.*

34. *Id.* Only in a Yeehaw Culture do you get employees fearing for their jobs if they point out that the company is violating accounting rules, SEC regs and, just generally, every federal statute ever passed, with the exception of those laws on the size of baby pacifiers.

35. *Id.* Ms. Watkins is the breadwinner for her family.

36. See Dawn Gilbertson, *Surprises at Finova Big Write Off, CEO's Retirement Send Stocks Down*, ARIZONA REPUBLIC, Mar. 28, 2000, at D1. Mr. Eichenfeld was one of those bigger-than-life CEOs, see *infra* notes 234-68, 404-26, and 478-80 and accompanying text for discussions about the CEOs of WorldCom, Tyco and Adelphia. He bought a \$3 million mansion and was the highest paid CEO in Arizona at Finova's peak, which very soon turned into a gully with the accompanying share price drop from \$54.50 in 1999 to 88 cents per share by the beginning of 2001. For full details on Finova, See MARIANNE M. JENNINGS, BUSINESS

ron had what these companies had just before their collapses: sycophantism among officers' immediate reports; fear among employees so expansive that they will not raise even the most obvious issues; and punishment for employees who question company processes or procedures.<sup>37</sup>

Ms. Watkins' memo to Kenneth Lay on August 15, 2001, included the following: "I am incredibly nervous that we will implode in a wave of accounting scandals. I have heard one manager-level employee from the principal investments group say, 'I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company.'"<sup>38</sup> Ms. Watkins advised Mr. Lay in that first anonymous memo that because of the accounting improprieties, "It sure looks to the layman on the street that we are hiding losses in a related company. . . ."<sup>39</sup>

By August 22, after discussing the memo, the accounting, and the issues with former colleagues at Andersen, Ms. Watkins overcame her fear and confessed to Mr. Lay in a face-to-face meeting that she was the one who had written the memo.<sup>40</sup> Ms. Watkins testified before Congress that she did not discuss her concerns or confess to writing the memo to Mr. Skilling or Mr. Fastow because she said, "It would have been a job-terminating move."<sup>41</sup>

And Ms. Watkins was not alone in the company in her fears. Knowledge about problems with Enron's true financial picture and its accounting practices were well known among employees. Enron employees were circulating via e-mail a "Top 10" list called, "Top Ten Reasons Enron Restructures so Frequently," Number 7 on the list was "Because the basic business model is to keep the outside investment analysts so confused that they will not be able to figure out that we don't know what we're doing," and Number 1 was "Forget all the hype about Fortune's #1 – congratulations

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ETHICS: CASE STUDIES AND SELECTED READINGS, (South-Western College Pub. 4th ed. 2002). (Hereinafter BUSINESS ETHICS)

37. For background on these companies, see JENNINGS, BUSINESS ETHICS, at 249-61. For information on Charles Keating, see *infra* note 242.

38. Michael Duffy, *What Did They Know and When Did They Know It?* TIME, Jan. 28, 2002, at 16.

39. *Id.*

40. Ms. Watkins had examined a series of the SPEs and had written in the margins of the papers she had reviewed, "There it is! That is the smoking gun. You cannot do this! . . . My understanding as an accountant is that a company can never use its own stock to generate a gain or avoid a loss on its income statement." Tom Hamburger, *Enron's Watkins Describes 'Arrogant' Culture*, WALL ST. J., Feb. 15, 2002, at A3.

41. *Id.* Andrew Fastow was indeed thrown into a tizzy by the Watkins actions. In his mind, demented by one-too-many FASB fast-and-loose interpretations, he was upset because he felt that Ms. Watkins was gunning for his job. Rebecca Smith, *Fastow Memo Defends Enron Partnerships And Sees Criticism as Ploy to Get His Job*, WALL ST. J., Feb. 20, 2002, at A3.

to Enron for having broken a Guinness Book of World Record with 942 organizations in one year."<sup>42</sup>

When Margaret Ceconi, an employee with Enron Energy Services, wrote a five-page memo to Kenneth Lay on August 28, 2001, stating that losses from Enron Energy Services were being moved to another sector in Enron in order to make the Energy Service arm look profitable, Mr. Lay referred her to HR for counseling on employee morale.<sup>43</sup> Employee Clayton Vernon was fired after he posted a question on company internal online discussion about whether Enron's accounting was too aggressive and used to overstate its profits. Another employee was fired for commenting on \$55 million paid to officers as retention bonuses in early December 2001.<sup>44</sup>

In 1995, James Alexander, an executive at Enron's Global Power subsidiary, spoke with Mr. Lay about his concerns that there were accounting irregularities (translate: mumbo jumbo) within the company and that deal makers within Enron were enriching themselves via the complex accounting transactions.<sup>45</sup> Referring to the Enron spin-off company he worked for as the "dead canary in the coal mine," Mr. Alexander spoke directly to Mr. Lay about his concerns.<sup>46</sup> Mr. Alexander's assertions were dismissed when Mr. Lay asked questions of others and was assured that he was "overanxious."<sup>47</sup> No changes were made, but Mr. Alexander was often referred to as a "thorn" in CEO Jeffrey Skilling's side.<sup>48</sup>

42. Matt Krantz, *Peeling Back the Layers of Enron's Breakdown*, USA TODAY, Jan. 22, 2002, at B1.

43. Julie Mason, *Concerned Ex-Worker Was Sent To Human Resources*, HOUSTON CHRON., at A11, Jan. 31, 2002. One line from her memo read, "Some would say the house of cards are falling." *Id.*

44. Alex Berenson, *Enron Fired Workers for Complaining Online*, N.Y. TIMES, Jan. 21, 2002, at C1. Mr. Vernon acknowledges that he got carried away with his language in the note and says he will not litigate, "I was using their equipment. . . . I was in their building, and it was a flagrant violation of company policy to do what I did. I'm not going to litigate it. I don't think it was unfair." *Id.* He indicated that the cancellation of the company Christmas party, coupled with the loss of value in his stock and the lack of any work to do at the office were the contributing factors for his messages and use of vulgarity therein. *Id.*

45. John Schwartz, *An Enron Unit Chief Warned, and Was Rebuffed*, N.Y. TIMES, Feb 20, 2002, at C1. Mr. Alexander was, of course, precisely correct. The amazing thing is that he saw it for 6 years before the company collapsed.

46. *Id.*

47. *Id.* At that time, Brent Scowcroft, the former presidential advisor and a retired general, was on the outside board and Lay used the psychology of, "How could you be right and men of this caliber be wrong?" to dismiss Mr. Alexander out-of-hand. Interestingly, Mr. Alexander left Enron and is now studying at the Yale Divinity School, whose motto is "light and truth." He was poised to be CFO of Enron when Mr. Fastow was brought in. Interestingly, Fastow was brought in when Alexander refused to sign SEC documents as the CFO unless he had full control over the development of the numbers.

48. *Id.* at C4.

*Cultural Factor 3 – The Young ‘Uns and Bigger-than-Life CEO*

Ken Lay was clearly the front-man charm for Enron. Mr. Lay put Houston on the map and the community hoisted him to a position of royalty born of gratitude even as it held him in awe for the new ways of doing business he had uncovered with the resulting largesse to Houston's economy.<sup>49</sup> Enron's annual executive meetings, held each January, kept getting more extravagant, even legendary in their opulence. The January 2001 executive meeting was held at the Hyatt Regency Hill Country Resort in San Antonio, and included an open bar, fistfuls of free cigars, and the presence of the company-sponsored racecar for the executives to try out.<sup>50</sup> But, Mr. Lay spread the largesse around with car washes for employees while they worked, a concierge in the lobby of Houston headquarters, massages for employees with an on-site masseuse, Starbucks that were cheaper because of a company subsidy, on-site health club, on-site physician, and great retirement programs that earned Enron rankings of #22 and #24 in *Fortune's* "100 Best Companies To Work For."<sup>51</sup>

Mr. Lay also had the same gift of the other CEOs of the companies discussed here: the ability to charm analysts in such a manner that they did not ask questions about how the stellar achievements of the company were possible. Indeed, when one analyst in the Houston area, John Olson, asked questions about the company's accounting, Mr. Lay protested mightily to the analyst's boss. Mr. Lay wrote a letter to Mr. Olson's employer complaining about the caution Mr. Olson had issued by clients and noted, "John Olson has been wrong about Enron for over 10 years and is still wrong. But he is consistant (sic)."<sup>52</sup>

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49. Of all the companies discussed in this piece, Enron most closely fits what the term "Yeekhaw" brings to mind. This was one wild officer group. The chief of Enron Broadband Services drove his car in Ferrari Challenge races. Local strippers loved the Enron executives who often brought office meetings and celebrations their way with one stripper at a favorite Enron joint indicating that she made \$1,200 in one afternoon from Enron executives who had arrived on a Friday afternoon to celebrate a closed deal they had just completed. Anita Raghavan, Kathryn Kranhold and Alexei Barrionuevo, *How Enron Created a Culture of Pushing Limits*, WALL ST. J., Aug. 26, 2002, at A1.

50. Kurt Eichenwald and Diana B. Henriques, *Enron Buffed Image to a Shine Even as It Rotted From Within*, N.Y. TIMES, Feb. 10, 2002, at A1. (At least 3 executives in the top officer group drove Ferraris. Anita Raghavan, Kathryn Kranhold and Alexei Barrionuevo, *How Enron Created a Culture of Pushing Limits*, WALL ST. J., August 26, 2002, at A1, A7.)

51. Alexei Barrionuevo, *Jobless in a Flash, Enron's Ex-Employees, are Stunned, Bitter, Ashamed*, WALL ST. J., Dec. 11, 2001, at B1. Shelly Branch, *The 100 Best Companies to Work For In America*, FORTUNE, Jan. 11, 1999, at 118. Enron appeared for the first time in the top 100 in 1999. *Id.* In 2000, it was ranked as #24, and in 2001 it was #22. Robert Levering and Milton Moskowitz, *The 100 Best Companies to Work For in America*, FORTUNE, Jan. 8, 2001, at 148.

52. John Schwartz, *Man Who Doubted Enron Enjoys New Recognition*, N.Y. TIMES, Jan. 21, 2002, at C8. Mr. Olson said that when his boss showed him the note from Mr. Lay, he responded, "You know that I'm old and worthless, but at least I can spell consistent." *Id.*

Even the media gave Mr. Lay a pass, apparently on the basis of financial glory. Only one reporter picked up on questions about Enron, Bethany McClean of FORTUNE, but her story appeared and then disappeared.<sup>53</sup> Peter Eavis of TheStreet.com also raised questions about Enron, including raising concerns about Fastow's dual roles, but no mainstream media picked up on his insights or writings.<sup>54</sup>

Mr. Lay enjoyed much more immunity than the halo effect of the big spender he was and had caused Enron to be. He had surrounded himself with young' uns trained in the ways of creative corporate finance who earned him the respect of Wall Street. He hired Harvard MBA Jeffrey Skilling as his second-in-command. Skilling was a pick from the McKinsey & Company consulting team that had been doing work for Enron on the energy trading strategy.<sup>55</sup> Andrew Fastow, Enron's CFO, was very much like the CFOs at WorldCom, Tyco and Adelphia: young, eager to be rich and consumed with maintaining the company's and their stations in life.<sup>56</sup> Mr. Fastow graduated from Tufts University and then the Kellogg School of Management of Northwestern University. Hired by Jeffrey Skilling, Mr. Fastow was only 29 at the time and rose quickly through the Enron ranks to emerge as CFO at age 36, after functioning as third in command following Mr. Skilling and Mr. Lay from the time he was 31.<sup>57</sup> Mr. Skilling and Mr. Fastow were so well regarded in the business community that none dared raise a question about them or their methodologies.<sup>58</sup> And Mr. Lay had planted in

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Mr. Olson has called Wall Street analysts, who fail to call them as they see them because they are in search of the fame and glory, "schnuckels," a Yiddish word for dupe. *Id.* See also *Why John Olson Wasn't Bullish on Enron*, [http://knowledge.wharton.upenn.edu/013002\\_ss3.html](http://knowledge.wharton.upenn.edu/013002_ss3.html) (last visited April 8, 2003).

53. Felicity Barringer, *10 Months Ago, Questions on Enron Came and Went With Little Notice*, N.Y. TIMES, Jan. 28, 2002, at A11. Fortune's managing editor, Rick Kirkland, called Bethany McLean's March 2001 story on Enron "prescient, but it kind of went out and sank." *Id.*

54. *Id.* An interesting note on all of these companies is that the reporters who did raise questions and those who were asking the right questions were the short sellers. Their ability to see through the opaque facades speaks volumes about the failures of the various systems designed to hold companies to a standard of virtue. See *infra* note 557-63 and accompanying text for more discussion of these issues and prevention.

55. John Schwartz, *Darth Vader. Machiavelli. Skilling Set Intense Pace*. N.Y. TIMES, Feb. 7, 2002, at C1.

56. See *infra* notes 238-43, 424-26, 485, 561 and accompanying text for discussion of Scott Sullivan, Mark Swartz, and Mark Rigas, CFOs of WorldCom, Tyco, and Adelphia.

57. Barboza, *supra* note 28, at A1. Mr. Fastow had married a Houston heiress and, at the time of his termination from Enron, he and his heiress wife were building an 11,500-square foot home. Mr. Fastow often told friends that the money someone made was the only way to measure a person's worth and success. *Id.*

58. *Id.* Mr. Fastow was honored as CFO of the year by CFO MAGAZINE for his innovative financing structures. Mr. Fastow indicated in his interview with the magazine editors that was featured in the issue in which his honor was announced that he kept Enron's credit rating high by keeping debts off the balance sheet. See *infra* note 426 and accompanying text in which Mark Swartz, CFO of Tyco is given the same honor for 2000. *Id.* Can this magazine pick 'em or what?



them the goal of Enron's continuing achievement above and beyond the crowd. As a CEO a full generation older and chairman of the Enron board, Fastow and Skilling continued to perform in the manner Mr. Lay had come to expect.

#### *Cultural Factor 4 – Weak Board*

To the untrained eye, sold on the notion that outsiders make for a strong board, the Enron board looked like a dream. The board consisted of the following:

- Kenneth L. Lay – Chair and CEO, *Enron*
- Wendy Gramm, PhD, economist, wife of former Sen. Phil Gramm of Texas
- Dr. John Mendelsohn, head of cancer research center in Houston<sup>59</sup>
- Robert A. Belfer – CEO, *Belfer Management*
- Norman P. Blake, Jr. – Chair, President and CEO, *Comdisco*
- Ronnie C. Chan – Chair, *Hang Lung Group*
- John H. Duncan – Former Chair Exec. Committee, *Gulf & Western Ind.*
- Robert K. Jaedicke – Professor of Accounting, *Stanford University*
- Charles A. LeMaistre – *Emeritus, University of Texas MD Anderson Cancer Ctr.*
- Paulo V. Ferraz Periera – Exec. Vice President, *Group Bozano*
- William C. Powers, Jr. – Dean, *University of Texas, School of Law*
- Frank Savage – CEO, *Savage Holdings*

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59. University of Texas M.D. Anderson Cancer Center in Houston. And here's a great piece of trivia in the six degrees of Kevin Bacon category: Dr. Mendelsohn's center developed the anticancer drug, Erbitux, that was being developed for market by ImClone Systems. Dr. Mendelsohn also served on the board of ImClone, which faced major issues when Erbitux was not given FDA approval, whose former CEO had been indicted and which is the subject of the Martha Stewart insider trading investigation in which she is alleged to have sold \$224,000 of ImClone stock the day before the public announcement of the FDA rejection. See Andrew Pollack and David Cay Johnston, *Former Chief of ImClone Systems is Charged With Insider Trading*, N.Y. TIMES, June 13, 2002, at B1; Jerry Markon, *Martha Stewart Sale of Stock Under Inquiry*, WALL ST. J., June 14, 2002, at C1.

- Raymond Troubh – Financial Consultant
- John Wakeham – Chair, *Press Complaints Commission*
- Herbert S. Winokur, Jr. – Chair, CEO, *Capricorn Holdings*

A dean, all outsiders, many who are CEOs, and it seems a worthy board. However, there were critical problems that made the board weak. First, the compensation paid to each board member was a \$380,000 per year retainer.<sup>60</sup> The size of the pay, which did not include additional compensation for meetings attended, was in and of itself, a conflict. However, there were additional individual conflicts among board members. And these were the types of conflicts that would not require SEC disclosure and are different from the types of conflicts corporate governance experts have been using to spot weaknesses in boards, such as too many insiders or relatives. For example, Dr. Mendelsohn, not only a board member, but also a member of the audit committee, had conflicts through the donations his center had received from both Enron and Ken and Linda Lay. The center had received a donation of \$92,508 from Enron as well as \$240,250 from Ken Lay and his wife Linda over a 5-year period that began when he joined the board.<sup>61</sup>

Herbert S. Winokur, Jr., one of Enron's original directors from its founding in 1985, serves on the board of Natco Company, a firm that did business with Enron subsidiaries.<sup>62</sup> Frank Savage, a senior executive at Alliance Capital Management, continued to have his firm buy and advised clients to buy Enron shares.<sup>63</sup> Lord John Wakeham, a member of the audit committee, had been a consultant for Enron's European unit at a rate of \$72,000 per year since 1996.<sup>64</sup> Wendy Gramm, also an audit committee member, directs the Mercatus Center Regulatory Studies Program at George Mason University, to which Enron donated \$50,000.<sup>65</sup>

There were other questions of good board processes in that attendance was not what it should have been, especially among the international board members. And, despite clear best practices to the contrary, Enron had had the same audit committee chair since the time the company was

60. Reed Abelson, *Enron Board Comes Under a Storm of Criticism*, N.Y. TIMES, Dec. 16, 2001, § 3, at 4.

61. Jo Thomas and Reed Abelson, *How a Top Medical Researcher Became Entangled With Enron*, N.Y. TIMES, Jan. 28, 2002, at C1. The total amount Enron had donated to the center since 1985 (he joined the Enron board in 1995) was \$1,564,928.

62. Abelson, *supra* note 60, at 4. The total amount of business for Natco was \$1.5 million and that information need not be disclosed because Natco is privately held.

63. Reed Abelson and Kenneth N. Gilpin, *2 Enron Roles Raise Questions of Allegiance*, N.Y. TIMES, Dec. 7, 2001, at C1.

64. Joann S. Lublin, *Inside, Outside Enron, Audit Panel is Scrutinized*, WALL ST. J., Feb. 1, 2002, at C1.

65. *Id.*

founded. Dean Robert K. Jaedicke, professor emeritus at Stanford, had been chair of Enron's audit committee since 1985.<sup>66</sup>

The Congressional hearings into the Enron collapse focused on what the hearings concluded was a failure by the Enron board to catch obvious "red flags." It was not just a board weak with a financial stake. This was a board that failed to heed the telltale signs of fraud. Exhibit 1 was a chart in the Congressional report entitled "Red Flags Known to Enron's Board."<sup>67</sup> Herewith some of the red flags:

- At the February 1999 audit committee meeting, Andersen partner David Duncan told the board members that Enron's accounting practices tended to "push limits" and were "at the edge" of generally accepted accounting principles (GAAP).<sup>68</sup>
- Throughout 1999-2001, the Board was informed that gross revenues had doubled and tripled, and that these funds were being generated by off-the-books entities run by their own CFO did not give the directors pause. The corporate minutes do not show one iota of curiosity about these stunning returns.<sup>69</sup>
- The board waived its own conflict of interest policy on a regular basis to permit more off-the-book entities and more Fastow and Koppers' involvement.<sup>70</sup>

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66. *Id.* Sarbanes-Oxley now limits even the audit partner in charge of a company to a five-year stint. Pub. L. No. 107-204, §203 (codified as amended at 15 U.S.C. §78j-1 (2002)).

67. SENATE GOVTL. AFFAIRS COMM., 107th Cong., *The Role of the Board of Directors in Enron's Collapse*, (Comm. Print 2002), [hereinafter *PSI Report*] at n.14 and accompanying text.

68. *Id.* at n.15 and accompanying text. The minutes of the audit committee reflect the Duncan discussion. *Id.* at n.28 and accompanying text. This was not a nuanced presentation by Mr. Duncan. He gave, and the minutes include, to the audit committee a one-page summary called, "Selected Observations 1998 Financial Reporting." *Id.* at n.30 and accompanying text. In the one-page summary Mr. Duncan highlighted Enron's key accounting issues including "Highly Structured Transactions," "Commodity and Equity Portfolio," "Purchase Accounting," and "Balance Sheet Issues." These issues were covered in a matrix that included three categories of risk for the audit committee. The three categories of risk were: "Accounting Judgments," "Disclosure Judgements (sic)," and "Rule Changes." Duncan used 3 categories for classification of risk in each of the areas covered in the summary: "H" for High risk, "M" for Medium Risk, and "L" for Low risk. Each issue Duncan listed in the summary had at least 2 "H's." *Id.*

69. *Id.* at n.15 and accompanying text. Mild curiosity would have prompted the least astute among us to ask, "Andy, how the heck are you making all this money?"

70. *Id.* at n.56 and accompanying text. See *infra* notes 77-88 for more information on the conflicts of interest issues. In fairness, or unfairness, depending on how you look at it, to the board, these red flags, even if heeded at this point (which was well into 2000) would not have

- Oddly, even the sudden resignation of CEO Jeffrey Skilling and Sherron Watkin's whistle-blower memo did not catapult the board into action. It accepted the word of management that the memo was nothing and closed its investigation into her allegation by October 2001.<sup>71</sup>

The Enron board was very much one that fulfilled a rubber-stamp function, willing to approve transactions they were cautioned were aggressive and high risk.<sup>72</sup> While it is possible that the board may not have understood the complexity of Enron's off-the-books wheeling and dealing, it certainly had sufficient expertise on the board to ask for an explanation.<sup>73</sup> And another red flag was the disclosure in Enron's 1999 and 2000 10-Ks that Enron had an interest in 3,000 separate entities listed, including 600 entities with the same PO Box address in the Cayman Islands.<sup>74</sup> But, this was a

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saved the day at Enron. At this point, the off-the-book entities were the collusion dreamed up by the officers to meet the numbers goals that had come to be expected at Enron. It was, at this point, a question of how far the fall would be and how soon it would occur. These red flags merely would have alerted the board to a cover-up. Perhaps an earlier and honest disclosure of the complex subterfuge might have preserved some of the company's value, but it was not as if the board was in prevention mode at the time the Congressional committee lists the red flags. The company was already so leveraged that there was little chance of shareholders seeing any preservation of their overvalued shares. The true red flags for Enron's board and for the boards of the other companies discussed herein were really much earlier and are covered in the solutions segment of this piece. See *infra* notes 498-573 and accompanying text.

71. *PSI Report, supra* note 67, at n.18 and accompanying text. Please note that this was no ordinary whistle-blower's memo, full of "I didn't get a pay raise" disgruntlement. This was a savvy memo with a warning about Skilling's leaving, "Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. . . . The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job." *Id.*

72. Further, the audit committee and board did have expertise. A business school dean ought to be a fairly good resource for information about business structure. Further, Lord Wakeham, a Brit and member of the Enron board, is what is known as a "chartered accountant" in Great Britain, the equivalent of a CPA. He also has chaired audit committees at other publicly held companies. When asked about Enron's bizarre structure, he responded that it was "relatively new" and "not done by many companies in the world." He also claimed he relied on Arthur Andersen and David Duncan. *Id.* at n.40 and accompanying text. It is also interesting to note that Mr. Fastow had generally already hired investment bankers for his various private placements for the off-the-books entities long before he obtained board approval on the various transactions. Mr. Fastow appeared to understand that he had a rubber stamp board. *Id.* at n.58 and accompanying text.

73. The author has been studying Enron and its collapse for 3 years, and she is still not completely conversant in all aspects of the off-the-books entities and wheeling and dealing. Had the author known that it was possible to make money by simply creating LLCs, LLPs, and then transferring funds and property among them in a gigantic shell game, she would have chosen fraud as a career path. See *infra* note 366 for more career choices based on the history and activities of these companies.

74. See Enron 10-Ks for 1999 and 2000 at Edgar at [www.sec.gov](http://www.sec.gov). It is possible that the directors may not have looked at the exhibits to these 10-Ks, which is where the entities would have been listed. And therein lies one of the first lessons from these companies for directors: ask to see the 10-K exhibits. There's gold, or the lack of gold and/or money, in those exhibits.

board filled with fear. At one point, the board recognizes, as it approves all of these off-the-books entities with Mr. Fastow as principal, that it does not really know how much Mr. Fastow is making as a principal, particularly in all the transactions with the company. Rather than haul the CFO in before the board and ask for an explanation, the Board names Dr. LeMaistre and John Duncan as delegates who are to go to Mr. Fastow and request the compensation information. Deferential as they were, Dr. LeMaistre and Mr. Duncan requested legal counsel to create talking points for them before they enter the tangled web of their company's CFO.<sup>75</sup> The humble directors got some information from Mr. Fastow, but he never furnished them with the full information they requested, and he quit returning their phone calls after the visit.<sup>76</sup>

### *Cultural Factor 5 – A Culture of Conflicts*

Enron represents the company of those discussed here with perhaps the most blatant conflict of interest issues. Enron had a fairly detailed code of ethics with controls on officer and employee involvement.<sup>77</sup> The Enron Code of Ethics has both a general and a specific policy on conflicts of interest. The general ethical principle on conflicts is:

*Employees of Enron Corp., its subsidiaries, and its affiliated companies (collectively the "Company") are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct*

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75. *PSI Report*, *supra* note 67, at n.104 and accompanying text. Here's the obsequious script legal counsel drafted for the boys. Scarecrow and Cowardly Lion were less timid in front of the Wizard of Oz:

We very much appreciate your willingness to visit with us. Andy, because of the current controversy surrounding LJM I and LJM II, we believe it would be helpful for the Board to have a general understanding of the amount of your investment and of your return on investment in the LJM entities. We understand that a detailed accounting of these matters will be done in connection with the response to the SEC inquiry. In responding to our questions with respect to your interest in the LJM entities, we would appreciate your including any interest . . . that the members of your family may have had in the entities.

*Id.* at n.107 and accompanying text.

76. *Id.* at n.108 and accompanying text. The number the directors were looking for from "Andy" was his total return on his role in these off-the-books entities, something they never did get and is now estimated to have been \$43 million. *Id.* Bill Saporito, *Speak No Evil*, TIME, Feb. 18, 2002, at 34. And here's another red flag: If you're on the board of a company and the CFO won't return your phone call or give you numbers, you might want to conduct a little investigation on your financial reports.

77. The author obtained the Enron code of ethics through E-bay. Former Enron employees, trying to make money as they could, were selling various Enron mementos, and the code of ethics seemed like a classic moneymaker. I won the bid for a mere \$45. The code of ethics arrived unopened. It had been, as we shall see, untouched by human hands.

*himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the company.*<sup>78</sup>

The specific provisions that related to ownership of businesses that do business with Enron provided:

The employer is entitled to expect of such person complete loyalty to the best interests of the Company. . . . Therefore, it follows that no full-time officer or employee should: . . .

*(c) Own an interest in or participate, directly or indirectly, in the profits of another entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.*<sup>79</sup>

The board waived its own policy for Mr. Fastow and his complex entities on at least 3 different occasions.<sup>80</sup> The waiver was, in and of itself, a red flag,

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78. ENRON, CODE OF ETHICS, EXECUTIVE AND MANAGEMENT 12 (2000) (on file with author).

79. *Id.* at 57.

80. The board played some semantics with this approval and will perhaps continue to do so as the litigation against it sorts itself out. Board minutes show that the board was asked to ratify the waiver that Mr. Lay had already granted to Mr. Fastow. Dean Jaedicke insists that such approval or ratification was not a waiver of the code of ethics, but rather an enforcement of it because the conflicts provision permitted the CEO to waive the conflicts policy. The board's ratification upheld the conflicts policy in Dean Jaedicke's mind. *PSI Report, supra* note 67, at n.58 and accompanying text. One can see why the dean wasn't much help in sorting through the complex off-the-books entities. He can't even bring himself to say that the board waived the conflict of interest policy after they had waived the conflicts of interest policy. Arthur Andersen and David Duncan, however, wanted the waiver that Dean Jaedicke did not consider a waiver. When Mr. Duncan was first asked to approve of the first off-the-books entity with Mr. Fastow as a principal, he was concerned enough to send an e-mail, on May 28, 1999, to Benjamin Neuhausen, a member Andersen's Professional Standards Group in Chicago. Mr. Neuhausen saw the issue and responded with a bit of outrage, "Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?" *Id.* at n.60 and accompanying text. Mr. Duncan, still not possessed of sufficient gumption to tell Mr. Fastow "No!" wrote back to Mr. Neuhausen on June 1, 1999:

[O]n your point 1 (i.e., the whole thing is a bad idea), I really couldn't agree more. Rest assured that I have already communicated and it has been agreed to by Andy that CEO, General [Counsel], and Board discuss-

and the board had a few moments of gumption, holding, at one point, a “vigorous discussion.”<sup>81</sup>

But, the conflicts issues with Mr. Fastow and the board were just a small part of a web of conflicts throughout management at Enron. Even Enron’s auditors had conflicts of interest. Andersen served as both Enron’s auditor as well as a consultant and was paid \$25 million for its audit work while its nonaudit fees were greater, at \$27 million.<sup>82</sup> Andersen was doing what virtually all of the other Big-Five accounting firms do, in terms of mixing the audit and consulting functions and all offering their unequivocal assurances that they have no conflicts of interest in mixing their roles.<sup>83</sup>

But, there was an overarching conflict with Andersen and Enron. The relationship was cozy at all levels. David Duncan, the audit partner for Enron from the Houston office was a close personal friend of Mr. Richard Causey, the company’s chief accounting officer as well as the man responsible for approving Mr. Fastow’s off-the-books entities.<sup>84</sup> So close was the Andersen/Enron connection that the employees at Enron were never sure who was working for Andersen and who was working for Enron at any particular time because Andersen staff had permanent offices at Enron (including Mr. Duncan). Enron often hired Andersen employees (witness Sherron Watkins) and office birthday parties were thrown for Andersen and Enron employees alike because no one was really sure who worked for whom and they did not want to risk slighting any employees.<sup>85</sup>

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sion and approval will be a requirement, on our part, for acceptance of a venture similar to what we have been discussing.

*Id.* at n.61 and accompanying text. Everyone was counting on everyone else to say “NO!” and no one ever did.

81. *Id.* at n.70 and accompanying text.

82. Deborah Solomon, *After Enron, a Push to Limit Accountants to . . . Accounting*, WALL ST. J., Jan. 25, 2002, at C1. The \$27 million included tax services as well as unspecified consulting services.

83. The Institutional Investors Council has urged publicly-held companies to adopt voluntary conflict-of-interest policies that would prevent the companies’ audit firms from performing anything other than audit services or consulting services, but not both. Disney is one company that has done just that and has dropped PricewaterhouseCoopers from performing both audit and consulting functions for the company. Gary Strauss, *Companies Take Action To Regain Investor Trust*, USA TODAY, July 17, 2002, at A1.

84. Anita Raghavan, *How a Bright Star at Andersen Fell Along With Enron*, WALL ST. J., May 15, 2002, at A1. Mr. Duncan and Mr. Causey took golf and fishing trips together, ate lunch together, played golf together, and this was all in between conspiring to cook the books. See also Cathy Booth Thomas and Deborah Fowler, *Will Enron’s Auditor Sing?* TIME, May 20, 2002, at 44.

85. In 2000, 7 former Andersen accountants became Enron employees. John Schwartz and Reed Abelson, *Auditor Struck Many As Smart and Upright*, N.Y. TIMES, Jan. 17, 2002, at C11.

And Mr. Lay was generous in nepotism and the resulting conflicts. Mr. Lay's son, Mark, did work for Enron for a time, but then went off on his own, creating two privately held technology firms. Enron not only signed contracts to do business with both companies, it invested in one of them.<sup>86</sup> Mark Lay was also hired by Enron as a consultant at a salary of \$1,000,000 that was part of a three-year contract that included 20,000 options for Enron stock.<sup>87</sup> Enron's major travel agency was co-owned by Mr. Lay's sister, Sharon Lay. Ms. Lay's Alliance Worldwide Travel booked more than \$10 million in travel for Enron and its employees.<sup>88</sup> In fact, Alliance had few other clients.

### *Cultural Factor 6 – A Culture of Innovation Like No Other*

Like the other companies examined herein, Enron executives cultivated a culture that had employees, investors, analysts, auditors and even regulators believing that they were unlike any other company; they were unique and hence their earnings and achievements would always be way above the norm. Jeffrey Skilling had a favorite line that he repeated over and over again in interviews, "We are on the side of angels."<sup>89</sup> Enron capitalized on the new open markets in electricity through its financial models that allowed it to hedge risk with future contracts for energy.<sup>90</sup> Other utilities even spoke of "the Enron model" as the strategic vision of the future.<sup>91</sup> Enron became known as "the biggest e-commerce company in the world."<sup>92</sup> There was the constant drumbeat of "better, faster, bigger" that came from the officers of the company. Mr. Skilling would dismiss those who questioned him and Enron as "not getting it."<sup>93</sup> Enron boasted that it was the

86. David Barboza and Kurt Eichenwald, *Son and Sister of Enron Chief Secured Deals*, N.Y. TIMES, Feb. 2, 2002, at A1.

87. *Id.*

88. *Id.*

89. Eichenwald, *supra* note 50, at A1. The full quote as it appeared in print was, "We are the good guys. We are on the side of angels." However, in television interviews, Mr. Skilling shortened it to, "we are on the side of angels." *Frontline, Blackout*, July, 2001.

90. Enron actually branched out on its hedging to all sorts of commodities including telecommunications wire load, bandwidth, lumber, and even television ad times. Rebecca Smith, *Enron Faces Collapse as Credit, Stock Dive and Dynegy Bolts*, WALL ST. J., Nov. 29, 2001, at A1, A10.

91. Kurt Eichenwald, *Audacious Climb to Success Ended in Dizzying Lunge*, N. Y. TIMES, Jan. 13, 2002, Sec. 1, at 1. There are continuing issues about what the Enron model really was. Charges of market manipulation in California and elsewhere have Enron under fire for illegal energy trades, as if the bankruptcy and utter moral collapse are not enough for the trustee to handle. See Richard A. Oppel, Jr. and Jeff Gerth, *Enron Forced up California Prices, Documents Show*, N.Y. TIMES, May 7, 2002, at A1; Kathryn Kranhold and Rebecca Smith, *Enron Had Assistance, Memos Say*, WALL ST. J., May 9, 2002, at A3; John Swartz, *Daschle: Somebody Ought to go to Jail*, USA TODAY, May 10, 2002, at B5.

92. Eichenwald, *supra* note 91, at A20.

93. *Id.*



“world’s largest energy company” and a plaque in the lobby for former Houston headquarters read, “The World’s Leading Company.”<sup>94</sup>

### *Cultural Factor 7 – A Culture of Social Responsibility*

Enron and its officers were models of philanthropic activities. Mr. Fastow was prominent in Houston’s Jewish community, active in the art museum, and had been the lead fundraiser for Houston’s Holocaust museum. Most who knew the Enronites were stunned when the stories of financial collapse and accounting mumbo jumbo emerged, with one Fastow friend who worked with the CFO in the community proclaiming, “The person I know bears absolutely no relation to the person who has been characterized, in some reports, within the walls of Enron.”<sup>95</sup> Other officers were involved in Junior Achievement.<sup>96</sup> Mr. Duncan was active and committed in his church with his pastor eventually giving an interview to the *New York Times* about the temptation, the failure to draw lines with Fastow and that Duncan was, just generally, a decent human being.<sup>97</sup>

Enron was the quintessential corporate citizen with universities around the country enjoying *noblesse oblige*, along with virtually every non-profit organization in the Houston area. Commentary following Enron’s collapse included observations on how much the company’s donations would be missed.

### *Debacle Two – WorldCom*

#### *The Company History*

How the mightier are fallen. It was 1983 when Bernard J. Ebbers (aka “Bernie”) founded Long Distance Discount Service (LDDS), a discount long-distance telephone company.<sup>98</sup> Allegedly, Mr. Ebbers, a former junior high school basketball coach from Edmonton, Alberta, launched the plan for what would become a multibillion-dollar, international company in a diner in Hattiesburg, Mississippi.<sup>99</sup> Poised on the eve of deregulation of the na-

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94. Bethany McLean, *Why Enron Went Bust*, FORTUNE, December 24, 2001, at 58.

95. Barboza, *supra* note 28, at A1.

96. Jim Yardley and Sheila K. Dewan, *Despite His Qualms, Scandal Engulfed Executive*, N.Y. TIMES, Jan. 27, 2002, Sec. 1, at 33.

97. Raghavan, *supra* note 84, at A1.

98. The author recognizes readers may have gathered its business from the name. However, there is a cite for the formation of LDDS, Seth Schiesel and Simon Romero, *WorldCom: Out of Obscurity to Under Inquiry*, N.Y. TIMES, March 13, 2002, at C1. Actually, only LDDS appears in this article, the actual name of the company can be found in relatively few sources, *but see*, Susan Pulliam, Jared Sandberg, and Dan Morse, *Prosecutors Gain Key Witness In Criminal Probe of WorldCom*, WALL ST. J., July 3, 2002, at A1.

99. Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, NY TIMES, August 8, 2002, at A1. The story goes that it was a diner at the Days Inn, not your high-dollar coffee shop. Mr. Ebbers, an owner of 13 such budget hotels at the time near beau-

tion's telephone monopoly, Mr. Ebbers and a group of small investors began a strategy selling discount long-distance phone service by buying network access wholesale from AT&T and other long-distance giants and then reselling it to consumers at a discount, cheaper than the large carriers' retail rates, but enough to make money for LDDS.<sup>100</sup>

By 1985, Ebbers was weary of the venture because LDDS was in constant need of cash infusions and his 13-chain budget motel chain appeared to be the cash cow for the fledgling long distance company. So, at yet another coffee shop meeting, he agreed to take over the management of the company.<sup>101</sup> Mr. Ebbes's diner strategy this time was growth through acquisition and he embarked on what one business writer described as a 15-year juggernaut of mergers.<sup>102</sup> LDDS acquired phone companies in 4 neighboring states and Ebbers pursued the strategy of a company that combined local service, long distance and data interchange, and the 1996 opening of competition in local phone service only made it easier for the strategy to work.

LDDS went public in 1989 and finished the year with its telephone services throughout 11 Southern states and a new name, WorldCom.<sup>103</sup> By 1998, WorldCom had merged 64 times, including mergers with MFS Communications, Metromedia, and Resurgens Communications Group.<sup>104</sup> Its 65<sup>th</sup> merger would be its biggest acquisition and the move that caught Wall Street attention. WorldCom made a \$37 billion offer to purchase MCI in a bidding war with British Telecommunications and GTE.<sup>105</sup> WorldCom won the bidding and completed what was at that time the largest merger in history.<sup>106</sup> WorldCom would acquire CompuServe and ANS Communications before its only failed merger in 2000 when the Justice Department nixed WorldCom's proposed merger with Sprint, citing a resulting lack of competition in long distance telecommunications if the merger were approved.<sup>107</sup>

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tiful metropolitan Hattiesburg, Mississippi, was the major investor. *Id.* See also Schiesel, *supra* note 98, at C1.

100. Barnaby J. Feder, *An Abrupt Departure Is Seen as a Harbinger*, N.Y. TIMES, May 1, 2002, at C1.

101. *Id.*

102. Eichenwald, *supra* note 99, at A1.

103. Feder, *supra* note 100, at C1. The company went public on NASDAQ.

104. Eichenwald, *supra* note 99, at A1. The MFS merger alone carried a \$12 billion price tag. *Id.*

105. Feder, *supra* note 100, at C1. British Telecom had begun the bidding in 1997 with \$19 billion, and it just kept going until Bernie won. Bert C. Roberts, Jr., the CEO of MCI, eventually took Bernie's offer that carried the additional perk of making him chairman of the newly merged WorldCom/MCI to be known as WorldCom.

106. Schiesel, *supra* note 98, at C1.

107. The Justice Department balked at the \$129 billion deal. Rebecca Blumenstein and Jared Sandberg, *WorldCom CEO Quits Amid Probe of Firm's Finances*, WALL ST. J. April 30, 2002, at A1.

By the time the Justice Department rejected its final merger proposal, WorldCom had grown to 61,800 employees with revenues of \$35.18 billion.<sup>108</sup> The bulk of its revenues came from commercial services including data, voice, Internet and international service with the second largest source of revenue being the consumer services division.<sup>109</sup>

*What Went Wrong: The Story of the Fall From Grace*

WorldCom fell over a period of agonizing months during 2002. The unraveling had really begun with the failure of the Sprint merger along with the accompanying burst in the dot-com bubble and the resulting decline in the need for broadband, Internet access and all the growth associated with the telecommunications industry.<sup>110</sup> As explained below, WorldCom was unable to sustain its revenue growth and engaged in some accounting activities that were questionable at best during the burst bubble period. When the economy took a general downturn in 2002, WorldCom could no longer sus-

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108. Feder, *supra* note 100, at C1. Although, *see infra* notes 125-33 for adjustments in those earnings. The author cannot guarantee those revenues will hold true because changes have been regular and forthcoming such that the revised revenue figures are reported in Eastern Daylight Savings time to establish their limitations in terms of duration.

109. Feder, *supra* note 100, at C1. The annual reports for 2000 and 2001 are no longer available on the company's Website. There is simply a statement that those reports are not currently available because they are being restated. *See* [www.worldcom.com](http://www.worldcom.com) (last visited January 11, 2003). WorldCom has filed a notice of delay in filing its 10-K with the SEC, and the notice explains the reason, "As reported in its Current Report on Form 8-K filed with the Securities and Exchange Commission ("SEC") on June 26, 2002, WorldCom, Inc. (the "Company") has announced its intention to restate its financial statements for 2001 and the first quarter of 2002 as a result of \$3.05 billion of transfers from line cost expenses to capital accounts during these periods that were not made in accordance with generally accepted accounting principles. *See* <http://www.sec.gov/Archives/edgar/data/723527/000091205702025338/0000912057-02-025338.txt> (last visited April 9, 2003). As reported in its Current Report on Form 8-K filed on August 9, 2002, the Company has announced that its ongoing internal review of its financial statements has discovered an additional \$3.3 billion in improperly reported earnings before interest, taxes, depreciation and amortization (EBITDA) for 1999, 2000, 2001 and first quarter 2002, which would require the Company also to restate its financial statements for 2000. The additional impact of these newly reported items on pre-tax income for 1999, 2000, 2001 and first quarter 2002 is \$3.83 billion. *See* <http://www.sec.gov/Archives/edgar/data/723527/000089375002000472/0000893750-02-000472.txt> (last visited April 9, 2003). "The Company has asked its external auditors, KPMG LLP ("KPMG"), to undertake a comprehensive audit of its financial statements for 2000, 2001 and 2002. A Special Investigative Committee of the Company's Board of Directors is overseeing an independent investigation of these matters by William R. McLucas, former Director of the Division of Enforcement for the SEC." WorldCom, NT-10-Q; Notice of Inability to Timely File 10-K, *available at* <http://www.sec.gov/Archives/edgar/data/723527/000089375002000485/0000893750-02-000485.txt> (last visited April 9, 2003).

110. The cuts in the telecom industry began in 2000. For example, between 2000 and 2001, Lucent reduced its employees from 106,000 to 77,000, Verizon went from 263,000 to 247,000, and there was a 52.8% decline in employees overall in the telecom industry from 2000 to 2002. Cuts in telecommunications workers during this period exceeded the cuts in any other industry. Louis Uchitelle, *Job Cuts Take Heavy Toll on Telecom Industry*, N.Y. TIMES, June 29, 2002, at C1.

tain the revenue growth even with the assistance of creative accounting. The manipulations became more obvious and those both inside and outside the company began to question the company's books.<sup>111</sup>

All along the road to the collapse there were bubbles of percolation, hinting at impending problems. As the Enron scandal was unfolding, the SEC announced that it was probing the accounting and finances of both WorldCom and Qwest, two of the country's telecommunications giants.<sup>112</sup> The announcement of the SEC investigation caused a drop in WorldCom's share price down to \$8.39, a 7% drop.<sup>113</sup> It was also in March that Cynthia Cooper, head of WorldCom internal audit, first got wind of some creative and not-so-creative accounting practices and she began her investigation.<sup>114</sup> WorldCom revealed that it had loaned its CEO, Mr. Ebbers, over \$415 million.<sup>115</sup> Sometime in April 2002, the board discovered that the ability of Mr. Ebbers to repay the loans was in doubt. The loans were consolidated into one promissory note, with the \$400 million-plus to be repaid by 2008, and,

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111. See *infra* notes 118-122 and accompanying text for more information on how the accounting tomfoolery was uncovered.

112. Andrew Backover, *WorldCom, Qwest face SEC scrutiny*, USA TODAY, Mar. 12, 2002, at B1. The SEC gave as its list of areas to be examined at WorldCom: charges against earnings, sales commissions, accounting policies for goodwill, loans to officers or directors, integration of computer systems between WorldCom and MCI and the company's earnings estimates. *Id.* The SEC inquiry was referred to as a "cloud of uncertainty" over WorldCom. Andrew Backover, *'Cloud of Uncertainty' Rains on WorldCom*, USA TODAY, Mar. 13, 2002, at B3.

113. Backover, *supra* note 112, at B1. In an ironic note, an analyst opined on the SEC investigation, "I don't think they are going to find anything they can prosecute. But you may have people try to rewrite the accounting rules so they are not so loose." *Id.* See *infra* notes 129, 163, 252, 297-98, 302, 305-06, 566 and accompanying text for more details on the undying optimism of analysts when it came to WorldCom.

114. Susan Pulliam and Deborah Solomon, *Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1. Ms. Cooper did alert the audit committee, but no further action was taken as she continued her investigation. *Id.*

115. Andrew Backover, *Questions on Ebbers Loans May Aid Probes*, USA TODAY, Nov. 6, 2002, at B3. The loans date back to Sept 6, 2000, when the price of WorldCom shares began to fall and Ebbers was on the line for margin calls on shares he had pledged as collateral for personal loans. If he could not meet the margin calls, then he would sell his shares in the market to raise cash (see *infra* notes 253, 255, 256-60, 266, 284, 288, 290-96 and accompanying text for more details on the loans and the propriety of them) and such a "dumping" of shares on the market would further deflate those declining share prices. Mr. Ebbers held over 27,000,000 WorldCom shares. The initial loan was for \$50 million, which was followed by a \$25 million loan on October 27, 2000, and loan guarantees of \$100 million on November 14, 2000. There was an additional loan of \$25 million in December 2000, and loan guarantees of \$150 million in January 2001. In January 2002, the compensation committee of the WorldCom board approved another \$65 million loan to Mr. Ebbers. *Id.*

as a condition, that Mr. Ebbers resign as CEO.<sup>116</sup> John Sidgmore, an officer and board member, assumed the position of CEO.<sup>117</sup>

At that point, the company, and most outsiders, seemed to believe that WorldCom was simply grappling with the end of a long line of mergers and the downturn in the telecommunications market.<sup>118</sup> Mr. Sidgmore undertook new leadership in a different era for WorldCom. However, Ms. Cooper's investigation was running parallel to the changes at the executive level and in May she discovered that there were some accounting practices, including there not being receipts for major expenses, that warranted board involvement.<sup>119</sup> In between her discoveries and informing the board, in early June 2002, Mr. Sidgmore announced that WorldCom was considering cutting its work force by 20%, or by about 16,000 jobs.<sup>120</sup>

WorldCom's executive team and board developing strategies for the telecommunications markets would collide with the Cooper parallel series of audit events that would ultimately change WorldCom and its officers forever. In early June, Ms. Cooper confronted Scott Sullivan, the CFO, with questions about the booking of operating expenses as capital expenses and was rebuffed.<sup>121</sup> Unable to secure an adequate explanation from Mr. Sullivan and even asked to delay her audit, Ms. Cooper took the documentation and concerns to the head of the audit committee, Max Bobbitt, and then to the meeting of the audit committee in Washington, D.C., on June 20, 2002.<sup>122</sup> Mr. Sullivan was given an opportunity to respond at that board meeting, but could offer no explanation other than his belief that the expenses were correctly booked.

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116. *Id.* Rebecca Blumenstein and Jared Sandberg, *WorldCom CEO Quits Amid Probe of Firm's Finances*, WALL ST. J., April 30, 2002, at A1. Mr. Ebbers reached his decision on April 26, 2002, following phone calls from outside directors. *Id.*

117. *Id.* Mr. Sidgmore reflected on his assumption of the position, "It's fair to say that some of the directors were increasingly concerned in the last couple of weeks and Bernie was increasingly frustrated. . . . It's no secret that there has been a lot of pressure on the company for the past year." *Id.* Mr. Ebbers resigned both his roles as president and CEO and agreed also to leave the board. *Id.*

118. Rebecca Blumenstein, Mitchell Pacelle and Deborah Solomon, *WorldCom's Problems Mount In Wake of Ebbers Departure*, WALL ST. J., May 1, 2002, at A1. Mr. Sidgmore indicated he would restructure the company, and the stock rose from \$2.35 per share to \$2.48 per share, a 5.5% increase. "We are going to look at all of our available options. I would not have taken this job if I thought we were going to be out of business next week." *Id.*

119. Pulliam, *supra* note 114, at A1.

120. Andrew Backover, *Struggling WorldCom Could Jettison 16,000 Jobs*, USA TODAY, June 5, 2002, at B1.

121. Ms. Cooper refers to Mr. Sullivan as the most respected person in the company, but that he was hostile, and "when someone is hostile, my instinct is to find out." Amanda Ripley, *The Night Detective*, TIME, Dec. 30, 2002 – Jan. 6, 2003, 45, at 47.

122. Ripley, *supra* note 23, at 48. Mr. Sullivan told Ms. Cooper that he was planning a "write down" in the second quarter if she could just hold off on the investigation. Kurt Eichenwald and Simon Romero, *Inquiry Finds Effort at Delay At WorldCom*, N.Y. TIMES, July 4, 2002, at C1.

Mr. Sullivan, who refused to resign and defended his accounting practices until that final meeting, was fired that day by the board.<sup>123</sup> David Myers, the controller for the company, resigned the following day.<sup>124</sup> Following sufficient review by Ms. Cooper and the company's new auditor, KPMG, WorldCom announced on June 25, 2002, that it had overstated cash flow by \$3.9 billion for 2001 and the first quarter of 2002 by booking ordinary expenses as capital expenditures.<sup>125</sup> WorldCom's shares dropped 76% to 20 cents per share.<sup>126</sup> Trading was halted for three sessions, and when it was reopened, more than 1.5 billion shares of WorldCom were dumped on the market, sending the share price down from 77 cents to 6 cents in what was the highest selling frenzy in the history of the market.<sup>127</sup> WorldCom's bonds dropped from 79 cents just before the announcement of the accounting irregularities to 13 cents just following the announcement.<sup>128</sup> There was a flurry of subpoenas from Congress for the officers of the company.<sup>129</sup> The officers all took the Fifth Amendment and \$2 billion in federal contracts held by WorldCom was under review by the General Services Administration because federal regulations prohibit federal agencies from doing business with companies under investigation for financial improprieties.<sup>130</sup>

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123. Ripley, *supra* note 23, at 49.

124. *Id.*

125. Andrew Backover, Thor Valdmanis, Matt Krantz and Michelle Kessler, *WorldCom Finds Accounting Fraud*, USA TODAY, June 26, 2002, at 1B. See *infra* notes 140-85 and accompanying text for more discussion of the accounting practices as well as the applicable rules.

126. *Id.* This restatement remains the largest in history, more than doubling the previous record set by Rite-Aid of \$1.6 billion.

127. Matt Krantz, *Investors Dump WorldCom Stock at Record Pace*, USA TODAY, July 2, 2002, at 3B. It was the first time in the history of the market that more than one billion shares had ever been traded in one day. The pace exceeded the previous record of 671 million shares sold in one day, a record WorldCom held only for a few days until this trading reopened. WorldCom was delisted from the NASDAQ on July 5, 2002. *Id.* How can this data about July 5 be from an article on July 2? The official delisting occurs after 20 days if the company does not request a hearing. WorldCom thus announced the official delisting on July 29, 2002. [www.worldcom.com](http://www.worldcom.com), Press releases, July 29, 2002.

128. Henny Sender and Carrick Mollenkamp, *WorldCom Bondholders Study Plan*, WALL ST. J., July 5, 2002, at A6.

129. Andrew Backover and Thor Valdmanis, *WorldCom Scandal Brings Subpoenas, Condemnation*, USA TODAY, June 28, 2002, at 1A. Mr. Ebbers, Mr. Sullivan, Mr. Sidgmore and Salomon Smith Barney analyst, Jack Grubman were subpoenaed. The House Financial Services Committee conducted the investigation. Michael Schroder, Jerry Markon, Tom Hamburger and Greg Hitt, *Congress Begins WorldCom Investigation*, WALL ST. J., June 28, 2002, at A3.

130. Yochi J. Dreazen, *WorldCom's Federal Contracts May Be Vital*, WALL ST. J., July 10, 2002, at B2. The regulations require federal agencies to deal with a "responsible contractor," which means the company must have a "satisfactory record of integrity and business ethics." The GSA had already banned Enron and Arthur Andersen from future government contracts once their difficulties emerged during 2001 and 2002. *Id.* For information on the Fifth Amendment, see Andrew Backover and Paul Davidson, *WorldCom Grilling Turns Up No Definitive Answers*, USA TODAY, July 9, 2002, at 1B.

The SEC filed fraud charges within three days and asked for an explanation from WorldCom about exactly what had been done in its accounting.<sup>131</sup> And the restatements would not end in June 2002. On August 8, 2002, WorldCom announced that it had found an additional \$3.3 billion in earnings misstatements from 2000, with portions from 1999.<sup>132</sup> In between those stunning announcements, WorldCom would declare bankruptcy on July 22, 2002, the largest bankruptcy in the history of the United States.<sup>133</sup>

Shortly after WorldCom filed for bankruptcy, the federal government indicted Scott Sullivan, David Myers, Betty Vinson, Buford Yates, Troy Normand, and a host of other characters involved in developing the company's financial reports.<sup>134</sup> Investigations of the company by both the Justice Department and the SEC continue along with a Congressional investigation and one by the bankruptcy court.<sup>135</sup> Before the year ended, most of the WorldCom board had resigned, Michael D. Capellas, the former CEO of Compaq Computers, replaced Mr. Sidgmore and there was another revision of WorldCom revenues, bringing the total revisions to \$9 billion.<sup>136</sup> How-

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131. Andrew Backover and Thor Valdmanis, *WorldCom Report Will Face Scrutiny*, USA TODAY, July 1, 2002, at 1B.

132. Kevin Maney and Thor Valdmanis, *WorldCom Reveals \$3.3B More in Discrepancies*, USA TODAY, Aug. 9, 2002, at 1B. At that point, WorldCom announced that it would go back no further than 1999 because it only needed three years of audited books in order to emerge from bankruptcy. *Id.*

133. Simon Romero and Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July 22, 2002, at A1. The bankruptcy has got to be the largest in the world ever as well because, well, the drop-off in businesses after the U.S. is fairly dramatic. There were over 100 pages of creditors listed in the filing and 50 U.S. banks were the largest of the unsecured creditors of the company. Jon Swartz, *WorldCom Faces Financial Examiner*, USA TODAY, July 23, 2002, at 1B. WorldCom had over \$33 billion in debt and \$100 billion in assets. Andrew Backover, *WorldCom Files for Chapter 11 Protection*, USA TODAY, July 22, 2002, at 1A. The idea of the size of this bankruptcy was discussed in *USA Today: WorldCom's annual revenues equal the gross domestic product of Ecuador (that's a lot of bananas, eh?); WorldCom's assets are the equivalent of all the assets of United Airlines, Delta Airlines and Southwest Airlines. WorldCom's networks connect 79,383 buildings or 10 times the number of buildings in downtown Chicago.* Kevin Maney and Andrew Backover, *WorldCom's Bomb*, USA TODAY, July 22, 2002, at 1B.

134. Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1. See also Deborah Solomon and Susan Pulliam, *U.S., Pushing WorldCom Case, Indicts Ex-CFO and His Aide*, WALL ST. J., Aug. 29, 2002, at A1. Yates was the former director of general accounting, Myers was the former controller, Vinson was the former director of management reporting and Normand was the former director of legal entity accounting.

135. Simon Romero, *Inside Inquiry By WorldCom Is Continuing*, N.Y. TIMES, July 6, 2002, at B1. The bankruptcy appointee, Richard Thornburgh, worked with the Justice Department in developing his report. Jon Swartz, *WorldCom Faces Financial Examiner*, USA TODAY, July 23, 2002, at 1B. For more information on the Thornburgh report, see *supra* note 12, and *infra* notes 178, 246, 253, 293 and accompanying text.

136. Seth Schiesel, *WorldCom Sees More Revisions Of Its Figures*, N.Y. TIMES, Nov. 11, 2002, at C1. Jared Sandberg, *Six Directors Quit as WorldCom Breaks With Past*, N.Y. TIMES, Dec. 18, 2002, at A3. Andrew Backover and Kevin Maney, *WorldCom to Replace Sidgmore*,

ever, WorldCom did reach a settlement with the SEC on the \$9 billion accounting problems. The civil fraud suit settlement does not admit any wrongdoing, and will require the payment of fines, but has eliminated one source of worry for the company's creditors and investors.<sup>137</sup> The consent decree involved oversight by a type of probation officer over the company's activities and gives the SEC discretion in terms of the amount of fine that can be assessed in the future.<sup>138</sup> On December 9, 2002, WorldCom ran full-page ads in the country's major newspapers with the following message, "We're changing management. We're changing business practices. We're changing WorldCom."<sup>139</sup>

*What Went Wrong: Fancy Accounting and Mergers*<sup>140</sup>

WorldCom's acquisition strategy was a brilliant one, but it had its downside, which was that there always had to be a bigger and better merger for the WorldCom numbers to keep growing.<sup>141</sup> If the mergers stopped, so

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USA TODAY, Sept. 11, 2002, at 1B. Stephanie N. Mehta, *Can Mike Save WorldCom?* FORTUNE, Dec. 9, 2002, at 163.

137. Seth Schiesel and Simon Romero, *WorldCom Strikes a Deal with S.E.C.*, N.Y. TIMES, Nov. 27, 2002, at C1.

138. Jon Swartz, *WorldCom Settles Big Issues With SEC*, USA TODAY, Nov. 27, 2002, at 1B. According to the terms of the settlement, WorldCom agreed

[N]ot to violate securities laws in the future; to provide reasonable training and education to its senior operational officers and financial reporting personnel to minimize the possibility of future violations; to retain a consultant to review the effectiveness of WorldCom's material internal accounting control structure and policies; and that the Corporate Monitor in the case will review the adequacy and effectiveness of WorldCom's corporate governance and ethics policies.

*WorldCom and SEC Settle Civil Lawsuit*, THE ACCOUNTANT, Dec. 18, 2002, at 8. See also *SEC v. WorldCom, Inc.*, 2002 WL 31760246 (Dec. 10, 2002 S.D.N.Y. 2002).

139. N.Y. TIMES, Dec. 9, 2002, at C3; USA TODAY, Dec. 11, 2002, at 4A.

140. "Fancy accounting" is also called "creative accounting," "aggressive accounting," "accounting acrobatics," and, in harsh prosecutorial circles and federal securities statutes, "cooking the books." "The root of the accounting problem is that stock-market bubbles reward aggressive accounting, since it inflates earnings and helps push up companies' stock prices. As bubbles develop and the continued inflation of stock prices becomes paramount, conservative accountants and executives become discredited and bending the rules becomes standard." E.S. Browning, *Burst Bubbles Often Expose Cooked Books And Trigger SEC Probes, Bankruptcy Filings*, WALL ST. J., Feb. 11, 2002, at C1.

141. Actually, if Mr. Ebbers had paid more attention to the operations side of the business, see *infra* notes 186-201 and accompanying text, he would have had a brilliant strategy for owning the market. He would continue to sell bandwidth at marginal cost so that no one else was able to afford the cost of laying new fiber. That, coupled with the acquisitions, would leave WorldCom owning the market. To do so, WorldCom needed to grow customers, in addition to growing through acquisition, but its skill was not in marketing. Additionally, each new acquisition brought new debt to service and new debt to service meant higher prices. Higher prices, poor service and low customer growth meant its strategy was failing at both ends. At least one analyst saw the brilliance of the strategy, had it been executed properly. Andy Kessler, *Bernie Bites the Dust*, WALL ST. J., May 1, 2002, at A18.



did the fancy accounting WorldCom used in booking the mergers.<sup>142</sup> The fancy accounting was not unusual in the 1990s, but it was accounting that drove up share prices contingent on the fancy accounting continuing, and the fancy accounting could not continue if there were no further mergers for which the fancy accounting could be done.<sup>143</sup>

The fancy accounting had several component parts, one of which was utter confusion. The pace of the mergers was so frenetic and the accounting and financials so different because of interim mergers that even the most sophisticated analysts had trouble keeping up with the books.<sup>144</sup> The confusion component was, oddly, a selling point for WorldCom because of an interesting phenomenon consuming Wall Street and investors during the 1990s. The market bubble in which WorldCom grew was not new or different from previous bubbles, but it was an irrational bubble nonetheless that did not allow movers and shakers to think through what was really happening in companies or financial statements.<sup>145</sup>

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142. Here's how an expert describes the merger accounting drive:

The acquirer uses its high stock price – and often heaps of debt – to make a purchase that automatically boosts dollar earnings. But it also dilutes the stock of the buyer's shareholders. Serial acquirers [and WorldCom was a serial acquirer] typically pay large premiums, and the bigger the premium, the more shares or debt they must issue. To overcome the dilution of their shares or rising interest payments, the combined company must rapidly grow earnings by creating huge synergies. That seldom happens, and when the synergies don't materialize, the stock price drops. The company can no longer trade highflying shares for acquisitions. The game is over.

Shawn Tully, *Don't Get Burned*, FORTUNE, FEB. 18, 2002, at 89, 90.

143. If this sounds like doublespeak, it is doublespeak and so were the financial statements of WorldCom. One former WorldCom executive phrased it this way, "The boost from post-acquisition accounting was like a drug. But it meant bigger deals had to come along to keep the ball rolling." Eichenwald, *supra* note 10, at B4. Oddly, compliance with accounting rules is not compliance with the law. "One can violate SEC laws and still comply with generally accepted accounting principles," Steve Liesman, *SEC Accounting Cop's Warning: Playing By Rules May Not Ward Off Fraud Issues*, WALL ST. J., Feb. 12, 2002, at C1.

144. One analyst, post-WorldCom collapse noted, "You always had this question about whether WorldCom was a house of cards. Everything was pro-forma. It drove us nuts." Blumenstein and Sandberg, *supra* note 18, at A9. Not nuts enough to dump the stock, but nuts enough to just keep quiet and hope it all worked out. Another analyst referred to the financial markets of this era as a "pooling of ignorance." David Rynecki, *Articles of Faith: How Investors Got Taken in by the False Profits*, FORTUNE, April 2, 2001, at 76.

145. Commissioner Cynthia Glassman included the following in a speech she gave to the American Society of Corporate Secretaries on September 27, 2002:

[T]he distribution of securities by companies that had not made a previous public offering reached the highest level in history. This activity in new issues took place in a climate of general optimism and speculative interest. The public eagerly sought stocks of companies in certain "glamour" industries, especially the electronics industry, in the expectation that they

There was an accompanying phenomenon to the general confusion and rapid pace phenomenon of investing in companies one could not really understand. In fact, there was generic confusion as well as company-specific confusion.<sup>146</sup> That is, analysts were often at a loss to explain earnings growth, P/E ratios, cash sources, and all the basics of running a business.<sup>147</sup> The more confusing, this investment theory went, the better the investment.<sup>148</sup> Indeed, the more confusing, the higher the rate of return and even greater the climb of the stock price.<sup>149</sup> WorldCom's stock reached \$64.50

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would rise to a substantial premium - an expectation that was often fulfilled. Within a few days or even hours after the initial distribution, these so-called hot issues would be traded at premiums of as much as 300 percent above the original offering price. In many cases the price of a "hot" issue later fell to a fraction of its original offering price.

This passage, of course, is not describing the Internet bubble of the 1990s, but rather speculation in electronics stocks in the late 1950s and early 1960s, which was documented in the Commission's "Special Study of the Securities Markets" - published in 1963. Available at [www.sec.gov/news/speech](http://www.sec.gov/news/speech). (last visited January 11, 2003).

146. This phenomenon of confusion ruling in a bullish market is not unique to the 1990's stock market. Following the 1929 stock market crash, one of the biggest collapses, and a shocker to the investment world, was the bankruptcy of Middle West Utilities. The company was run by Samuel Insull according to the prevailing, and confusing, structure of the time, "elaborate webs of holding companies, each helping hide the others' financial weaknesses, an artifice strangely similar to what Enron did with its partnerships," E.S. Browning, *Burst Bubbles Often Expose Cooked Books and Trigger SEC Probes, Bankruptcy Filings*, WALL ST. J., Feb. 11, 2002, at C1. Following the bubble burst in the early 1970s, accounting firm Peat Marwick, Mitchell was censured for its failure to conduct proper audits of five companies that crashed after PMM had given the firms clean and ongoing entity opinions. After the October 1987 crash, Drexel, Burnham & Lambert, Michael Milken's junk bond firm, see *supra* note 4, collapsed along with a host of other companies and the savings and loan industry. *Id.*

147. Account Professor Mike Willenborg describes this lax attitude about confusing and inexplicable numbers as follows, "You wonder where some of the skepticism was." Jonathan Weil, *'Going Concerns': Did Accountants Fail To Flag Problems at Dot-Com Casualties?* WALL ST. J., Feb. 9, 2001, at C1.

148. See, i.e., Enron's complexity, *supra* notes 42 and accompanying text. "Complexity allowed Enron to hide the true picture from the capital markets." A quote from finance Professor Henry T.C. Hu at the University of Texas. Daniel Altman, *Contracts So Complex They Imperil the System*, N.Y. TIMES, Feb. 24, 2002, § 3, at 1. As late as February 2002, analysts were reassuring themselves that all would be well with WorldCom, and one analyst was on the record as telling clients that the rumor swirls surrounding WorldCom would die down. E.S. Browning, *Burst Bubbles Often Expose Cooked Books And Trigger SEC Probes, Bankruptcy Filings*, WALL ST. J., Feb. 11, 2002, at C1.

149. "Companies can use accounting to disguise their real earnings growth. It's hard for us and we're experts." Portfolio manager Abel Garcia of AIM Technology Fund, in Matt Krantz, *There's Just No Accounting for Teach Earnings*, USA TODAY, June 20, 2001, at 1B. Bill Parish, investment manager for Parish & Co. explained, "There's massive corruption of the system. Earnings are grossly overstated." *Id.* And accounting Professor Brent Trueman of Berkeley added, "Reported numbers may not reflect the true income from operations." *Id.* The phenomenon accompanies bubbles. "It is absolutely what almost invariably happens after every bubble. You should expect them [bankruptcies, scandals and accounting disclosures], but that doesn't mean that people who haven't been through it before aren't going to be surprised. The bigger the binge, the longer and more severe the hangover." E.S. Brown-

per share in June 1999, but was at \$0.83 on June 26, 2002, following the announcement of fancy accounting reversals.<sup>150</sup>

WorldCom's fancy merger accounting was not unusual, nor is there any allegation that its methods violated accounting rules.<sup>151</sup> The fancy merger accounting goes like this: a company acquires another (as WorldCom did 65 times) and is permitted to take a restructuring charge against earnings, the infamous "one-time charge."<sup>152</sup> The restructuring charge is a management determination and both reasonable and unreasonable minds differ on what the charges for restructuring following a merger should be.<sup>153</sup> The tendency for managers is to overstate the restructuring charges and toss the extra charges, over and above actual charges, into reserves, sometimes referred to as the "cookie jar."<sup>154</sup> So, if, for example, a company made an acquisition and booked \$2 billion for restructuring charges, its earnings picture for that year would look quite awful.<sup>155</sup> However, the actual costs of the

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ing, *Burst Bubbles Often Expose Cooked Books And Trigger SEC Probes, Bankruptcy Filings*, WALL ST. J., Feb. 11, 2002, at C1.

150. Robin Sidel, *Sorry, Wrong Number: Some Untimely Analyst Advice on WorldCom Raises Eyebrows*, WALL ST. J., June 27, 2002, at A12. So great was the faith of the market in the market and companies such as WorldCom that even after the SEC announced that it was investigating several aspects of WorldCom accounting, including its fancy merger accounting, the representative of its largest shareholder, the Vanguard Group, publicly defended the company noting that the market was unfairly punishing WorldCom for failures such as Global Crossing and Enron. Little did he know. Patrick McGeehan and Geraldine Fabrikant, *Big Investors Maintain Fight in WorldCom Despite Inquiry*, N.Y. TIMES, Mar. 14, 2002, at C1.

151. *But see supra* note 143 for a discussion that compliance with accounting rules is not necessarily avoidance of fraud.

152. Warren Buffett attacked these charges in one of his infamous annual reports in which he indicts poor business and accounting practices, "In recent years, it has seemed that no earnings statement is complete without them [one-time charges]. The origins of these charges, though, are never explored. When it comes to corporate blunders, CEOs invoke the concept of the Virgin Birth." Lee Clifford, *Is Your Stock Addicted to Write-Offs?* FORTUNE, April 2, 2001, at 166.

153. Between 1997 and 2000, 85 publicly traded companies had to restate their earnings because the SEC (could be the reasonable or the unreasonable minds in this setting depending upon your affiliations and, well, your mindset) differed with the restructuring charges that the company booked. Those restatements represented 12% of all the accounting restatements for the period and represented the third largest cause of restatements, with number one being misstated revenues and number two being extent of liabilities. Karl Schoenberger, *When the Numbers Just Don't Add Up*, N.Y. TIMES, Aug. 19, 2001, at BU3. "Companies have huge discretion [in how big or small the reserves are]." Henny Sender, *Call Up the Reserves: WorldCom's Disclosure Is Warning for Investors*, WALL ST. J., July 3, 2002, at C1.

154. The accounting term is "reserves," and they are established for bad-debt losses, receivables and other anticipated losses. For example, American Greetings Corp. maintains reserves for anticipated returns of unsold greeting cards from retailers. Sender, *supra* note 30, at C4. However, the term "cookie jar" came about because the reserves have become a resource for lean years. Geoffrey Colvin, *Scandal Outrage, Part III*, FORTUNE, October 28, 2002, at 56.

155. Not that awful earnings were much of a problem during the bubble market of the 1990s. "Since there's no uniformity as to what goes into pro forma earnings, there's no comparability. It's just an undisciplined number that's at the heart of the calculation." Jonathan

restructuring are spread out over the time it takes for the company to restructure, which is actually two to three years, and some of the charges booked may not actually occur.<sup>156</sup> The hit to earnings has already been taken all at once with this factor by itself opening the door for upwards and rosier earnings growth in the years following the merger and the booking of the restructuring charges. Then, one mustn't forget that there is the cookie jar into which management can dip to use reserves should a subsequent year prove to be truly awful, thereby boosting earnings, or at least smoothing them out for investors.<sup>157</sup> Indeed, the reserves can then be used to meet targets so that investors, Wall Street and everyone is happy because the company is sailing along as promised.<sup>158</sup> So, taking the example further, if the actual charges are \$1.5 billion, then the company has \$500,000,000 in reserves to feed into earnings in order to demonstrate growth in earnings where there may not be actual growth and to create the appearance of a smooth and upward trend.<sup>159</sup>

Scott Sullivan, the CFO of WorldCom, was able to employ reserves to keep WorldCom going for two years after the merger with Sprint failed in 2000.<sup>160</sup> Because there were no further mergers, the serial Ponzi scheme built on acquisitions had to end and would have ended in 2000 had it not been for WorldCom's rather sizeable reserves.<sup>161</sup> Again, management discretion allows the reserves to be fed back into earnings as desired. Earnings can appear to be growing, but they are not growing as a result of product sales; they are growing because of the reserves from restructuring being fed

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Weil, *Terms Like 'Operating,' 'Core,' 'Pro Forma' Catch Fire, Leave Investors Muddled*, WALL ST. J., Aug. 21, 2001, at A1.

156. In its investigation of these restructuring charges, the SEC found that companies took charges for services that might be rendered in the future by lawyers, accountants, and investment bankers, bonuses and other compensation for officers, training expenses for retraining employees, and training expenses for any employees the newly merged company might have to hire in order to complete the restructuring. In other words, a great many non-real expenses were taken. Carol Loomis, *Lies, Damned Lies and Managed Earnings: The Crackdown is Here*, FORTUNE, Aug. 2, 1999, at 74, 84.

157. While restructuring charges are discussed in the context of mergers and acquisitions here, they can also be taken when a company is, for example, reducing its size. Rite Aid took a restructuring charge in 1999 of \$299 million for what it called its closing of 379 stores. The SEC forced a restatement that took the figure to \$144 million. Carol J. Loomis, *Lies, Damned Lies and Managed Earnings: The Crackdown is Here*, FORTUNE, Aug. 2, 1999, at 74, 84.

158. One research firm put the restructuring charges for 1998 at \$76 billion for publicly traded companies. There were 1,400 such companies taking these charges. Louis Uchitelle, *Corporate Profits Are Tasty, But Artificially Flavored*, N.Y. TIMES, Mar. 28, 1999, at BU3.

159. Other companies have been in regulatory difficulties for the improper use of reserves. For example, Xerox agreed to pay a \$10 million fine in 2002 for what the SEC called the "intentional or reckless use of reserves" without disclosure of the purpose of those reserves, something the SEC deemed fraudulent. Mark Maremont, *Xerox Overstated Pretax Income By \$1.41 Billion, Filing Reveals*, WALL ST. J., July 1, 2002, at A3. Xerox's restatement totaled \$1.41 billion.

160. Geoffrey Colvin, *Scandal Outrage, Part III*, FORTUNE, Oct. 28, 2002, at 56.

161. Well, the reserves and some other creative accounting detailed *infra* at notes 140-85 and accompanying text.

into the earnings picture.<sup>162</sup> Without continuous feeding from those reserved charges, the company's earnings picture may be very bleak, as was the case with WorldCom when its long run of continually pricey mergers ended in 2000.<sup>163</sup>

*What Went Wrong: Not So Fancy Accounting and Expenses*

With the merger reserves quickly eaten away, WorldCom's CFO, Scott Sullivan,<sup>164</sup> had to find a means for keeping those earnings singing. While the precise timing for the new accounting strategy remains unclear,<sup>165</sup> most experts agree that at least by the first quarter of 2001, Mr. Sullivan and staff of now felons, embarked on a not-so-fancy-accounting strategy that would keep WorldCom afloat, but was not exactly in compliance with Gen-

162. One expert estimates the WorldCom's reserves could have been as high as \$10 billion. Henny Sender, *Call Up the Reserves: WorldCom's Disclosure Is Warning for Investors*, WALL ST. J., July 3, 2002, at C1. The SEC began investigating WorldCom's use of reserves in July 2002. The press release from WorldCom read, "Questions have been raised regarding certain material reversals of reserve accounts during 2000 and 1999." Simon Romero and Floyd Norris, *New Bookkeeping Problems Are Disclosed by WorldCom*, N.Y. TIMES, July 2, 2002, at A1.

163. While the irrational exuberance of the market as well as Jack Grubman's calls on his beloved WorldCom, *see infra* notes 252, 297, 298, 302, 305, 306, 566 for more information on Mr. Grubman, prevented a complete retreat from WorldCom following the failed Sprint merger, there were analysts who predicted the fall of WorldCom when the merger failed. Scott Cleland, founder of Precursor Group, a Washington, D.C.-based investment research firm, predicted that the WorldCom/Sprint merger would fail, and, that if the merger failed, WorldCom would be a "dead model walking." Stephanie N. Mehta, *Calling WorldCom's Woes*, FORTUNE, July 22, 2002, at 30. Mr. Ebberts promptly called Mr. Cleland an "idiot." Mr. Cleland does not own any individual stocks and is a stickler for conflicts of interest. Indeed, in his interview for FORTUNE magazine on his prescient call on WorldCom he said, "I should tell you I'm a Republican." *Id.*

164. For purposes of discussion, we place the responsibility at the feet and chef arms, ala cooking, of CFO Scott Sullivan. Thus far, Mr. Sullivan and his underlings are the only ones to be indicted for the cooking of the books. David D. Myers, WorldCom's former controller, and Mr. Sullivan were both indicted on federal charges of fraud and conspiracy on August 1, 2002. Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1. Mr. Myers entered a guilty plea to 3 felony counts of fraud on September 26, 2002. Deborah Solomon, *WorldCom's Ex-Controller Pleads Guilty to Fraud*, WALL ST. J., Sept. 27, 2002, at A3. Others named as unindicted co-conspirators were Buford Yates Jr., former director of accounting at WorldCom, and two other accounting staff members, Betty L. Vinson and Troy M. Normand. Mr. Buford Yates initially entered a not guilty plea. He offered no apology for his name either. Simon Romero and Jonathan D. Glater, *Wider WorldCom Case Is Called Likely*, N.Y. TIMES, Sept. 5, 2002, at C9. However, just one month later, Mr. Yates entered a guilty plea to securities fraud and conspiracy and agreed to cooperate with the Justice Department. Jerry Markon, *WorldCom's Yates Pleads Guilty*, WALL ST. J., Oct. 8, 2002, at A3. Betty Vinson and Troy Normand also entered guilty pleas to fraud and conspiracy just three days after Mr. Yates' plea. *2 Ex-Officials of WorldCom Plead Guilty*, N.Y. TIMES, Oct. 11, 2002, at C10.

165. Disclosures near the end of 2002 put the date at 1999. Stephanie N. Meta, *WorldCom's Latest Headache*, FORTUNE, Nov. 25, 2002, at 34, 35.

erally Accepted Accounting Principles (GAAP).<sup>166</sup> In fact, the not-so-fancy-accounting strategy was not even in compliance with common sense. Mr. Sullivan and merry band of underworld accountants were taking ordinary expenses and booking them as capital expenditures so as to boost earnings.<sup>167</sup>

Here's how the not-so-creative scandal worked. For example, in 2001, WorldCom had \$3.1 billion in long-distance charges.<sup>168</sup> Recalling back to the diner founding days of WorldCom, the company's initial strategy was to purchase wholesale long distance and then sell it retail to consumers and make a tidy profit. But, those long-distance wholesale charges are the expenses of doing businesses. So, the \$3.1 billion should have been booked as an operating expense. However, a \$3.1 billion hit to earnings meant that the stellar performance streak of mighty WorldCom would have ended with a loss for 2001. So, Mr. Sullivan and his sycophantic accountants charged the \$3.1 billion as a capital expense and planned to amortize this amount over 10 years, a far lesser hit to the old earnings streak. The difference was that WorldCom, by capitalizing the operating expenses, showed net income of \$1.38 billion for 2001, right on target.<sup>169</sup>

However, one does have to come up with a way to make all the entries on the books of the company. And making stuff up does not always leave time for creating the paper trail to go along with the fabrication. If you are going to book \$3.1 billion, actually \$3.8 because Sullivan added in more than just long-distance charges, in capital expenses, GAAP requires that you have some invoices for the property that you are capitalizing. The intricate, but not so delicate spool of this accounting lapse began unwinding when Gene Morse, a member of WorldCom's internal audit group, found \$500 million in computer expenses, but could not find any documentation or invoices.<sup>170</sup>

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166. In fact, most accounting experts were absolutely stunned when the accounting strategy was revealed because the practice was so completely contra to accounting rules and practice. The story in the *New York Times* was titled, "Big Lapse in Auditing Is Puzzling Some Accountants and Other Experts," N.Y. TIMES, June 28, 2002, at C4.

167. Jared Sandberg, Deborah Solomon and Rebecca Blumenstein, *Inside WorldCom's Unearthing Of a Vast Accounting Scandal*, WALL ST. J., June 27, 2002, at A1.

168. *Id.*

169. In fact, WorldCom was eerily meeting its targets precisely. One analyst did, however, notice that WorldCom was making its targets for several quarters in a row within fractions of cents. "When you see that they're making it by one one-hundredth of a penny you know the odds of that happening twice in a row are very slim. It indicates they're willing to stretch to make the quarter." Jared Sandberg, Deborah Solomon, and Nicole Harris, *WorldCom Investigations Shift Focus to Ousted CEO Ebbers*, WALL ST. J., July 1, 2002, at A1.

170. This type of thing is always the makings of a bad day for someone in internal audit in a company. The lack of a taxicab receipt for \$25 is something employees do to internal audit all the time. But, \$500 mil in computers without your BestBuy receipt is pushing the limits. Susan Pulliam and Deborah Solomon, *How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1. Mr. Morse is quoted in the article as saying,

The WorldCom strategy was different from Enron in that there were no off-the-books transactions and complex interrelationships and partnerships. The not-so-fancy accounting here was to simply “to “back into the number needed” to meet forecasts the company had made for Wall Street.<sup>171</sup> Mr. Sullivan’s mantra was that the company had to keep line costs at 42%; anything that went beyond that was just shifted to capital expenditures.<sup>172</sup> The result was that costs were kept down even as profits were pumped artificially high.<sup>173</sup> The initial disclosure of the \$3.85 billion sent a shock wave through the business world,<sup>174</sup> but before the year was out, that number would rise to \$9 billion, a tough write-off for any company.<sup>175</sup> Further, a report by former attorney general Richard Thornburgh indicates that the not-so-fancy accounting extended into the reporting of revenues, not just expenses.<sup>176</sup> Mr. Thornburgh’s report, partially excised at the time of its release

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upon uncovering the missing BestBuy invoices, “Oh my God!” *Id.* The author doubts that even He could be much help in a case this far in violation of GAAP and seriously doubts that He intervenes in fraud cases generally. However, Mr. Ebbers sees things differently. He appeared at Easthaven Baptist Church on the Sunday immediately following the revelation of the WorldCom accounting impropriety as usual to teach his Sunday school class and attend services. He addressed the congregation, “I just want you to know you aren’t going to church with a crook. This has been a strange week at best . . . . On Tuesday I received a call telling me what was happening at WorldCom. I don’t know what the situation is with all that has been reported. I don’t know what all is going to happen or what mistakes have been made . . . . No one will find me to have knowingly committed fraud. More than anything else, I hope that my witness for Jesus Christ [will not be jeopardized].” The congregation gave Mr. Ebbers a standing ovation. Jared Sandberg, Deborah Solomon, and Nicole Harris, *WorldCom Investigations Shift Focus to Ousted CEO Ebbers*, WALL ST. J., July 1, 2002, at A1. Mr. Ebbers continues to teach Sunday school each Sunday at 9:15 AM, and then stays for the 90-minute service held afterward. Jayne O’Donnell, *Ebbers Acts as if Nothing is Amiss*, USA TODAY, Sept. 19, 2002, at 1B.

171. Sandberg, *supra* note 167, at A8.

172. Initially, the investigation revealed that the access fees were the only operating expenses shifted to capital expenses. However, maintenance and repair costs were also shifted to capital accounts when the 42% figure was in jeopardy. Sandberg, *supra* note 167, at A8.

173. At this writing, there remains another issue that has not yet been resolved and that is whether the data traffic that was reported at the various WorldCom divisions was real, and which one analyst indicates will, when discovered, make the accounting fraud seem like “baby stuff.” Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1. Indeed, in June 2000, the man who would become the WorldCom CEO following the announcement of the multi-billion dollar adjustments, John Sidgmore, announced that his unit, the Uunet Internet, was not profitable and that capacity, but not traffic, was growing. *Id.*

174. WorldCom’s initial \$3.8 billion restatement was six times the Enron restatement of earnings. Jared Sandberg, Deborah Solomon and Rebecca Blumenstein, *Inside WorldCom’s Unearthing Of a Vast Accounting Scandal*, WALL ST. J., June 27, 2001, at A1.

175. Additional fraud charges filed by the SEC in November 2002 indicate that the full story on WorldCom’s accounting is not yet known, “As a result of, among other things, WorldCom’s chronic and pervasive failures to follow GAAP standards, and to mandate and institute appropriate internal controls, the exact amount and extent of WorldCom’s overstatement of its income has not yet been quantified.” Kurt Eichenwald and Seth Schiesel, *SEC Files New Charges on WorldCom*, N.Y. TIMES, Nov. 6, 2002, at C1.

176. Jared Sandberg and Susan Pulliam, *Report by WorldCom Examiner Finds New Fraudulent Activities*, WALL ST. J., Nov. 5, 2002, at A1.

in deference to the Justice Department investigation, reveals that there were eventually two sets of books prepared for David Myers and Mr. Sullivan by Buford Yates.<sup>177</sup> Mr. Yates prepared two charts for the men with one chart offering the real revenues and the next chart showing the revenue numbers WorldCom needed to post in order to make the numbers the company had given to Wall Street analysts.<sup>178</sup>

The relatively simple, and likely fraudulent accounting is all the more troublesome because it went on for so long without detection and without someone from within the company who knew what was happening speaking up about cooking the books.<sup>179</sup> However, as noted in the earlier discussion of the market in general, the fabrication could have been easily rationalized in the minds of these struggling accountants. At the time of WorldCom's rise, Wall Street analysts were enamored of EBITDA.<sup>180</sup> EBITDA, or earnings before interest, taxes, depreciation and amortization, was the number used for valuation of companies' shares.<sup>181</sup> It's a bizarre

177. Mr. Myers and Mr. Yates are confessed felons, and their turning government witnesses does not bode well for the indicted Mr. Sullivan.

178. The Thornburgh report says, "Accordingly, the company undertook an analysis of ways to boost the company's quarterly revenues. Ultimately, it appears that improper additions were later booked in connection with this process." Sandberg and Pulliam, *supra* note 51, at A8. There is a logic to the timeline here. In November 2000, Mr. Ebbers and Mr. Sullivan met with analysts and for the first time had to revise their earnings estimates, reducing them by 30%. Mr. Ebbers apologized at that meeting, the share price fell 20% and the not-so-creative accounting began in the first quarter of 2001. Andrew Backover, *Trouble May Have Started in November 2000*, USA TODAY, July 1, 2002, at 3A.

179. Also known as "creative accounting," etc. See *supra* notes 3, 12, 140, 161, 178 and *infra* note 279. Really, any time you are going to work and preparing two sets of books, there ought to be some twinge of guilt or at least some shred of human dignity that allows you to say, "My name is Buford, I'm 40 years old, and I work in Jackson, Mississippi making up numbers to report on financial statements for a company founded in a Days Inn coffee shop."

180. Said EEE-BEE-DAH. For those of you who were fans of television's *Mork & Mindy*, starring Robin Williams and Pam Dawber, this term would have fit well into Mr. William's, aka Mork's, vocabulary on the show in which he played a spaceman from another planet. Really, it is hard to fathom how such a silly-sounding term could become the focus of financial wizards. One feels like a fool just saying it. For all you BLUE BOOK ZEALOTS, *Mork & Mindy* was an ABC Television series that ran from Sept. 14, 1978 through August 12, 1982, created by Garry Marshall, brother of Penny Marshall, and creator of *Happy Days*, where Mork first appeared. The show went one year longer than television's previous wacky comedy about aliens, *My Favorite Martian*. The author refuses to give a citation to such a show. [*Mork & Mindy* (ABC television broadcast, Sept. 14, 1978 through Aug. 12, 1982). – Eds. THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION R. 18.5, at 142-43 (Columbia Law Review Ass'n et al. eds., 17th ed. 2000).]

181. EBITDA has its origins, oddly and ironically, in the 1980s with Milken and his fellow merry raiders. They used what mainstream businesses and analysts viewed as a dubious financial analysis tool of a renegade band of ne'er-do-wells who tossed about the term as if it were some new discovery that the rest of the financial world had missed. Soon, however, companies began to discover that EBITDA did not have the constraints of those testy GAAP rules, and that investors and analysts were coming more and more to rely on EBITDA as if it were cash flow. EBITDA is an accounting trick that flies beneath accounting radar and has some glaring faults such as ignoring the expense characteristics of a company. Depreciation



methodology, akin to saying, "Without all of these expenses we just lopped off, this company would have had earnings." And in WorldCom's case, taking the \$3.8 billion as capital expenses not only made net income higher, it meant that nothing showed up in EBITDA because, of course, the depreciation for this \$3.8 billion capital expense is not reflected there because, well, the developers of EBITDA said it wasn't relevant.<sup>182</sup> So, if one begins with an artificial number as the foundation for Wall Street evaluation, it is not a far stretch for financial officers of companies to rationalize fooling around with said arbitrary number.<sup>183</sup> In fact, following the WorldCom restatements of income, and realizing the utter futility of EBITDA as a measure of performance, most experts marked the death of EBITDA as a means of valuation.<sup>184</sup> In a surreal world, boundaries and rules seem irrelevant.<sup>185</sup>

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for companies with heavy equipment use is a real expense because of the need to replace that equipment so often. But, their EBITDA looks the same as a company that has as its only real equipment its office building which is depreciated, and accurately so, over decades. The cash needs of the two firms are remarkably different. Herb Greenberg, *Alphabet Dupe: Why Ebitda Falls Short*, FORTUNE, July 10, 2000, at 240.

182. When WorldCom announced its restatement of the initial \$3.8 billion, one business journalist wrote, "And while it may be premature to announce the demise of one of Wall Street's most common performance tools, some investors and accounting specialists are hoping that scrutiny now being paid to shortcomings of it will reduce its role, if nothing else." Martin Peers and Robin Sidel, *Days May Be Numbered for Ebitda Numbers*, WALL ST. J., July 5, 2002, at C1. Another added, "I think the days of having Ebitda being the focus of earnings release are probably numbered." *Id.*

183. There were some prescient souls who were concerned about the artificial nature of the profits of the stars of the bubble. Warren Buffett wrote in 1999 that companies that cannot achieve earnings legitimately "resort to unadmirable accounting stratagems" to "manufacture desired 'earnings.'" Louis Uchtelle, *Corporate Profits Are Tasty, But Artificially Flavored*, N.Y. TIMES, Mar. 28, 1999, at BU3. An accounting professor described the situation that same year as follows, "My intuition tells me that profitability in the United States is basically solid, but there is a layer of earnings that is illusionary." *Id.*

184. Wireless telecommunications analyst, Thomas Lee, observed upon the WorldCom restatement, "This is going to totally discredit Ebitda as a valuation method, and as a way to analyze the health of a company." Jesse Drucker and Henny Sender, *Strategy Behind Accounting Scheme*, WALL ST. J., June 27, 2002, at A9. The question of EBITDA's validity had been raised long before the burst bubble. In 2000, Moody's analyst Pamela Stump wrote a 24-page paper (although the author suspects that in the real world they refer to this things as "reports," not "papers" as we who grade for a living do) focusing on the "critical failures" of EBITDA. "Is the use of Ebitda becoming too commonplace . . . and replacing thoughtful analysis." Herb Greenberg, *Alphabet Dupe: Why Ebitda Falls Short*, FORTUNE, July 10, 2000, at 240. Mr. Greenberg is surely an interesting character. At the time he wrote his piece, the parent company for his beloved employer, FORTUNE, Time Warner, touted Ebitda.

185. Jack Ciesleski, of R.G. Associates, a research firm, put the earnings overstatement figure at \$10.4 billion for S & P companies in 1999, and added, "Earnings gaming is widespread." Louis Uchtelle, *Corporate Profits Are Tasty, But Artificially Flavored*, N.Y. TIMES, Mar. 28, 1999, at BU3. Between 1997 and 2000, the most frequent reason given for the 723 earnings restatements filed with the SEC was "Misstated revenues." Karl Schoenberger, *When the Numbers Just Don't Add Up*, N.Y. TIMES, Aug. 19, 2001, at BU1. Interestingly, misstated revenue was also the reason given for 66% of all federal securities class action lawsuits filed in 2000. *Id.*

*What Went Wrong: The Management and Operations of WorldCom*

The creative and not-so-creative accounting at WorldCom may have been a symptom, and not the problem. Mr. Ebbers made no secret of the fact that he was not crazy about business fundamentals.<sup>186</sup> These were not crack-jack managers running this company.<sup>187</sup> In addition to all the made-up stuff, the company had a heck of a time keeping track of its collectibles, those things that bring in the cash.<sup>188</sup> The constant mergers did not enhance efficiencies and the billing system for WorldCom customers was in turmoil.<sup>189</sup> WorldCom had 55 different billing systems and the litigation from customers to show that the billing systems were not studies in accuracy.<sup>190</sup> In fact, part of the SEC investigation of WorldCom focuses on whether WorldCom capitalized on the chaotic billing system to boost revenues. One technique being investigated is whether services sold to one customer were then booked twice as revenues in different divisions, all with at least one billing system.<sup>191</sup> In fact, three stellar performers at WorldCom were fired because they had used the fact that revenues could often be booked twice in the confusing systems to pump up the sales commission figures for their teams of salespeople. The three simply listed sales from other divisions for

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186. Barnaby J. Feder, *An Abrupt Departure Is Seen as a Harbinger*, N.Y. TIMES, May 1, 2002, at C1. One analyst noted, "Bernie was endearing, but he didn't even have a working knowledge of the business." Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1. Even in his own investments, Mr. Ebbers tended to focus on the simplest aspects of running the business. When he visited his dealerships in Mississippi, he managed by cutting costs in things such as the allotment of cell phones to sales personnel, eliminating the water cooler, and even requiring that the heating bills be reduced. Jayne O'Donnell and Andrew Backover, *Ebbers' High-Risk Act Came Crashing Down on Him*, USA TODAY, Dec. 12, 2002, at 1B.

187. One of the original investors in LDDS described the level of depth in senior management at WorldCom as follows, "The only experience Bernie had before operating a long-distance company was he used the phone." Barnaby J. Feder, *An Abrupt Departure Is Seen as a Harbinger*, N.Y. TIMES, May 1, 2002, at C1. An analyst described the company as follows, "WorldCom wasn't operated at all, it was just on auto pilot, using bubble gum and Band-Aids as solutions to its problems." Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1.

188. In a press conference at the National Press Club where newly appointed then-CEO, John Sidgmore, answered questions for the first time, several questions focused on how the accounting lapses had gone on for so long without being detected, "No single operating unit knows what's going on in the rest of the organization and it all came together at Scott Sullivan's level, to be honest with you." Marcy Gordon, *WorldCom CEO Blames Former Execs For Woes*, CHI. TRIB., from the Associated Press, July 2, 2002, at B1.

189. One analyst noted that Mr. Ebbers may not have even seen the importance of operations, "Bernie viewed this as a series of financial-engineering maneuvers and never truly understood the business that he was in." *Id.* at C2.

190. Scott Woolley, *Bernie At Bay*, FORTUNE, April 15, 2002, at 63. The CEO of one WorldCom customer said, "They can't even tell you what they're owed." *Id.*

191. *Id.*

their employees and were able to boost commissions substantially.<sup>192</sup> In September 2000, WorldCom did take a write-down of \$685 million for uncollectable revenues.<sup>193</sup>

Customer relations were not always solid. With each new merger came the problems of integrating the new company's technology to create a seamless communications network, something that never quite happened. Technical problems galore meant testy customers as well as the expense of constant troubleshooting.<sup>194</sup>

But customers had other reasons to gripe. With each new merger came new computer systems and somehow the systems never integrated. MCI customers would find their service disconnected for nonpayment because the WorldCom side that did the billing never got the payment that went to the MCI side.<sup>195</sup> Even when the customer's account was located, there was a great deal of foot dragging by WorldCom in terms of both bill payment and acknowledgment of customer corrections.<sup>196</sup> Cherry Communications filed suit against WorldCom for \$100 million in "false and questionable" bills from 1992-1996.<sup>197</sup> This Cherry company went into Chapter 11 bankruptcy and WorldCom was left holding the bag for \$200 million in uncollectable revenues, give or take \$100 million or so spread across the 55 billing systems. WorldCom did get stock in a reorganized Cherry Communications, but therein was another issue in WorldCom's management. Many of its customers were new start-ups with grand ideas, fixing to take on the local Bell system or charging outrageously high fees for Internet access. These were small companies that constituted high credit risks and WorldCom management was not particularly concerned with those details. On

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192. Yochi J. Dreazen, *WorldCom Suspends Executives in Scandal Over Order Booking*, WALL ST. J., Feb. 15, 2002, at A3. There are some who theorize that the public discharge of the three sales executives tipped WorldCom's hand on its lax accounting across divisions and the possible double-booking of revenues.

193. Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1.

194. *Id.*

195. Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1. Marc Perkel owned a software company that had MCI service, but it was cut off by WorldCom and with his phones gone, his business was shut down. After three different employees spoke with him, they discovered his account on the MCI side. His business had suffered and he closed it down and moved across country. For one year following the termination of his service he continued to receive bills from WorldCom.

196. When WorldCom would finally acknowledge over billing of customers, reps would be given instructions to drag their feet on payment so that it would fall into the next quarter. Kevin Maney, *WorldCom Unraveled As Top Execs' Unity Crumbled*, USA TODAY, June 28, 2002, at 1B.

197. *Id.* WorldCom settled another suit with a customer for \$88 million.

average, two to three of WorldCom's commercial customers filed bankruptcy during any given quarter.<sup>198</sup>

The problems were never solved because of one additional management issue, the constant merger of executives from other companies with WorldCom managers.<sup>199</sup> MCI had the experience, but WorldCom had control. No one took the lead in an integration effort and the result was WorldCom was saddled with excess and expensive capacity from dual systems not properly integrated. Power struggles apparently contributed to a type of nepotism in which Mississippi-based executives were awarded the vice president positions in charge of operations and billing, and they lacked the experience and expertise that was necessary to fix the problems created by the mergers and create an effective billing system and integrated technology.<sup>200</sup>

WorldCom was a company admired and touted by analysts, but its financial picture and merger growth were deceptive. Further, beneath the phenomenal performance of its stock, at least on the surface, were a dysfunctional company and management team unable to solve the nuts and bolts operational issues critical for its long-term profitability.<sup>201</sup> However, poor management and earnings voodoo may have been the symptoms of underlying problems in WorldCom's culture.

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198. *Id.* The CEO of Verizon "questioned the quality of WorldCom's earnings and customer base" in a Merrill Lynch conference in March 2002. *Id.*

199. One employee noted that WorldCom was doing mergers and acquisitions so quickly that "[n]obody had time to adjust. There was a (reorganization) every couple of months, so people didn't know who they were supposed to be reporting to or what they were supposed to be working on." Kevin Maney, *WorldCom Unraveled As Top Execs' Unity Unraveled*, USA TODAY, June 28, 2002, at 1B.

200. WorldCom's struggles in operations and billing were described as follows:

In the area of accounts receivable and credit collections, WorldCom picked the wrong people to run it. It's a complex area, and you have to have skilled business people involved. But there were big power struggles at the vice president level, and they put some of their own guys in there who were from Clinton, Miss., who didn't know much about the business.

Eichenwald, *supra* note 195, at B2.

201. Indeed, there are indications from some of the Ebberts' meetings with analysts that he seemed unaware of the strategic threats his company was facing. When asked about a wireless strategy at one such meeting, Mr. Ebberts responded with anger indicating the cellular people were stupid and not making any money. At the time, the cellular people were drawing long-distance customers away with their low-rate minute plans. Andy Kessler, *Bernie Bites the Dust*, WALL ST. J., May 1, 2002, at A18.

## What Went Wrong – The Underlying Causes of What Went Wrong: The WorldCom Culture

### *Cultural Factor 1 – Pressure to Maintain Those Numbers*

*The complexity of accounting strategies often masks a simple goal, to do whatever it takes to meet Wall Street's expectations.*<sup>202</sup>

A clear signal in the Yeehaw Culture is that finances, financing, meeting numbers and satisfying Wall Street is paramount. Mr. Ebbers was a Wall Street favorite.<sup>203</sup> And he made it clear to Wall Street as well as WorldCom's employees that his goals rested in the financial end of the business, not in its fundamentals.<sup>204</sup> Mr. Ebbers described his business strategy succinctly in 1997, "Our goal is not to capture market share or be global. Our goal is to be the No. 1 stock on Wall Street."<sup>205</sup> In his privately commissioned report on the company's downfall, former U.S. Attorney General Dick Thornburgh referred to WorldCom as a "culture of greed."<sup>206</sup>

WorldCom's revenues went from \$950 million in 1992 to \$4.5 billion by 1996.<sup>207</sup> The language of their annual reports reflected the obsession with growth and meeting numbers.<sup>208</sup> The following is an excerpt from 1997 that even reduces the numbers to a "per employee" basis for earnings:

*On a pro forma basis, total revenues increased over 30 percent on volume gains of 35 percent. WorldCom's efficiency in SG&A per revenue dollar is not at the expense of effec-*

202. Professor Barbara Lougee, as quoted in Simon Romero and Floyd Norris, *New Book-keeping Problems Are Disclosed by WorldCom*, N.Y. TIMES, July 2, 2002, at A1.

203. One analyst described Mr. Ebbers' meetings with Wall Street analysts as "prayer meetings" in which no one asked any questions or challenged any numbers. Barnaby J. Feder, *An Abrupt Departure Is Seen as a Harbinger*, N.Y. TIMES, May 1, 2002, at C1.

204. It is a fascinating comment on our times and the nature of the financial markets at that time that a CEO could stand before analysts and indicate that he had no interest in business fundamentals, only in the finances. The author has been unable to locate a source documenting when paying attention to business fundamentals was divorced from the financial end of the business. The author does not believe that the fundamentals can be handled in isolation from profit. Then again, the author does not subscribe to EBITDA or making up earnings.

205. Barnaby J. Feder, *An Abrupt Departure Is Seen as a Harbinger*, N.Y. TIMES, May 1, 2002, at C1.

206. Andrew Backover, *Report Slams Culture At WorldCom*, USA TODAY, Nov. 5, 2002, at 1B.

207. These numbers were all computed using the company's annual reports found under "Investor relations" at [www.worldcom.com](http://www.worldcom.com). The numbers were computed using "Selected Financial Data" as called out in each of the annual reports.

208. For example, the 1997 annual report included the following in the introductory paragraph, "For WorldCom, 1997 will be remembered as a year of achievement. Our core businesses set new standards for growth. On top of sustained revenue growth, improving margins and effective deployment of capital . . . ." Available at [www.worldcom.com](http://www.worldcom.com) (1997 Annual Report, p. 2).

*tiveness, as the Company once again outstripped its major competitors with its ability to add incremental year-over-year internal revenue growth of \$1.7 billion for the year. WorldCom continues to lead with the productivity of its employees. On average, each employee generates over \$500,000 of revenue per year, based on 1997 results.*<sup>209</sup>

Operating income rose 132% from 1997 to 1998, sales increased to \$800 billion and the price of WorldCom's stock rose 137%, all of which were mentioned in Mr. Ebbers' opening letter in the annual report.<sup>210</sup> By 1999, Mr. Ebbers had little but numbers in his letter in the annual report: Internet business for WorldCom was up 57%, its data business was up 27%, its international business was up 53%, and its increase in net income was 217%.<sup>211</sup> And he always promised more and better.<sup>212</sup> Until 2000, when the bubble burst and Mr. Ebbers had no numbers in his annual report letter to the shareholders. Things were grim that year, but he promised the company had learned and would deliver a "strong, solid performance in 2001."<sup>213</sup>

The scrambling to meet the numbers over the years and even just the promised "solid performance" for 2001 is astonishing to review both for its magnitude as well as for the clear understanding of those involved that they were violating accounting principles.<sup>214</sup> An e-mail sent on July 25, 2000, from Buford Yates, director of general accounting, to David Myers, controller, reflected his doubts about changing the operating expense of purchased wire capacity to a capital expense, "I might be narrow-minded, but I can't see a logical path for capitalizing excess capacity."<sup>215</sup> Both realizing the problem, they went to Mr. Sullivan, and Yates' e-mail to him reads, "David and I have reviewed and discussed your logic of capitalizing excess capacity and can find no support within the current accounting guidelines that would allow for this accounting treatment."<sup>216</sup> Mr. Myers admitted to investigators "this approach had no basis in accounting principles."<sup>217</sup> Nonetheless, the change from operating expenses to capitalization went forward with Betty

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209. *Id.*

210. [www.worldcom.com](http://www.worldcom.com). 1998 Annual Report.

211. [www.worldcom.com](http://www.worldcom.com). 1999 Annual Report, Bernard Ebbers' letter to shareholders.

212. In 1998, Mr. Ebbers said that if WorldCom just grew with the market, it would meet its earning targets. *Id.*

213. [www.worldcom.com](http://www.worldcom.com). 2000 Annual e-report, Bernard Ebbers' letter to shareholders.

214. Astonishing, but not unique. A 2001 survey of CFOs indicated that 17% of CFOs at public corporations feel pressure from their CEOs to misrepresent financial results. Jim Hopkins, *CFOs Join Their Bosses On The Hot Seat*, USA TODAY, July 16, 2002, at 3B.

215. Kevin Maney, Andrew Backover and Paul Davidson, *Prosecutors Target WorldCom's Ex-CFO*, USA TODAY, Aug. 29, 2002, at 1B.

216. *Id.*

217. Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1, C5.

Vinson and Troy Normand, employees in accounting, making the adjustments in the books per orders from David Myers.<sup>218</sup>

Before making the decision on the accounting changes, neither Mr. Myers nor Mr. Sullivan consulted with WorldCom's outside auditor, Arthur Andersen.<sup>219</sup> The criminal complaint in Mr. Myers' case, and the one to which he entered a guilty plea, included the following description of the role of financial pressures in their decisions and accounting practices, Sullivan and Myers decided to work backward, picking the earnings numbers that they knew the analysts expected to see, and then forcing WorldCom's financials to match those numbers."<sup>220</sup>

Congressional documents indicate that both Mr. Myers and Mr. Sullivan met with other executives indicating the need to "do whatever necessary to get Telco/Margins back in line."<sup>221</sup> Myers has subsequently indicated that once they started down the road, it was tough to stop.<sup>222</sup>

Later discussions between Mr. Myers and the head of WorldCom's internal audit, Cynthia Cooper, reflect that he understood "there were no

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218. The changes were apparently justified, but not justified sufficiently for them to make the changes themselves. The issue in the ongoing investigation is whether Myers and the others can implicate Sullivan. Vinson and Normand were both fired. Yates resigned shortly before the charges were brought against him, Vinson and Normand. Maney et al., *supra* note 215, at B1. See also Simon Romero & Jonathan D. Glater, *Wider WorldCom Case Is Called Likely*, N.Y. TIMES, SEPT. 5, 2002, at C9, (providing background on titles of employees noted).

219. Eichenwald, *supra* note 91, at C5. Andersen did not have a good couple of years. Andersen was not just the auditor for WorldCom, it was the auditor for Enron, Sunbeam, Waste Management and just about all the companies you are going to see discussed *infra* for having bad moves and cultures to allow them.

220. Eichenwald, *supra* note 91, at C5. Once they developed the correct numbers, they simply relied on employees to make "journal entries" to make the accounting changes. Those employees who did the journal entries have cooperated with the government or have been indicted or both. *Id.* While Mr. Sullivan has offered a proffer to government lawyers indicating that Mr. Ebbers was aware of the accounting changes, there is no independent corroborating evidence of such, and Mr. Ebbers' degree of knowledge and involvement remains unclear at this time. Yochi J. Dreazen et al., *Sullivan Says Ebbers Knew of WorldCom Methods*, WALL ST. J., July 12, 2002, at A3. Oddly, Mr. Ebbers took the Fifth Amendment when called to testify before the House Financial Services Committee. However, he took the Fifth only after reading a statement that included the following, "When all of the activities at WorldCom are fully aired and when I get the opportunity – and I'm very much looking forward to it – to explain my actions in a setting that will not compromise my ability to defend myself in the legal proceedings arising out of recent events, I believe that no one will conclude that I engaged in any criminal or fraudulent conduct during my tenure at WorldCom. Until that time, however, I must respectfully decline to answer the questions of this committee." Andrew Backover & Paul Davidson, *WorldCom Grilling Turns up no Definitive Answers; Former Executives Refuse to Testify; Others Point Fingers*, USA TODAY, July 9, 2002, at 1B.

221. Jayne O'Donnell & Andrew Backover, *WorldCom's Bad Math May Date Back to 1999; Lawmakers Dive into E-mails from Former CFO and Controller*, USA TODAY, July 16, 2002, at B1.

222. *Id.*

specific accounting pronouncements" that would justify the changes.<sup>223</sup> When Ms. Cooper raised the question to Mr. Myers about how the changes could be explained to the SEC, Mr. Myers, reflecting the view that it was a temporary change to see the company through until the financial picture changed, said that "he had hoped it would not have to be explained."<sup>224</sup>

### *Cultural Factor 2 – Fear and Silence*

Given the obvious nature of the not-so-creative accounting, it was clear to many employees that there was a problem. However, the culture of WorldCom was one of fear and silence. Those who spoke up were often out. For example, Steven Brabbs, a WorldCom executive who was based in London and who was the director of international finance and control, raised the question of the accounting changes, that affected his division, to David Myers. Mr. Brabbs discovered, after his division's books had been closed, that \$33.6 million in line costs had been dropped from his books through a journal entry.<sup>225</sup> Unable to find support or explanation for the entry, Mr. Brabbs raised the question of documentation to Mr. Myers. When he had no response, he suggested that perhaps Arthur Andersen should be consulted to determine the propriety of the changes.<sup>226</sup> Mr. Brabbs also raised his concerns in a meeting with other internal financial executives at WorldCom. Following the meeting, Mr. Myers expressed anger at him for so doing.<sup>227</sup>

When the next quarter financials were due, Mr. Brabbs received instructions to make these transfers at his level rather than having them done by journal entry at the corporate level. Because he was still uncomfortable with the process, but could get no response from headquarters, he established an entity and placed the costs in there. He felt his solution at least kept his books for the international division clean.<sup>228</sup> He continued to raise the question about the accounting propriety, but the only response he ever got was that it was being done as a "Scott Sullivan directive."<sup>229</sup>

Congressional documents verify that many within the company approached Mr. Myers, from as far back as July 2000, who were concerned

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223. Yocki J. Dreazen & Deborah Solomon, *WorldCom Aide Conceded Flaws*, WALL ST. J., July 16, 2002, at A3.

224. *Id.*

225. Kurt Eichenwald, *Auditing Woes At WorldCom Were Noted Two Years Ago*, N.Y. TIMES, July 15, 2002, at C1.

226. *Id.* Mr. Brabbs' statement indicates, "After phone calls and e-mails to the U.S., we were told that entry had been made on the basis of a directive from Scott Sullivan. Despite repeated requests, we were given no support of [sic] explanation for the entry." *Id.*

227. *Id.*

228. *Id.*

229. *Id.*



about the accounting changes, but he went forward with them anyway.<sup>230</sup> Rep. Billy Tauzin described the congressional findings related to the culture of fear and pressure as follows, “The bottomline is people inside this company were trying to tell its leaders you can’t do what you want to do, and these leaders were telling them they had to.”<sup>231</sup> When Steven Brabbs continued to raise his concerns about the accounting practices at WorldCom, even with Arthur Andersen, he received an e-mail from David Myers ordering him to “not have any more meetings with AA for any reason.”<sup>232</sup>

Employees could often see issues that the rest of the world ignored or could not know. For example, when the loans to Mr. Ebbers by the board began,<sup>233</sup> employees at WorldCom began calling their company “WorldRon,” after Enron because the loans to Mr. Ebbers had an eerie resemblance to the actions of Ken Lay as he took cash out of the flailing Enron. They saw their companies as similar, but no one within WorldCom was discussing either the loans or the similarities.<sup>234</sup>

Even when questions about WorldCom’s accounting made their way out of the company and into the public eye, neither the Board nor the public reacted sufficiently to take steps to investigate possible accounting improprieties. In a class action suit filed in 2001, WorldCom employees provided affidavits indicating that WorldCom was “understating costs, hiding bad debt, backdating contracts to book orders earlier than accounting rules allow.”<sup>235</sup> The 113-page suit was filed in federal district court in Jackson,

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230. *Id.* Mr. Myers is an interesting character study. He held a senior vice president’s position at WorldCom and was well liked by the other officers and the staff. Even the prosecutors like him, as well as lawyers conducting the internal WorldCom probe. Described as a WorldCom “cheerleader” by co-workers, Myers was referred to around the company as “Mr. GQ” because he dressed so fashionably. Jim Hopkins, *CFOs Join Their Bosses on the Hot Seat: WorldCom Shows Power Has Shifted*, USA TODAY, July 16, 2002, at 3B.

231. O’Donnell & Backover, *supra* note 221, at B1.

232. Jessica Sommar, *E-Mail Blackmail – WorldCom Memo Threatened Conscience-Stricken Exec*, N.Y. POST, Aug. 27, 2002, at 27.

233. *See infra* notes 253, 255, 256, 260, 266, 284, 288, 290-96 and accompanying text for discussion of these loans.

234. Bethany McLean & Peter Elkind, *EndCom?, Worldron?, EnWorld?*, FORTUNE, July 22, 2002, at 30. What the WorldCom employees did not know is that Enron employees were trying to think of a way to solve the problems with its flailing broadband subsidiary and actually ran by CEO Jeffrey Skilling an idea for Enron to buy WorldCom. Skilling put the big kibosh on the idea. One can only imagine what the accounting of these two firms would have looked like or smelled like, for that matter. *Id.*

235. Neil Weinberg, *Asleep at the Switch: WorldCom Book-Cooking Was Laid Out a Year Ago*, FORBES, July 22, 2002, at 38.

Mississippi, home of WorldCom headquarters.<sup>236</sup> The board was aware of the suit, but, upon its dismissal, did nothing to investigate the allegations.<sup>237</sup>

*Cultural Factor 3 – The Young ‘Uns and Bigger-than-Life CEO*

Like Enron, WorldCom was run by a young group of executives. Mr. Sullivan, who turned 40 on the day he was fired by the WorldCom board, assumed the helm of WorldCom’s finances as CFO in 1994, at age 32.<sup>238</sup> Arriving at WorldCom in 1992 through its merger with Advanced Telecommunications where he had been since 1987, Mr. Sullivan and Mr. Ebbers became inseparable in the mergers and deals they put together over the next 8 years.<sup>239</sup>

There was a clear desire on Mr. Sullivan’s part to please Mr. Ebbers. Indeed, Mr. Ebbers praised Mr. Sullivan publicly and saw to it that he was well compensated for his efforts.<sup>240</sup> Indeed, Mr. Sullivan, in addition to his

236. The complaint had attached 100 interviews with former WorldCom employees, striking in their detail. *Id.* Some examples included receivables that were over 7 years old and significant delays in paying suppliers in order to increase net profit figures.

237. Judge William H. Barbour, a first cousin to and former law partner of Haley Barbour, the former Republican National Committee Chairman, and second cousin to Henry Barbour, the campaign chairman for Rep. Charles Pickering, the largest recipient in Congress of WorldCom donations, dismissed the suit. Federal judicial guidelines did not require Judge Barbour to recuse himself. *Id.*

238. Shawn Young & Evan Perez, *Finance Chief of WorldCom Got High Marks on Wall Street*, WALL ST. J., June 27, 2002, at B1. The joke around the WorldCom offices when Mr. Sullivan assumed the CFO slot was that he was “barely shaving.” *Id.* Mr. Sullivan graduated with a degree in accounting from Oswego State University in 1983 and received offers from 6 of what were then the Big 8 accounting firms. *Id.* He accepted the offer from KPMG and became a manager there before taking the position in Boca Raton, Florida, for Advanced. Mr. Sullivan still lives in Florida and declined to move to Jackson, Mississippi, WorldCom headquarters. He commuted by the corporation’s jet from Florida to Jackson. *Id.*

239. He earned the nickname “whiz kid,” and while Mr. Ebbers was the showman and charisma for WorldCom, Mr. Sullivan was the detail man. Mr. Ebbers frequently answered questions from analysts and others with, “We’ll have to ask Scott.” Barnaby J. Feder & David Leonhardt, *From Low Profile to No Profile*, N.Y. TIMES, June 27, 2002, at C1. When Mr. Sullivan was appointed to the WorldCom board at age 34, in 1996, the company press release included this quote from Mr. Ebbers, “Over the years WorldCom, Inc. has benefited [sic] immensely from the outstanding array of talent and business acumen of our Board of Directors, and Scott Sullivan will be an excellent addition to that group. He brings to the table a proven background of expertise and dedication to the Company.” Press Release, WorldCom, Inc., *WorldCom Inc. Appoints New Board Member* (March 12, 1996) at <http://www.worldcom.com/global/about/news/1996>.

240. Mr. Ebbers said of Mr. Sullivan, “He has no peer in his ability to earn the trust and confidence of the investment community.” Feder & Leonhardt, *supra* note 111, at C6. According to WorldCom proxy statements, Mr. Sullivan’s compensation was as follows: 1997: salary, \$500,000 and bonus, \$3,500,000; 1998: salary, \$500,000, bonus, \$2,000,000; 1999: salary \$600,000, bonus, \$2,760,000; 2000, \$700,000 salary; \$10,000,000 bonus, and for 2001, Mr. Sullivan earned a salary of \$700,000 and a bonus of \$10,000,000. These figures do not include the stock options which were for the period 1997-2001: 1.5 million, 900,000, 900,000, 619,140 and 928,710. See 14-A Proxy Statements, WorldCom, Inc. (1997-2001), at

role as CFO, served as the secretary for the board.<sup>241</sup> And Mr. Ebbers fit the pattern of the CEOs of companies that have experienced ethical collapse, which is the bigger-than-life and often quirky CEO.<sup>242</sup> In this CEO profile, there is an investment community enamored of the CEO, a CEO with profligate spending habits, a CEO who breeds sycophantism in employees by his demands and presence, and deference by the business press and analysts toward these bigger-than-life characters.<sup>243</sup>

Mr. Ebbers was flamboyant, a 6' 4" man who tended toward cowboy boots and blue jeans and a charisma that took hold as well among investment bankers as it did in Jackson, Mississippi.<sup>244</sup> Even as the company stock was falling, long before the accounting problems surfaced, few who lived in Mississippi who had invested in WorldCom would let go of their stock because of an abiding faith in Ebbers.<sup>245</sup> Analysts embraced what they saw as the Ebbers' three-pronged strategy for WorldCom's success: "aggressive salesmanship, ruthless cost-cutting<sup>246</sup> and its passion for acquisi-

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<http://www.sec.gov/cgi-bin/browse-edgar>. Mr. Sullivan, however, lived a humble existence until the last two years. He still lives with his wife, who has chronic health problems, in a home in Florida that is valued at \$178,000, but they were in the process of constructing a home in Boca Raton, Florida area at a cost estimated to be \$10,000,000, with the lot costing \$2.45 million. There was at least one report that the two men were compatible only in the context of the company. One source indicated, "Success glued them together but neither had much good to say about the other in private." Federal & Leonhardt, *supra* note 111, at C6.

241. 14-a Proxy Statement, WorldCom, Inc., (April 22, 2002), available at <http://www.sec.gov/Archives/edgar/data/723527/000091205702015985/a20772472def.14a.txt>

242. This theme develops as the discussion of the companies unfolds. However, in addition to the companies covered herein, there are the historical cases of Charles Keating and Lincoln Savings and Loan, Q.T. Wiles and Miniscribe, John DeLorean and the Delorean Corporation, Steve Madden and Madden Shoes, and Robert Bennett and New Era Philanthropy.

243. One business reporter phrased the downfall of Mr. Ebbers as follows, "I'm content to agree that Bernie should have turned over the shaping of WorldCom's adulthood to Sidgmore & Sullivan years ago. But egos the size of his have to be kicked out, and of course this one was too." Daniel Heninger, *Bye-Bye Bernie Drops the Curtain on the 1990s*, WALL ST. J., May 3, 2002, at A10. Again, further examples of the ego-laden CEO follow in the general discussion of governance reforms, see *infra* notes 498-573 and accompanying text.

244. Mr. Ebbers was a 1957 graduate of Mississippi College, located in Clinton, Mississippi, about 30 minutes away from Jackson, Mississippi, where Mr. Ebbers built the headquarters for WorldCom. Chris Woodyard, *Pressure to Perform Felt as Problems Hit; Trouble May Have Started in Nov. 2000*, USA TODAY, July 1, 2002, at 3B.

245. *Id.* Even when the first multi-billion-dollar restatement came, many near Clinton appeared to be more in mourning than angry. Kelly Greene & Rick Brooks, *WorldCom Staff Now Are Saying 'Just Like Enron,'* WALL ST. J., June 27, 2002, at A9. One employee, sharing the shock with bar patrons at Bravo Italian Restaurant & Bar said, "People are taking it with exceptional grace. In my experience with MCI, I have never worked for a better company." *Id.* Others give Bernie the benefit of the doubt, concluding that he might not have known about the distortion of the numbers, "[W]e've kind of held judgment until we know the entire story and whether he had knowledge," from Mr. Ebbers' minister. Jayne O'Donnell, *Ebbers Acts as if Nothing Is Amiss*, USA TODAY, Sept. 19, 2002, at B1.

246. Once an acquisition was complete, Mr. Ebbers always took to the budgets and began Draconian cost cuts. For example, he once eliminated free coffee and also decreed that sales

tion."<sup>247</sup> The acquisitions were so steady and stunning, the financials in their pro forma form so confusing and Mr. Ebbers so larger-than-life that few investors or analysts questioned the Ebbers' formula.<sup>248</sup> Just Mr. Ebbers' story of a Canadian high school basketball player winning a scholarship to a small Mississippi college and then starting a successful business there in a state hungry for successful businesses carried its weight and charm for Ebbers and his WorldCom ideas.<sup>249</sup> Further, Mr. Ebbers appeared to outsiders to carry the same business acumen over into his personal investments.<sup>250</sup> By 1999, Mr. Ebbers had a net worth of \$1.4 billion, earning him the rank of 174 among the richest Americans.<sup>251</sup> Mr. Ebbers' personal life did take some twists and turns. He divorced his wife of 27 years while WorldCom

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visits 400 miles or less from the sales office had to be accomplished through driving; no flights for 400 miles or less. Jayne O'Donnell & Andrew Backover, *Ebbers High-Risk Act Came Crashing Down on Him; WorldCom Founder Loved Deals but Couldn't Keep Them Flying*, USA TODAY, December 12, 2002, at B1. Mr. Ebbers' obsession with cost-cutting may have compromised the internal audit function of the company. The internal audit group was so focused on efficiencies in operations and cutting costs that it did not spot the GAAP nightmare within the company until employees began notifying them. See *infra* notes 268-72 and accompanying text. The Thornburgh report cites the focus of the internal audit group on costs as a weakness in the internal controls of the company. While he commends the unit for finally uncovering the accounting nightmare, Thornburgh does note that the internal audit function of a company is much more than cost-cutting. Kurt Eichenwald & Seth Schiesel, *S.E.C. Files New Charges on WorldCom*, N.Y. TIMES, Nov. 6, 2002, at C1.

247. Schiesel & Romero, *supra* note 98, at C1. Little did we know that the ruthless cost-cutting was accounting mumbo jumbo. It's no big deal cutting costs when you just shift operating expenses over into capital expenses and hope for the best, which, as we all know now, never happened. If you can survive a \$7 billion dollar restatement of earnings, you've mastered the trick to cost-cutting through accounting mumbo jumbo. See also *supra* note 85 and accompanying text for a description of the meetings with analysts, referred to as "prayer meetings" with few questions and no challenges.

248. "During the company's heyday, few analysts complained that the frenetic pace of acquisitions made it difficult to gauge the company's health, a task also complicated by WorldCom's reliance on confusing proforma figures in its financial reports." Rebecca Blumenstein & Jared Sandberg, *WorldCom CEO Quits Amid Probe of Firm's Finances*, WALL STREET J., Apr. 30, 2002, at A1. Further, Mr. Ebbers was an "icon" and "larger than life." Blumenstein & Sandberg, *supra* note 107, at A9.

249. Henninger, *supra* note 243, at A10.

250. However, Mr. Ebbers suffered in his personal investments from the same problems that existed at WorldCom. Mr. Ebbers was good at buying, but not so good at managing. Most outsiders believe he overpaid for his investments and that he was so distant in the day-to-day management that employees referred to him as "the bank," meaning that they could simply turn to him for cash for those things they desired and even when they did not operate at a profit or were just short of cash. O'Donnell & Backover, *supra* note 246, at B1.

251. While the value of his WorldCom stock was the lion's share of that figure (as of December 12, 2002, the stock was down to a total worth of \$3,000,000), Mr. Ebbers owned a minor hockey league team (the Mississippi Indoor Bandits), a trucking company, Canada's largest ranch (500,000 acres, 20,000 head of Hereford), a fly-fishing resort, a general store, an ATC dealership, a lumberyard, one plantation, two farms, and forest properties equivalent in acreage to half the size of Rhode Island. Susan Pulliam et al., *Former WorldCom CEO Built and Empire on Mountain of Debt*, WALL ST. J., Dec. 31, 2002, at A1.

was at its peak and married, in 1998, an executive from WorldCom at Clinton headquarters who was nearly 30 years his junior.<sup>252</sup>

Mr. Ebbers' infallible charm extended into one more venue, that of his board of directors.<sup>253</sup> Mr. Ebbers was able to persuade the board to allow WorldCom to extend loans to him, in excess of \$415 million, with the money to be used, according to Mr. Ebbers, to rescue his failing businesses.<sup>254</sup> The problem with the loans, among many others, was that the stock Mr. Ebbers used to secure them was also the stock he had pledged to WorldCom's creditors in order to obtain financing for the company.<sup>255</sup> The result was that WorldCom directors had taken a subordinated security interest in stock that had already been pledged, placing it well at the end of the line in terms of creditors, and even both the creditors and the Board assumed that the value of the WorldCom stock would remain at equal or higher levels.<sup>256</sup>

While the board's loans to Mr. Ebbers put it at risk of losing \$415 million, the control of the company was actually at greater risk because Mr. Ebbers had pledged about \$1 billion in WorldCom stock in total to his creditors for loans.<sup>257</sup> By 2001, when WorldCom's stock price began to drop, Mr. Ebbers' net worth had slipped to \$295 million, \$286.6 of which was World-

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252. O'Donnell, *supra* note 245, at B1. See *infra* notes 129, 163, 252, 297, 298, 302, 305, 306, 566 for more information on Jack Grubman from Salomon, who attended Mr. Ebbers' wedding and billed Salomon for the expenses of attending. Jessica Sommar, *Here Comes the Bribe: Grubman Expensed Trip to Ebbers' Wedding*, N.Y. POST, Aug. 30, 2002, at 39.

253. The Thornburgh report noted that the Board abdicated its responsibilities in the compensation committee to Mr. Ebbers as it approved the loans made to him and advanced funds even without documentation being completed or signatures obtained. Jared Sandberg & Susan Pulliam, *WorldCom Seeks SEC Accord as Report Claims Wider Fraud*, WALL ST. J., Nov. 5, 2002, A1, at A3.

254. Deborah Solomon & Jared Sandberg, *WorldCom's False Profits Climb*, WALL ST. J., Nov. 6, 2002, at A3.

255. And there is one more complication and twist. Mr. Ebbers had also pledged the same shares to his personal creditors and creditors for his other businesses as collateral for loans there. Solomon & Sandberg, *supra* note 169, at A1.

256. The loans began in September 2000 and included \$199 million to pay a debt Mr. Ebbers owed to Bank of America, \$36.5 million to cover a line of credit used for Mississippi College, and \$165 million because Mr. Ebbers asked and for purposes not yet clear to investigators. There is speculation that this last bundle of money may have been used by Mr. Ebbers to meet his margin calls on stock accounts or in the construction of a new home. The board was not told that the money would be used for personal reasons and only understood that the money was being advanced to cover company obligations involving Mr. Ebbers. Solomon & Sandberg, *supra* note 169, at A1. It is in this area that Mr. Ebbers has his greatest exposure to criminal liability. Funds advanced by the company to cover margin calls for business purposes that are then used for personal expenses make it "much easier for a prosecutor to show criminal intent." Kurt Eichenwald, *Corporate Loans Used Personally, Report Discloses*, N.Y. TIMES, Nov. 5, 2002, at C1. (quoting former federal prosecutor John J. Fahy).

257. Sandberg & Pulliam, *supra* note 253, at A1. See *infra* notes 253, 255, 256-60, 284, 288, 290-95 and accompanying text for more information on the loans and lenders.

Com stock, which was slipping in price.<sup>258</sup> And the board was making the lion's share of the loans to cover margin calls because if the board had not advanced the funds for Ebbers to cover his margin calls, then he would have had to dump his shares onto the market, thus depressing the price of WorldCom's already depressed shares even further as well as jeopardizing the collateral for the loans.<sup>259</sup> The board had climbed into a bottomless pit and the loans continued from 2000 through 2002.<sup>260</sup> Further, the compensation committee, headed by Stiles Kellett, approved the loans, but the loans were not taken forward to the full board because legal counsel for WorldCom indicated full board approval was not necessary.<sup>261</sup>

For Mr. Ebbers to have obtained the amount of loans that he did based on WorldCom stock, with nearly half coming from the company itself, offers ample evidence of the superstar CEO phenomenon that had consumed those surrounding Mr. Ebbers.<sup>262</sup> Further, the immediate executive team surrounding Mr. Ebbers was a group of executives a full generation younger than Mr. Ebbers whose deference was clear and who, by the abdication of the compensation committee of the board to Mr. Ebbers, set their salaries and bonuses.<sup>263</sup> The balance of power in the executive team was such that there would be no internal challenges to Mr. Ebbers.<sup>264</sup> Mr. Ebbers was de-

258. Sandberg & Pulliam, *supra* note 253, at A1.

259. Andrew Backover, *Questions on Ebbers Loans May Aid Probes; Former WorldCom CEO Under Scrutiny*, USA TODAY, November 6, 2002, at B3.

260. *Id.*

261. *Id.* Keep the name Stiles Kellett in mind both because it is worse than Buford, *see supra* notes 164, 179, and because Mr. Kellett has his own difficulties, *see infra* note 276.

262. Even during intensive questioning by the FBI about the company's accounting practices following Mr. Ebbers' departure, many WorldCom employees opined that if the internal audit folks had just let Bernie and Scott alone and not raised the problems that Bernie could have pulled them all through the crisis. Even the audit team was deferential to Mr. Ebbers. When two WorldCom employees raised questions about the aggressive use of reserves to cover expenses and thereby increase profits, the two outside audit partners sided with Sullivan and Ebbers. Susan Pulliam & Deborah Solomon, *Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1. The author does not put too much stock in Andersen being deferential to Ebbers. There were very few people and companies Andersen wasn't deferential to during the 1990s and it has its decline and demise to show for it. A saying around the audit world is that Andersen would have deferred to Barney the purple dinosaur on an accounting interpretation.

263. Indeed, many employees spotted the accounting irregularities as they were taking place, but they were forced by the executives who reported to Mr. Ebbers to do as they were told and not question the financial reporting they were asked to do. O'Donnell & Backover, *supra* note 221, at B1. The first consideration in the executive compensation plan approved by the board was the recommendation of Mr. Ebbers. Proxy Statement, WorldCom, Inc., (2001) at <http://www.sec.gov/cgi-bin/browse-edgar>.

264. Mark Abide, an employee in WorldCom's Richardson, Texas offices who was in charge of accounting there, sent along to the company's internal audit division a newspaper article about an employee in his office who had been fired after he raised questions about the accounting related to capital expenditures. The termination apparently was typical, but Mr. Abide felt the internal audit staff should look into the problem because of the termination. Pulliam & Solomon, *supra* note 262, at A1. One analyst described the WorldCom phenome-

scribed as “intimidating and brusque.”<sup>265</sup> But, he also took a personal interest in his officer team and they became beholden to Mr. Ebbers not just for their jobs, retention and bonuses, but even for personal loans Mr. Ebbers made to them. Ronald Beaumont, the chief operating officer of WorldCom, asked Mr. Ebbers for an advance in 2001 on his bonus because he had used his WorldCom stock to collateralize a loan on a ranch he had purchased and was facing margin calls on the loan.<sup>266</sup> Mr. Ebbers did not grant the advance on the bonus but personally loaned \$650,000 to Mr. Beaumont.<sup>267</sup>

Even as the internal audit staff began to uncover the creative accounting with reserves and the not-so-creative accounting with capitalizing ordinary expenses, they were forced to work secretly.<sup>268</sup> Indeed, so chilly

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non as “a game of chicken, where you get as close as possible to the end before getting out. We all knew WorldCom couldn’t go on forever.” Kurt Eichenward, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1.

265. Feder & Leonhardt, *supra* note 239, at C1.

266. For those not schooled in the ways of high finance (translate: darn risky transactions that involve Wall Street types who also tend to be ruthless), margin calls accompany loans secured by stock. Not being naïve, except when it comes to giant telecom companies, these lenders want to be sure that the stock they have taken as a pledge for collateral will cover the debt. However, if the stock price drops, then the collateral ain’t what it used to be and the lender needs further protection. At that point, the debtor is required to ante up, and rather than insert a “DEBTOR ANTES UP” clause in a loan agreement among such sophisticated types, the Wall Street types insert a “MARGIN CALL.” In lay terms, it means that the debtor has to come up with the cash to provide the lender with adequate security equal to the value of the stock at the time the creditor took it as collateral. So, if, for example, the debtor pledged stock worth \$3,000,000 for a \$3,000,000 loan and the value of the stock declined to a total of \$2,300,000, then the margin call is for \$700,000. When, as in WorldCom’s case, the stock drops from \$60 a share to \$2.50, there will be one heck of a margin call. If the debtor does not meet the margin call, then the creditor has the right to take the collateral, which might or might not include the ranch. The additional problem of the margin call phenomenon is that if the creditor takes the shares, then chances are, the shares will be dumped in the market for cash, and often companies don’t want that large a block of shares dumped on the market. But, when executives go around pledging shares willy nilly, then there is that risk unless the company steps in and loans the money for the margin call. Mr. Ebbers was loaning the money to Mr. Beaumont for his margin call – and it was nearly the \$700,000 in this hypothetical. None of this is footnoted because it is entirely the musings of the author, but musings used in the classroom nigh over 25 years in teaching MBA students the downside of loans with margin calls as well as the ethics issues involved therein. *See infra* notes 290-95 for a discussion of the conflicts of interest issues involved in these loans to executives for covering margin calls on their personal loans.

267. Shawn Young & Jared Sandberg, *WorldCom Can Pay Full Severance*, WALL ST. J., Oct. 2, 2002, at B4. Mr. Beaumont was interviewed extensively by federal investigators and was demoted from his position as COO in October 2002 to a position of president of strategy and business development.

268. Pulliam & Solomon, *supra* note 262, at A1. They were rebuffed by Andersen in their inquiries for information and asked by CFO Sullivan to hold off on their investigation until the next quarter. *Id.* The internal auditors worked at night to avoid detection and, at one point, concerned that their work might be sabotaged, one of the audit staff members purchased a CD burner and began burning data they were gathering onto the CD Rom and storing it elsewhere so that their efforts and findings would not be destroyed. Amanda Ripley, *The Night Detective*, TIME, Dec. 30, 2002, at 47.

was their reception when they met with Mr. Sullivan, that Cynthia Cooper, the head of WorldCom's internal audit, arranged to meet with Max Bobbitt, the head of the board's audit committee in secret fashion at a local Hampton Inn so that there would be no repercussions for her or her staff as they completed their work.<sup>269</sup> And employees who were concerned about the accounting, even those without financial background kept silence for fear of retaliatory action as they digested the termination of employees who did raise the issues about accounting practices.<sup>270</sup> Indeed, the instructions from the officer group were to do whatever it took to get the WorldCom infamous margins back.<sup>271</sup>

At one point, while Ms. Cooper's internal audit team was conducting its investigation, Mr. Sullivan confronted one of her auditors, Gene Morse, in the cafeteria. During his five years at WorldCom, he had only spoken to Mr. Sullivan twice. Mr. Sullivan asked what he was working on and Mr. Morse responded with information about another project and responded, "International capital expenditures," something which seemed to satisfy Mr. Sullivan.<sup>272</sup>

#### *Cultural Factor 4 – Weak Board*

The board at WorldCom was often referred to as "Bernie's Board."<sup>273</sup> Carl Aycock had been a member of the board since 1983 when

269. There is a certain irony here. WorldCom was hatched in a low-price motel and its unraveling began at a similar location.

270. One employee who worked as a billing and research analyst indicated that he kept saying to himself, "How could this place stay in business? It was a shell game." Kevin Maney, *WorldCom Unraveled as Top Execs' Unity Crumbled; Company Turns into Dysfunctional Family, Lost Focus*, USA TODAY, June 28, 2002, at B1.

271. An e-mail from former WorldCom controller, David Myers, written on March 5, 2001, discusses a meeting in which he, Tom Bosley, COO Ron Beaumont, Scott Sullivan and Mr. Ebbers discussed that those in the company should "do whatever necessary to get Telco/Margins back in line." O'Donnell and Backover, *supra* note 221, at B1.

272. Pulliam & Solomon, *supra* note 262, at A1.

273. Jared Sandberg & Joann S. Lublin, *Questioning the Books: WorldCom's Travails Could Affect Its Directors*, WALL ST. J., June 28, 2002, at A9. All of the directors became millionaires after their humble beginnings when the board meetings were held at the Western Sizzlin' Steakhouse in Hattiesburg, Mississippi. Jared Sandberg, *Six Directors Quit as WorldCom Breaks With Past*, WALL ST. J., Dec. 18, 2002, at A6. A former board member, Mike Lewis said few board members would disagree with Mr. Ebbers, "Rule No. 1: Don't bet against Bernie. Rule No. 2: See Rule No.1." *Id.* As the chart below indicates, three of the board members (not including Mr. Ebbers) were insiders and three others were with Mr. Ebbers from the beginning, with several being carried over from his motel chain days. Unlike Enron, this was not a board with excessive compensation. While board members were entitled to WorldCom or MCI stock in lieu of fees and were awarded options each year, their annual retainer was \$35,000 per year, with \$750 for committee meetings attended on the same day as the board meetings and \$1,000 for other committee meetings. Proxy Statement, WorldCom, Inc., (2001) at <http://www.sec.gov/cgi-bin/browse-edgar>.



the original company was founded.<sup>274</sup> Max Bobbitt and Francesco Galesi, who were friends of Mr. Ebbers, joined the board in 1992.<sup>275</sup> And one board member, Stiles A. Kellett, Jr., an original board member and friend of Mr. Ebbers from the early motel-meeting days, resigned in October 2002 after revelations about his extensive use of the company jet.<sup>276</sup>

The board deferred to Mr. Ebbers, who had been the company's only CEO for the 19 years of its existence, not taking action to remove him until it was clear that its position in terms of its loans to him could no longer be protected or justified.<sup>277</sup> That removal came only after the value of the company's stock had declined by 82% in 2002 down to \$2.50 per share, down from the \$60-plus prices in 1999.<sup>278</sup> Mr. Ebbers was reportedly stunned that Mr. Bobbitt and Mr. Kellett, two long-time friends and board members, delivered the message of his termination via phone call as Ebbers worked at WorldCom headquarters.<sup>279</sup>

The shock was appropriate given the board's deference in the past. In 2000, the compensation committee, again without approval from the full board, put together a key executive retention package designed to keep critical WorldCom executives from being lured away to the dot-coms or other telecoms.<sup>280</sup> The key to the key executive retention program was that Mr. Ebbers was given full discretion to determine who was covered and how much they were given.<sup>281</sup>

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274. Seth Schiesel, *Most of Board at WorldCom Resign Posts*, N.Y. TIMES, Dec. 18, 2002, at C7.

275. *Id.*

276. Mr. Kellett used the jet after paying a fee of \$1 per month. The usual cost of such a Falcon 20 jet would be \$1,000,000 per year. The information about the use was not disclosed in the company's public filings and such a benefit at such a value required disclosure. Susan Pulliam et al., *WorldCom Board Will Consider Rescinding Ebbers's Severance*, WALL ST J., Sept. 10, 2002, at A1.

277. Rebecca Blumenstein et al., *WorldCom's Problems Mount In Wake of Ebbers Departure*, WALL ST. J., May 1, 2002, at A1.

278. [www.worldcom.com](http://www.worldcom.com). Go to investor relations and then to stock price history. Site last visited on January 19, 2003.

279. Blumenstein, *supra* note 277, at A1. The action by the board followed by the Sullivan not-so-creative accounting revelations sent the stock reeling. It finished at 83 cents per share on June 27, 2002. P.J. Huffstutter, *WorldCom's Woes Spill Over*, CHI. TRIB., June 27, 2002, at B1.

280. Barnaby J. Feder, *Turmoil at WorldCom: The Executives; Bonuses Meant To Retain Talent Now Risk Anger*, N.Y. TIMES, June 28, 2002, at C6.

281. The result was that both Mr. Ebbers and Mr. Sullivan received \$10 million retention bonuses in 2000. Under the terms of the retention bonuses, anyone who left the company, for any reason before a period of two years from the time the bonus had expired, had to repay the retention bonus. The repayments were something WorldCom pursued aggressively, even against executives whose responsibilities had been cut so dramatically that they interpreted the company's intent as one of getting them to leave. Ironically, this means Mr. Ebbers and Mr. Sullivan must repay their \$10 million. *Id.*

Even upon Mr. Ebbers' departure, the board gave Mr. Ebbers the last say with a severance package that included \$1.5 million per year for the rest of his life, 30 hours of use of the company jet, full medical and life insurance coverage, and the possibility of consulting fees beyond a minimum amount required under the terms of the package.<sup>282</sup>

This was also not a particularly curious board. As noted earlier, despite a lawsuit in which employees with specific knowledge about the company's accounting practices filed affidavits, the board simply dismissed the employees and affidavits when a judge dismissed the class-action suit.<sup>283</sup> And the board was not told of \$75 million in loans to Mr. Ebbers or a \$100 million loan guarantee for Mr. Ebbers' personal loans until two months after the loans and guarantees had been signed for him. Two board meetings went by after the loan approvals before the board was informed and the approval came without any request for advice from WorldCom's general counsel.<sup>284</sup>

The composition of the WorldCom board and their backgrounds, as of the final proxy statement prior to the restatements of income and the bankruptcy (2001 proxy) were:

<u>Board Member</u>	<u>Background</u>	<u>#shares held (WorldCom)</u> <sup>285</sup>
James C. Allen	Investment director Meritage Private Equity Fund <sup>286</sup> Came on the board in 1998 in WorldCom merger with Brooks Fiber Properties where he was CEO and Chairman	412,749
Judith Areen	Dean, Georgetown Law Center since 1989 Professor since 1976	113,849
Carl J. Aycock	Director since 1983 Officer of WorldCom until 1995 CFO of Ebbers' motel corp. until 1992	972,875
Ronald Beaumont	COO, WorldCom WorldCom officer since 1996	2,063,798

282. *Id.*

283. Neil Weinberg, *WorldCom's Board Alerted To Fraud In 2001*, FORBES, Aug. 12, 2002, at 56. See also Eichenward, *supra* note 225, at C1.

284. Backover, *supra* note 259, at B3.

285. The directors also owned MCI shares that are listed in the proxy, but not included here.

286. The background on the directors was found at Proxy Statement, WorldCom, Inc., (2001) at <http://www.sec.gov/cgi-bin/browse-edgar>.

	Director of Digex <sup>287</sup>	
Max E. Bobbitt	Former CEO Asian American Telecom Telecom consultant	433,749
Bernard J. Ebbers	President, CEO Director of Digex Director since 1983	26,946,871
Francesco Galesi	Chair, Galesi Group Real estate, oil, telecom co.	1,800,393
Stiles A. Kellett, Jr.	Kellett Investment Group, CEO	6,120,361
Gordon S. Macklin	Pres. NASD, 1970-87 Chair, Hambrecht & Quist 1987-92 Director, Franklin Templeton Funds	224,387
Bert C. Roberts, Jr.	Former Chair, CEO MCI Director, Digex	1,705,968
John W. Sidgmore	Director, vice chair Since 1996; COO 1996-1998 CEO UUNET Technologies until 1996 Director – Microstrategy	5,534,544

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287. Digex is WorldCom's Website company. [www.digex.com](http://www.digex.com). There is cross-pollination of the boards and management teams because through its Intermedia acquisition, WorldCom owns 61.4% of Digex's stock. Take a gander at Digex's 10-K for some real EBITDA. Here's some telling language:

In addition, EBITDA before certain charges is not a term defined by generally accepted accounting principles and as a result our measure of EBITDA before certain charges might not be comparable to similarly titled measures used by other companies. However, we believe that EBITDA before certain charges is relevant and useful information which is often reported and widely used by analysts, investors and other interested parties in the Web and application hosting industry.

Digex 10-K, Dec 31, 2001, at 35-36. Mr. Ebbers was not up for election as a board member at the Digex annual meeting held in May 2002. However, Mr. Sullivan, Mr. Beaumont and Mr. Roberts were nominated and elected. Mr. Sullivan was removed in July 2002. *See* Digex 8-K dated July 15, 2002, and filed July 18, 2002. Mr. Beaumont's responsibilities at WorldCom as chief operating officer were eliminated in October 2002 and he was given the position of president of strategy and business development. Young & Sandberg, *supra* note 267, at B4.

Scott D. Sullivan	CFO, Treasurer, Secretary Director, Digex	3,264,438
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All Directors and current executive officers: 49,593,982 or 1.7%

### *Cultural Factor 5 – A Culture of Conflicts*

It would perhaps be easier to explain what WorldCom did that did not amount to a conflict of interest than it is to outline all the conflicts of interest that were occurring and became inextricably intertwined. To begin with there were the loans made by the board to Mr. Ebbers to cover the margin calls on his personal loans.<sup>288</sup> When the price of WorldCom stock began to sink, Mr. Ebbers' loans that had been collateralized with WorldCom stock were jeopardized and lenders were demanding their margin calls, that is, that Mr. Ebbers put up the cash to balance the collateral out because of the loss in value to WorldCom stock.<sup>289</sup> With Mr. Ebbers in that position, the board had several fears. The first fear is the embarrassment of a CEO having to bail out his own stock on his loans. The second fear was that Mr. Ebbers would have to sell a significant block of WorldCom stock in order to raise the cash for the margin calls, which would have meant further deflation in the already declining price of WorldCom shares.<sup>290</sup> So, the board had investor interests at the heart of its decision to grant Mr. Ebbers the loans. Mr. Ebbers was thus the CEO of a company to whom he owed nearly one-half billion dollars and his ability to repay was largely tied to the value of the company shares. His personal liability interests conflicted with his role as a CEO.

Such loans create temptations for officers and the board to inflate the value of the stock so as not to cost the company any further share price reduction or even the default on the loans that now make the company part of the personal business of its CEO, yet another conflict.<sup>291</sup> The board's duty to its shareholders is compromised through personal relationships with the officers.<sup>292</sup> And clearly, the value of the shares was contingent upon the

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288. Loans to a CEO may be problematic in and of themselves. However, when those loans are made at an interest rate of 2.15%, it becomes difficult to see how such a use of shareholder money provides shareholders with the best return. Deborah Solomon & Rebecca Blumenstein, *Telecom: Mississippi Blues: Loans Proved to be Ebbers's Downfall*, WALL ST. J., May 1, 2002, at A8.

289. Shawn Young, *Big WorldCom Loan May Have Spurred Inquiry*, WALL ST. J., Mar. 14, 2002, at A3.

290. On October 3, 2000, Mr. Ebbers filed a notice of his intention to sell 3 million shares of WorldCom. The sale would have been at a price of \$29.44 per share and would have resulted in Mr. Ebbers receiving \$88.3 million in cash. Investors panicked at just the announcement of Ebbers' intentions, which is when the board became involved with loans to Mr. Ebbers.

291. Young, *supra* note 289, at A3.

292. In his testimony before Congress, John Sidgmore referred to the loans to Ebbers as "a dereliction of duty" by the directors. Backover & Davidson, *supra* note 220, at B1.

performance of the loans and the share price, something the financials controlled by the CEO and board could control, even manipulate.<sup>293</sup>

Even the loans to Mr. Ebbers were fraught with conflicts because the banks were lending money to Mr. Ebbers with the hope of gaining WorldCom business. Mr. Ebbers' personal loans are reflected in the following chart:

<u>LENDER</u>	<u>AMOUNT</u>	<u>STATUS</u> <sup>294</sup>
Citigroup	\$552 million	\$88 million repaid
WorldCom	\$415 million	Collateral seized
Bank of America	\$253 million	Repaid
UBS Paine Webber	\$ 51 million	Repaid
Toronto-Dominion	\$ 40 million	Repaid
Morgan Keegan	\$ 11.6 million	Repaid
J.P. Morgan Chase	\$ 10.8 million	Repaid
Bank of North Georgia	\$ 10.8 million	Repaid <sup>295</sup>

The personal loans to Ebbers brought results for the banks in terms of WorldCom business.<sup>296</sup> For example, Citigroup is the parent company for Salomon Smith Barney, an investment bank and broker whose star telecommunications analyst, Jack Grubman, was perhaps WorldCom's biggest cheerleader.<sup>297</sup> Mr. Grubman's continuing positive reports on WorldCom, despite the slide of the company's stock and the clear signals from the mar-

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293. The Thornburgh report cites these conflicts and concludes that there was a "culture of greed" at WorldCom. Andrew Backover, *Report Slams Culture at WorldCom; Findings Could Help Prosecutors' Case*, USA TODAY, Nov. 5, 2002, at B1.

294. Susan Pulliam, *supra* note 251, at A1.

295. Some loans were used to repay the others. For example, Citibank loans were used to repay the Toronto-Dominion loan. *Id.*

296. At least one lawsuit by a shareholder alleges that the loans were made in exchange for business with WorldCom. Andrew Backover, *Suit: Links Loans, WorldCom Stock*, USA TODAY, Oct. 15, 2002, at B3.

297. For example, WorldCom had the following quote from Mr. Grubman that was included in WorldCom's 1997 annual report that was still posted on its Website through July 2002, "If one were to find comparables to WorldCom . . . the list would be very short and would include the likes of Merck, Home Depot, Wal-Mart, Coke, Microsoft, Gillette and Disney." Neil Weinberg, *Wal-Mart Could Sue for Libel*, FORBES, Aug. 12, 2002, at 56.

ket, earned him a subpoena to the Congressional hearings, alongside Msrs. Ebbers and Sullivan.<sup>298</sup>

Mr. Grubman's relationship with WorldCom's senior management continues to be a target of investigation at the Congressional level and elsewhere for reasons other than the personal loan relationships and the glowing reports from Mr. Grubman.<sup>299</sup> WorldCom gave the bulk of its investment banking business to Salomon Smith Barney and it gave Mr. Ebbers and others the first shot at hot IPO stocks.<sup>300</sup> The figures in congressional records indicate that Mr. Ebbers made \$11 million in profits from investments in 21 IPOs recommended to him by Salomon Smith Barney, and, more particularly, Mr. Grubman.<sup>301</sup> And Mr. Grubman continued to issue nothing but

298. Susan Pulliam et al., *WorldCom Is Denounced at Hearing*, WALL ST. J., July 9, 2002, at A3. When asked if he had ever recommended to anyone that they sell WorldCom stock, Mr. Grubman replied, "I don't talk to individual investors." *Id.* The New York Stock Exchange has been conducting investigations into the activities of Salomon brokers who have filed suit against the brokers for their aggressive recommendations on WorldCom. The brokers' defense is that they too were victims of Mr., Grubman's overzealous recommendations on the company. Gretchen Morgenson, *Salomon Under Inquiry on WorldCom Options*, N.Y. TIMES, Mar. 13, 2002, at C9. Former WorldCom employees who were directed to a special number when they wished to exercise their options and they were discouraged from doing so by Salomon brokers who handled the WorldCom employee options program have filed the suit that has been filed. Gretchen Morgenson, *Outrage Is Rising as Options Turn to Dust*, N.Y. TIMES, Mar. 11, 2002, at C1.

299. Charles Gasparino et al., *Salomon Made IPO Allocations Available to Ebbers, Others*, WALL ST. J., Aug. 28, 2002, at A1.

300. Gretchen Morgenson, *Ebbers Made \$11 Million on 21 Stock Offerings*, N.Y. TIMES, Aug. 31, 2002, at C1. Another instructional tip for those not schooled in the ways of high-falutin finance. The allocation practice is referred to as spinning. IPO is initial primary offering and during the hey day of the dot-coms, many of their IPOs were so anticipated and the value of the shares increased so dramatically that getting in on the floor when the shares were first offered was a critical financial move. For example, in 1999, the average increase in stock prices in IPOs during the first day of trading was 60%. Gretchen Morgenson, *Ebbers Got Million Shares in Hot Deals*, N.Y. TIMES, August 28, 2002, at C1. Apparently, there were plenty of games going on in terms of how those shares were allocated initially and Ebbers was one of the players let in on the best IPOs by Salomon Smith Barney. One expert described the allocation system as follows, "Looking back, it looks more and more like a pyramid scheme. . . . The deals explain why people weren't more diligent in making decisions about funding these small companies. If the money was spread all over the place and everyone who participated early was almost guaranteed a return because of the hype, they had no incentive to try and differentiate the technology. And in the end, all the technology turned out to be identical and commodity-like." Gretchen Morgenson, *Deals Within Telecom Deals*, N.Y. TIMES, Aug. 28, 2002, at BU1.

301. Morgenson, *Ebbers Made \$11 Million*, *supra* note 300, at C1. Rep. Michael Oxley, co-sponsor of the eventual reform legislation that would be passed, (Sarbanes-Oxley, *see supra* note 2 and accompanying text) said that such IPO allocation systems were wrong, "This is an example of how insiders were able to game the system at the expense of the average investor. It raises policy questions about the fairness of the process that brings new listings to the markets." *Id.* Mr. Ebbers' largest allocation was 205,000 in Qwest, a telecommunications company that went public in 1997 and which is currently under investigation by the SEC. Morgenson, *Ebbers Got Million*, *supra* note 300 and accompanying text for Ebbers information; and Andrew Backover, *WorldCom, Qwest face SEC scrutiny*, USA TODAY, Mar. 12,

positive reports on WorldCom as he became completely intertwined with the company, Mr. Ebbers and its success.<sup>302</sup>

Further, Mr. Ebbers was not the sole beneficiary of the Salomon Smith Barney IPO allocations, although he was the largest beneficiary.<sup>303</sup> Stiles A. Kellett Jr. (director, 31,500 shares), Scott Sullivan (CFO, 32,300 shares), Francesco Galesi (director), John Sidgmore (officer, director and CEO after Ebbers' ouster), and James Crowe (former director of WorldCom), were also beneficiaries of the IPO allocations.<sup>304</sup> Apparently, those who enjoyed the benefits of Salomon's allocations also stuck with Mr. Grubman in terms of his advice once the shares were allocated, often staying with the shares for too long because of Mr. Grubman's overly optimistic views on telecommunications-related companies' stock.<sup>305</sup> However, Citigroup and Salomon both denied that there was any *quid pro quo* between

2002, at B1. for information on Qwest inquiry. Qwest's shares are down 95% from 2000. Thor Valdmanis & Andrew Backover, *Lawsuit Targets Telecom Execs' Stock Windfalls*, USA TODAY, Oct. 1, 2002, at B1.

302. The sycophantism of Mr. Grubman is difficult to describe because it seems almost parody, as the ending is now known. Mr. Grubman introduced Mr. Ebbers at analyst meetings as "the smartest guy in the industry." Randall Smith & Deborah Solomon, *Ebbers's Exit Hurts WorldCom's Biggest Fan*, WALL ST. J., May 3, 2002, at C1. It was not until the stock had lost 90% of its value, and just six weeks before its collapse that Mr. Grubman issued a negative recommendation on WorldCom. *Id.* Mr. Grubman was free with his negative recommendations on other telecom companies. And Salomon would earn \$21 million in fees if the WorldCom-Sprint merger was approved in 1999. He wrote, "[W]e do not think any other telco will be as fully integrated and growth-oriented as this combination," *Id.* Mr. Grubman attended WorldCom board meetings and offered advice. Andrew Backover & Jayne O'Donnell, *WorldCom Scrutiny Touches on E-mail; Salomon Analyst Asked Sullivan About Rumors*, USA TODAY, July 8, 2002, at B1.

303. He was, however, the greatest beneficiary, receiving allocations of over 1,000,000 shares in IPOs done by Salomon during the time when Salomon served as WorldCom's investment banker. Charles Gasparino et al., *Salomon Made IPO Allocations Available to Ebbers, Others*, WALL ST. J., Aug. 28, 2002, at A1.

304. Mr. Crowe had denounced such IPO allocations when the investigations began in July 2002, "[S]uch sweetheart deals, even if they may be technically legal . . . [are] wrong." Morgenson, *Ebbers Made \$11 Million*, *supra* note 300, at C1. It is impossible to know the full numbers on the allocations because many of the executives held brokerage accounts in the names of trusts, LLCs and partnerships and those also received allocations but short of litigation and subpoena, it would be impossible to know the owners of such accounts. Morgenson, *Ebbers Got Million*, *supra* note 300, at C1. Additional information on the officers and the allocation in the telecom industry was found at Gretchen Morgenson, *Deals Within Telecom Deals*, N.Y. TIMES, Aug. 28, 2002, at BU1.

305. Morgenson, *Deals Within Telecom Deals*, *supra* note 304, at BU1. In other words, WorldCom was not the only stock about which Mr. Grubman was wrong in terms of its performance. For example, Mr. Ebbers paid \$805,000 for 35,000 shares of stock in the IPO of Williams Communications Group and received \$1.5 cents for his shares when Williams went into bankruptcy. *Id.* Mr. Grubman was as bullish on Williams as he was on WorldCom, right down to the bankruptcy when he finally issued a "sell" recommendation on both. In e-mails uncovered by an investigation of analysts conducted by New York Attorney General Eliot Spitzer, Mr. Grubman complained privately that he was forced to continue his "buy" ratings on stocks that he considered dogs. Valdmanis & Backover, *supra* note 301, at B1. Mr. Spitzer has filed suit against the analysts for "profiteering" in IPOs. *Id.*

Ebbers, WorldCom and the companies for WorldCom's investment banking business.<sup>306</sup>

*Cultural Factor 6 – A Culture of Innovation Like No Other*

WorldCom was possessed of one final trait in its culture that seems to foretell doom when combined with the presence of the other factors. This trait is one that brings about a certain hubris in not just the management team, but all those who hang their fortunes on the company's success. This factor is one that is present from the outset and is best summarized with the phrase, "The rest of the business world has never done it right before, but we know how to do it."<sup>307</sup> To a large extent, those in the company are correct, at least initially, about their innovation and ideas. Enron did indeed have a new way of viewing the energy markets and new ideas on how to make those markets more competitive.<sup>308</sup> And, as noted earlier, Mr. Ebbers' ideas about telecommunications were grounded in basic economics and if executed properly, would have positioned WorldCom as the leader in the telecommunications industry.<sup>309</sup> However, at some point, even innovators must comply with the rules of accounting and tend to the mundane aspects of business.<sup>310</sup> When in a company the claims of innovation and distinction

306. And we can certainly all see that the allocations were done in utter disregard of those investment banking fees. Are you like me; are you thinking, "All these breaks and the guy still lost it all? All these inside deals and the guy still managed to blow it? Heck, all these deals and the guy still had to borrow money?" The allocations violated the law when there is consistent allocation to top clients of the investment banker and those allocations are not disclosed to the public because such allocations and favoritism constitute material market information that should be disclosed to the investment public. Morgenson, *Ebbers Got Million*, *supra* note 300, at C15. Mr. Ebbers' attorney has indicated he never believed that the allocations obligated him in anyway to Citigroup or Salomon. When he was asked at the Congressional hearings whether his company allocated the shares on the basis of investment banking business, Mr. Grubman responded, "I don't recall. I'm not saying 'no.' I'm not saying 'yes.'" Susan Pulliam *et al.*, *WorldCom Is Denounced*, *supra* note 298, at A3. Experts refer to the tight-knit group in the IPO allocations of telecom stocks as the "telecom mafia." Morgenson, *Ebbers Got Million*, *supra* note 300, at C15.

307. The WorldCom era on Wall Street has been likened by those who were competing with the company to being in a race with an athlete who is later found to be on steroids. In fact, at AT&T, Michael Keith, the head of its business services division, was replaced after just 9 months on the job because he could not match WorldCom's profit margins. When Mr. Keith told C. Michael Armstrong, CEO of AT&T, that those margins were just not possible, he was removed from his position. Seth Schiesel, *Trying to Catch WorldCom's Mirage*, N.Y. TIMES, June 30, 2002, at BU1. William T. Esrey, the CEO of Sprint said, "Our performance did not quite compare and we were blaming ourselves. We didn't understand what we were doing wrong. We were like, 'What are we missing here?'" *Id.* Isn't it interesting to learn that CEOs use the Valley Girl vernacular, "So I'm all," "And I'm like," and "Whatever, like WorldCom was totally bogus." See e.g. CLUELESS (Paramount 1995) and FAST TIMES AT RIDGEMONT HIGH (Universal 1982).

308. See *supra* note 22.

309. See *supra* notes 186, 201 and accompanying text.

310. This retention of some grounding in human vulnerability is difficult especially, as in the case of WorldCom, when a smitten press corps offers standing ovations to Mr. Ebbers



purchase a self-perceived immunity from the buffetings of the markets, the requirements of business operations, the principles of accounting, and even the laws and regulations of financial markets, the executive team of that company transforms itself from an energetic group of innovators with the best of intentions into a diabolical group hell-bent on preservation of status and position in everything from the company's share price to their own personal financial positions and wealth accumulations.<sup>311</sup> Such an executive team does not begin with deception; it begins with innovation that is executed poorly and finished with schemes, artifices and rules violations undertaken with the intent of preservation. A self-perception, born of that initial innovation and initially unique market position and standing, consumes logic in that they believe, unlike those who have gone before and failed in such deceptions, that they will be able to pull it all off and maintain the company's position. BUSINESS WEEK referred to WorldCom as "the very model of a 21<sup>st</sup> century phone company . . . . [T]he deal [MCI] will offer businesses one-stop shopping for all their communications needs."<sup>312</sup>

The psychology of "How Could They Have Done It?" is present in the culture of innovation because these executives have never failed, have been used to the accolades of accomplishing the impossible, and, to a large extent have been given an immunity from those around them charged with the responsibility of reining in those who exceed their authority, overstep legal and ethical boundaries, or compromise shareholder interests for self-interest.<sup>313</sup> Their innovation status buys them a pass from scrutiny. They see themselves as being unlike anyone else in the industry or who has come be-

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when he stands before the National Press Club and provides his rags-to-riches story about the transformation of "an obscure long-distance company into one of the country's fastest growing corporations." Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1.

311. It is also a bit of common trait that goes along with innovators that they continue to believe that they can outperform in what has been a relatively low-earnings area. When all was said and done, WorldCom was a utility. And utilities have had stable, but not stellar earnings over the years and while WorldCom had revenues galore, its acquisitions also gave it debt galore and so its shares were overpriced from the outset because the innovators made investors believe that they were somehow a cut above your basic utility stock. "The real issue isn't accounting. It is the incentive people had to use questionable accounting. The truth is that this never was an industry, which made phenomenal returns. People forget this was foremost a utility business." Henny Sender, *WorldCom Discovers It Has Few Friends*, WALL ST. J., June 28, 2002, at C3. During WorldCom's heyday, analysts would visit Sprint and tell the executive team to dump local business and follow the WorldCom model, "You should have seen in the '92,'95,'96 period, all of the guys from New York would come by with their suspenders – the know, the investment bankers – and would say: 'You've got to get rid of this slow-growing local business. It's a dog,'" was the description by Sprint's CEO, William Esrey. Seth Schiesel, *Trying to Catch WorldCom's Earnings Mirage*, N.Y. TIMES, June 30, 2002, at BU15.

312. Available at [www.worldcom.com](http://www.worldcom.com). (annual report cover 1997).

313. "Wall Street was more than captivated by these new guys; they were eating the lotus leaves and it made companies like AT&T and Sprint look stodgy in comparison." Seth Schiesel, *Trying to Catch WorldCom's Earnings Mirage*, N.Y. TIMES, June 30, 2002, at BU14.

fore them.<sup>314</sup> The absence of scrutiny only extends and expands the cover-up period during which innovation has vanished and the executive team is buried beneath the harsh reality of business and the unrelenting demands of operations, markets and customers. To breathe during this immersion in reality, the executive teams props open windows and doors with toothpicks of flimsy accounting and temporary air vents that they hope will last until they can undertake massive reconstruction.

That WorldCom's numbers reversals are stunning in comparison to Enron is no surprise because the fixes undertaken by innovators run in direct proportion to their accomplishments.<sup>315</sup> In WorldCom's case, a phone company from Mississippi started in a coffee shop by a former basketball coach was able to purchase 65 other companies, including several of the largest in the world. Those achievements provide the foundation for the extraordinary accounting faux pas, in both type and amount.<sup>316</sup> Who could expect anything less than \$9 billion in income restatements from a company that conquered the world of telecom from a small corner of Mississippi?<sup>317</sup> It was only natural that it would be the largest bankruptcy in the history of the

314. Here are some quotes from Bernard J. Ebbers' letter to shareholders in the 1999 WorldCom Annual report. Written at the height of the telecom and dot-com markets, and just after the WorldCom coup with MCI, the language is telling, "What we do better than any other name," "WorldCom has become the preeminent Internet and data company of the world," and "We continue to lead this market of virtually unlimited demand and mind-boggling speed." There you have it, they were Leonardo DeCaprio who was "King of the World" in *Titanic*. *TITANIC* (Paramount 1997). You may recall that he perished in frozen water clinging to a piece of wood, which is just about the fate of Ebbers and WorldCom. Being "king of the world" does not always portend of good fortune ahead. Indeed, as this enormously long piece is attempting to spell out – such arrogance buys you deception, fraud, criminal charges and a stock price of about 8 cents per share. Never be "king of the world." Settle for a well-run company with modest growth.

315. It is stunning to note that even as the internal auditors were closing in, a new auditor was raising questions, and there were confrontations for receipts for expenses, Scott Sullivan was thinking he could delay the wolves at the door, planning to ride out the storm for one more quarter and then begin issuing corrections to the financials in the form of write-offs. Kurt Eichenwald and Simon Romero, *Inquiry Finds Effort at Delay At WorldCom*, N.Y. TIMES, July 4, 2002, at C1.

316. To the end, the executives insisted nothing was wrong. In an interview with CNN in March 2002, just after the SEC had announce it was investigating WorldCom's accounting, Mr. Ebbers said, "We have spent an inordinate amount of time trying to decide if there are any issues that we can discover with respect to the questions they asked. And we can find none." Andrew Backover, '*Cloud of Uncertainty*' Rains on WorldCom, USA TODAY, Mar. 13, 2002, at 3B.

317. Seth Schiesel, *WorldCom Sees More Revisions Of Its Figures*, N.Y. TIMES, Nov. 11, 2002, at C1. As of this date, the company was unable to provide a final figure, but assured that it would probably exceed the \$9 billion that had dripped out from the time of the first restatement of \$3 billion and some change. There remains the issue of swaps, in which the telecoms simply sold capacity to each other in order to pump up revenues. Those transactions are also under investigation. Simon Romero and Seth Schiesel, *The Fiber Optic Fantasy Slips Away*, Feb. 17, 2002, at BU1. For information on the investigation of WorldCom and Qwest swaps of capacity, see Andrew Backover, *WorldCom, Qwest face SEC scrutiny*, USA TODAY, Mar. 12, 2002, at B.

United States and bring about the largest default on corporate bonds in history.<sup>318</sup> Even the nature of the “cooked books” was revealing in that violations of the accounting rules were not even a matter of interpretation; they were lacking in the creativity of Enron and undertaken in defiance of accounting rules, not as a matter of interpretation, with the hope of postponing the inevitable collapse.<sup>319</sup> In fact, so great was the hope of a turnaround that, unlike many of the officers of Enron, the officers of WorldCom were not engaged in the rapid dumping of shares of the company. For the three years of 1999, 2000 and 2001, insiders at WorldCom sold only \$14.8 million in WorldCom shares; however, they also bought no shares in 2001 and only purchased \$2 million in shares in 2000.<sup>320</sup> The sales of the insiders are summarized in the table below.

**SALES BY WORLDCOM INSIDERS**

NAME	TITLE	YEAR	SHARES	\$
John Sidgmore	Vice Chair/VP	1998		\$48 mil
		1999		\$70.7 mil
		2000		
		2001	24,503	\$441,054
Scott Sullivan	CFO	1998		
		1999		
		2000		
		2001	475,000	\$18.1 mil
Francesco Galesi	Director	2002	2.9 mil	\$27 mil <sup>321</sup>
Carl Aycoco	Director	2002	859,791	\$4.5 mil <sup>322</sup>

318. For the rankings on bankruptcy, see [www.bankruptcydata.com](http://www.bankruptcydata.com). For information on the bond default, see Gregory Zuckerman, *WorldCom's Bonds: Worst Ever?* WALL ST. J., May 1, 2002, at C1. Analysts indicated never have corporate bonds sunk so far so fast as did WorldCom's. "WorldCom absolutely blows everything else away." *Id.*

319. Jesse Drucker and Henny Sender, *Strategy Behind Accounting Scheme*, WALL ST. J., June 27, 2002, at A9. One also cannot forget that the pressure to sustain extraordinary growth was tremendous. Karl Schoenberger, *When the Numbers Just Don't Add Up*, N.Y. TIMES, Aug. 13, 2002, at BU1.

320. Matt Krantz, *Unlike Enron, WorldCom's Insiders Didn't Dump Their Stock*, USA TODAY, Aug. 21, 2002, at B.

321. *Id.*

322. Barnaby J. Feder and David Leonhardt, *From Low Profile to No Profile*, N.Y. TIMES, June 27, 2002, at C1, C6.

*Cultural Factor 7 – A Culture of Social Responsibility*

Like Enron, WorldCom and its officers were ideal corporate citizens.<sup>323</sup> WorldCom's \$5,000,000 grant to "underserved" children won it this praise from Jesse Jackson, whose Rainbow/PUSH coalition worked closely with WorldCom, "This is an example of the type of commitment our communities need from corporate America. If we provide our children with the technology to learn, we empower a new generation to compete in our technology-driven world."<sup>324</sup> WorldCom provided free phone calls for victims of hurricanes,<sup>325</sup> gave free holiday phone calls to the members of the U.S. armed forces around the world,<sup>326</sup> sponsored the Monterey Jazz Festival,<sup>327</sup> contributed school kits to 100,000 children in Central America,<sup>328</sup> sponsored a program with President Clinton for Internet training for all teachers in the 7 Delta-area states,<sup>329</sup> established voter registration hotlines and Websites with AOL in cooperation with Congress,<sup>330</sup> and turned over its

323. As noted earlier, *supra* note 256, Mr. Ebbers served on the Board of Trustees for Mississippi College and had raised \$500 million for a fund drive there, more money than had ever been raised by the small college. Interns and graduates from the college worked at WorldCom. Clinton Mayor Rosemary Aultman called WorldCom, "a wonderful corporate citizen." Chris Woodyard, *Pressure To Perform Felt as Problems Hit*, USA TODAY, July 1, 2002, at 3A.

324. Available at [www.global.mci.com/news/news2.xml?newsid=5522&mode=long&lang=en&width=530&root=/&langlinks=off](http://www.global.mci.com/news/news2.xml?newsid=5522&mode=long&lang=en&width=530&root=/&langlinks=off), (last visited April 20, 2003), Press releases, 1999, Sept. 21, 1999, *\$5 million plan will enhance learning in underserved communities*. The grant was done in partnership with Brown University and President Gordon Gee of Brown said, "The partnership between Brown and MCI WorldCom will provide direct and lasting benefits to communities across the country and will give colleges and universities an important opportunity to advance the public mission of higher education." *Id.*

325. Available at <http://global.mci.com/news/news2.xml?newsid=5530&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 1999, Oct. 1, 1999 (for Hurricane Floyd victims). This was an ongoing program. Available at <http://global.mci.com/news/news2.xml?newsid=6122&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 1998, Oct. 23, 1998 (for victims of Central American hurricane).

326. Available at <http://global.mci.com/news/news2.xml?newsid=1370&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 2001, Dec. 21, 2001.

327. Available at <http://global.mci.com/news/news2.xml?newsid=5520&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 1999, Sept. 17, 1999.

328. Available at <http://global.mci.com/news/news2.xml?newsid=5496&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 1999, Aug. 4, 1999.

329. Available at <http://global.mci.com/news/news2.xml?newsid=5551&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 1999, Sept. 19, 1999. The training was free and called the Marco Polo program and was praised by both President Clinton and Secretary of Education Richard Riley for the opportunities it opened up to both teachers and students.

330. Available at <http://global.mci.com/news/news2.xml?newsid=5578&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 2000, Mar. 16, 2000.

tax credits in Colorado to a scholarship fund for ethnically diverse students.<sup>331</sup> On April 6, 2000, then-President Clinton announced that WorldCom had contributed \$10,000,000 toward his caused of "closing the digital divide." The scholarships were for Hispanic, African-American and Native American students for college and were unveiled at a press conference at the White House.<sup>332</sup>

WorldCom was, in the minds of those who were beneficiaries of the telecom largess, temporary though it may have been, a model of corporate citizenship and social responsibility. But, in the Yeehaw Culture, that stature and those activities are the penance for any misdeeds, such as booking operating expenses as capital expenses and lopping reserves off here and there in the interest of maintaining those numbers.

### *Tyco International: Another Challenged Culture*

As we travel through the Yeehaw Culture companies, think of the journey as a descending scale. Enron was a bit creative, WorldCom was not so creative, and as we arrive at Tyco, think in terms of not-so-creative embezzlement that impacted a company trying to survive with looting officers in a market stunned by Enron and WorldCom. The Yeehaw Culture has an enormously destructive effect on companies; the only differences are in how much of an effect and for how long.

### *What Went Wrong at Tyco*

Tyco International began as a research laboratory founded in 1960 by Arthur Rosenberg with the idea of doing contract research work for the government. By 1962, Rosenberg had incorporated and begun doing work for companies in the areas of high-tech materials and energy conversion, with two divisions of the holding company called, Tyco Semiconductor and Materials Research Laboratory. By 1964, the company went public and became primarily a manufacturer of products for commercial use. Today, the oldest of the three companies discussed for their Yeehaw Culture, Tyco

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331. Available at <http://global.mci.com/news/news2.xml?newsid=6120&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 1998, October 23, 1998. The managing director of the scholarship fund, called INROAD, said of the gift, "Forward thinking organizations, such as MCI WorldCom and CU-Colorado Springs, add a new dimension of support to INROAD. Pairing a strong technology-based education with challenging work experience will help students enhance their tools for success – and finding creative ways to do so will brighten their futures." *Id.*

332. Available at <http://global.mci.com/news/news2.xml?newsid=5589&mode=long&lang=en&width=530&root=/&langlinks=off> (last visited April 20, 2003), Press releases, 2000, Apr. 6, 2000. Mr. Ebbers was quoted as saying, "With a shortage of high-tech skilled workers in this country and groups of Americans at risk of being left behind in the digital age, this initiative helps close the digital divide while making perfect business sense. It's a good marriage of vital corporate and social objectives." *Id.* The goal was announced as one of increasing minority representation among high-tech workers.

is a conglomerate with a presence in over 100 countries and over 250,000 employees. Between 1991 and 2001, CEO Dennis Kozlowski took Tyco from \$3 billion in annual sales to \$36 billion in 2001 by paying \$60 billion for over 200 acquisitions.<sup>333</sup> Interestingly, in a move to reduce its U.S. tax bills, Tyco is based out of Bermuda despite having its headquarters in Exeter, New Hampshire.<sup>334</sup> Tyco, with a stake in telecommunications as well, is the parent company to Grinnell Security Systems, health care products companies, and just about anything else it can acquire, which has been its strategy for growth.<sup>335</sup> And where there are acquisitions aplenty, there is room for creative accounting.<sup>336</sup> In fact, the troubles that Tyco experienced initially were often attributed to a skittish market reacting to the falls of Enron and WorldCom as well as problems with Global Crossing and Kmart.<sup>337</sup>

Shortly after Enron's bankruptcy, Tyco began to experience a decline in its share price. From December 2001 through the middle of January

333. Daniel Eisenberg, *Dennis the Menace*, TIME, June 17, 2002, at 47. Tyco's shares climbed during the dot-com era as investors saw it as a solid investment without the proforma nonsense of the not-readily-understandable high-tech companies. Tyco's stock was at its high point in January 2001 with a price of \$62 per share. Mark Maremont, John Hechinger, Jerry Markon, and Gregory Zuckerman, *Kozlowski Quits Under a Cloud, Worsening Worries About Tyco*, WALL ST. J., June 4, 2002, at A1.

334. Available at [www.tyco.com](http://www.tyco.com); see investor relations, Tyco History and Alex Berenson, *Tyco Shares Fall as Investors Show Concern on Accounting*, N.Y. TIMES, Jan. 16, 2002, at C1. In other words, Enron and WorldCom were teeny, tiny companies in comparison to Tyco. The company was started in Waltham, Massachusetts. Alex Berenson and Andrew Ross Sorkin, *Tyco Shares Tumble On Growing Worries Of a Cash Squeeze*, N.Y. TIMES, Mar. 5, 2002, at C1. The relocation of its headquarters to Bermuda, a novel move by Tyco at that time that became common among U.S. corporations, reduced Tyco's corporate tax rate to 20%, a rate that is approximately one-half the average rate for a U.S. corporation. Mark Maremont, John Hechinger, Jerry Markon, and Gregory Zuckerman, *Kozlowski Quits Under a Cloud, Worsening Worries About Tyco*, WALL ST. J., June 4, 2002, at A1. In what could be called creative tax accounting, Tyco reported that 65% of its revenues come from operations within the United States while just 29% of its income did. William C. Symonds and Geri Smith, *The Tax Games Tyco Played*, BUSINESS WEEK ONLINE, July 1, 2002, [www.businessweek.com](http://www.businessweek.com). Congress continues to investigate the general practice and the IRS continues its Tyco probe. The author would like to note that given Kozlowski's spending, see *infra* notes 369-75 and accompanying text, it is quite possible that most of the revenues but very little of the income came from U.S. operations.

335. *Id.* available at <http://www.tyco.com/tyco/history.asp> (last visited April 20, 2003); see Tyco History. Tyco bought Grinnell, the security system and fire alarm company, Ludlow, the packaging company and a host of others during its especially aggressive expansion during the period from 1973-82.

336. See *infra* notes 353-68 and accompanying discussion for background on acquisitions accounting in WorldCom.

337. "Volatility in the options market rose markedly as skittish investors fretted about the accounting practices of U.S. Companies and as Global Crossing's bankruptcy filing – on the heels of similar filings from Kmart and Enron – fanned fears about what might come next." Kopin Tan, *Tyco's Options Soar, While Volatility Spikes On Concerns Over U.S. Accounting Practices*, WALL ST. J., Jan 30, 2002, at C14.

2002, Tyco's shares lost 20% of their value.<sup>338</sup> In fact, following a conference in which then-CEO Dennis Kozlowski tried to reassure the public and analysts that Tyco's accounting was sound, the shares were the most heavily traded of the day (68,000,000 on January 15, 2002) and the price dropped \$4.45 to \$47.95 per share.<sup>339</sup> However, at the same time as the investor loss of confidence in accounting for public corporations came the Tyco announcement that its earnings had dropped 24% for fiscal year 2001.<sup>340</sup> By February, the share price had tumbled to \$29.90, a drop of 50% from January 1, 2002.<sup>341</sup> Tyco was forced to borrow funds as it experienced what one analyst called a "crisis in confidence," noting, "The lack of confidence in the company by the capital markets to a degree becomes a self-fulfilling prophecy."<sup>342</sup> Along with the declaration that it had the cash to survive from the loans, Dennis Kozlowski announced that the company would be divided into 4 different companies in a strategic change from Tyco's growth-by-acquisition approach that had fueled its share price and success for nearly two decades.<sup>343</sup> The plan of dividing the company was dropped like a hot potato by April.<sup>344</sup> Between January and mid-June 2002, Tyco's stock fell 80%, with a ten-year low of \$10.10 in mid-June.<sup>345</sup>

Then there was another problem that emerged on January 28, 2002. Tyco announced that it had paid \$20 million to one of its outside directors, Frank E. Walsh, and a charity of which he is the head, for him to broker a

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338. Alex Berenson, *Tyco Shares Fall as Investors Show Concern on Accounting*, N.Y. TIMES, Jan. 16, 2002, at C1.

339. *Id.* Mr. Kozlowski said, "Our accounting has been reviewed and found to be sound. Our disclosure is exceptionally detailed." *Id.* at C1. There had also been a suggestion in an investment newsletter that the SEC was investigating Tyco. That newsletter appeared on January 2, 2002. Kate Kelly and Gregory Zuckerman, *Tyco Worries Send Stock Prices Lower Again*, WALL ST. J., Feb. 5, 2002, at C1.

340. John Hechinger, *Tyco to Lay Off 44% of Its Workers At Telecom Unit*, WALL ST. J., Feb. 8, 2002, at A5.

341. Alex Berenson and Andrew Ross Sorkin, *Tyco Shares Tumble On Growing Worries Of a Cash Squeeze*, N.Y. TIMES, Feb. 5, 2002, at C1.

342. *Id.* The company's bond ratings went from A to A- and Standard & Poor's changed its rating from A to BBB.

343. Floyd Norris, *Another Big Name Is Under Fire In a Market Numb by Enron*, N.Y. TIMES, Feb. 5, 2002, at C1. And layoffs were announced. On February 7, 2002, Tyco announced that it would lay off 44% of the workers in its telecommunications unit. John Hechinger, *Tyco to Lay Off 44% of Its Workers At Telecom Unit*, WALL STREET J., Feb. 8, 2002, at A5. One of the spin-offs would be of the company's finance unit. Andrew Ross Sorkin and Alex Berenson, *To Stem Crisis, Tyco Is Moving To Spin Off Finance Unit*, N.Y. TIMES, Feb. 6, 2002, at B1.

344. Alex Berenson, *Investigation Is Said to Focus on Tyco Chief Over Sales Tax*, N.Y. TIMES, June 3, 2002, at C6. The indecision took the bloom off Tyco's rose and drew attention to the company which, coupled with other events, led to phenomenal drops in the company's standing in the eyes of analysts and price in the eyes of investors. Although, it took such indecision to awaken the sleeping analysts. See *supra* notes 129, 163, 252, 297, 298, 302, 305, 306 for discussion of crackerjack analysts and *infra* note 506, for changes needed to remedy their influence in the Yeehaw Culture.

345. Daniel Eisenberg, *supra* note 333, at 49.

deal for one of Tyco's acquisitions.<sup>346</sup> The acquisition was CIT Group Finance, and Tyco acquired it for \$9.5 billion.<sup>347</sup> Mr. Walsh, who would later plead guilty to a violation of a New York statute as well as a violation of federal securities laws,<sup>348</sup> withheld information about the brokerage fee from the Tyco board and did not disclose the information as required on the company's SEC filings.<sup>349</sup> Once the SEC moved in, the company's stock continued its decline.<sup>350</sup> From January 2002 to August 2002, Tyco's stock price declined 80%.<sup>351</sup>

### *What Went Wrong: The Accounting Issues*

Investors and markets are not always jittery for no reason. There were some Tyco accounting issues that centered around its acquisitions and its accounting for those acquisitions.<sup>352</sup> What caused investors to seize upon Tyco's financials was that it seemed to be heavily in debt despite the fact that it was reporting oodles of cash flow.<sup>353</sup> The fact is understood if one thinks, oddly, "goodwill."<sup>354</sup> When one company acquires another company,

346. Kate Kelly and Gregory Zuckerman, *Tyco Worries Send Stock Prices Lower Again*, WALL ST. J., Feb 5, 2002, at C1.

347. Laurie P. Cohen and Mark Maremont, *Tyco Ex-Director Pleads Guilty*, WALL ST. J., Dec. 18, 2002, at C1.

348. The New York statute was the Martin Act, a 1926 law that Manhattan district attorney Robert M. Morgenthau used because it is a very broad business-law statute. The SEC violation was filing a false registration statement in which the \$20 million fee, required to be disclosed by law, was not disclosed.

349. *Id.* The payments were made to Mr. Walsh in July 2001, but the board was not told about them until December 2001. Andrew Ross Sorkin, *Tyco Figure Pays \$22.5 Million in Guilty Plea*, N.Y. TIMES, Dec. 18, 2002, at C2. This information was emerging at about the same time that Tyco's commercial paper market dried up and it was forced to turn to banks for loans. E.S. Browning, *Stocks Slump in Late-Day Selloff On Round of Ugly Corporate News*, WALL ST. J., June 4, 2002, at A1.

350. The SEC originally investigated in 1999 for 9 months and closed the matter with no enforcement action taken. Following the indictment of Mr. Kozlowski, *see infra* note 375 and accompanying text, the SEC announced that it would reopen its investigation of Tyco, most particularly looking at its acquisition accounting. Michael Schroeder and John Hechinger, *SEC Reopens Tyco Investigation*, WALL ST. J., June 13, 2002, at A3.

351. Kevin McCoy, *Authorities Widen Tyco Case, Look at Other Officials' Actions*, USA TODAY, Aug. 13, 2003, at 1A.

352. Tyco's problems emerged as the market was coping with Enron and WorldCom. Investors had awakened and were saying, "Dang, we better start asking some questions!" Actually Prof. Jeffrey Sonnenfeld of the Yale School of Management said it more eloquently, "For several years now, people were afraid to challenge what they didn't understand. It's only since October, or really since January, that we've seen the unraveling." Floyd Norris, *Now Will Come the Sorting Out of the Chief Executive's Legacy*, N.Y. TIMES, June 4, 2002, at C10.

353. Mark Maremont, *Tyco Made \$8 Billion of Acquisitions Over 3 Years but Didn't Disclose Them*, WALL ST. J., Feb 4, 2002, at A3.

354. For all those nonfinancial types, "goodwill" is an asset under accounting rules that takes into account the squishy, feely type of value a business has. For example, if you buy a dry-cleaning business, you are not only paying for the hangers and the pressers and racks, you



it must include the assets acquired in its balance sheet. The acquirer is in charge of establishing the value for the assets acquired. From 1998-2001, Tyco spent \$30 billion on acquisitions and attributed \$30 billion to goodwill.<sup>355</sup> For those of you unschooled in the ways of accounting, you may be thinking that the numbers match and whatever could be the problem?

The problem lies in the fact that the assets that are acquired are not carried on Tyco's books with any significant value. Assets, under accounting rules, lose their value over time.<sup>356</sup> Goodwill stays the same in perpetuity. However, if Tyco turns around and sells the assets it has acquired and booked at virtually zero value, the profit that it makes is a chunk of change and is reflected in the income of the company. The only way an investor in Tyco would be able to tell what has really happened in the accounting for an acquisition would be for the investor to have access to the balance sheets of the acquired companies so that he or she could see the value of the assets as they were carried on the books of the acquired company. The bump to earnings from the sale of the assets is lovely, but the bump to profits, with no offsetting costs, is tremendous.<sup>357</sup>

There were additional accounting issues related to the Tyco acquisitions.<sup>358</sup> One big one was that despite having made 700 acquisitions between 1998 and 2001 for about \$8 billion, Tyco never disclosed the acquisitions to the public.<sup>359</sup> The eventual disclosure of the phenomenal number of acquisitions did explain the lack of cash, but also deprived investors of the chance

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are paying for that dry cleaner's reputation in the community, the tendency of customers to return and their willingness to bring their dry cleaning to this establishment – goodwill.

355. Alex Berenson, *supra* note 344, at C15.

356. For you financial types, that's depreciation. The author has switched and put the nonfinancial explanation in the body of the text and moved the financial types to the footnotes, which they are always prone to read anyway because, as we have learned, the real meat of financial reports is always in the footnotes.

357. Alex Berenson, *supra* note 344, at C15. On September 25, 2002, Tyco announced a \$2.5 billion charge to its books to correct past accounting misdeeds following an internal investigation. Kevin McCoy, *Tyco cuts outlook, plans \$2.5B charge*, USA TODAY, Sept. 26, 2002, at 3B. Tyco also explained at the same time that its earnings would be lower. This phenomenon has been a universal result when accounting is done right – earnings drop. Andrew Ross Sorkin, *Tyco's Chief Says Earnings Will Be Lower Than Expected*, N.Y. TIMES, Sept. 26, 2002, at C1. Here's a funny quote from new Tyco CEO at that time, Edward D. Breen, "What is pretty neat, you know, in a very difficult environment, is our revenues are very good. We are not dropping off. We are not losing market share." *Id.* Again, it's a universal phenomenon. Booking expenses does bring the earnings down, no matter what the revenues.

358. The role and knowledge of Tyco's auditor, PricewaterhouseCoopers, remains an issue. The firm acknowledged being questioned by the New York district attorney's office, but it indicated it had no reason to believe it was anything other than a source of information. Mark Maremont and Laurie P. Cohen, *Tyco Probe Expands to Include Auditor PricewaterhouseCoopers*. WALL ST. J., Sept. 30, 2002, at A1. One accounting professor has called the Tyco financial statements "a blatant misstatement of both the income statement and the balance sheet." *Id.* at A8.

359. Mark Maremont, *supra* note 358, at A3.

to determine how much of Tyco's growth was due to acquisitions vs. the running of existing businesses.<sup>360</sup> Additionally, the disclosure of the acquisitions also explained a phenomenal boost in cash when Tyco acquired a security-alarm business.<sup>361</sup> Tyco enjoyed the immediate earnings and cash boost of the 800,000 new customers paying their monthly alarm bills from their security contracts that Tyco purchased, but investors, not knowing of the new acquisition, simply assumed that Tyco was growing existing business and attributed the bump in earnings and cash to incredible management.<sup>362</sup> Tyco also had some creative ways of reporting the acquisition of the contracts. Its books indicated it paid \$1,000 for the acquisition of an alarm security contract. But, it charged the dealer a \$200 "connection fee" so that it had to pay the dealer only \$800 cash. The full \$1,000 is booked as the cost of acquisition, but the \$200 is recorded as a reduction in expenses, which boosts both cash flow and earnings.<sup>363</sup>

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360. *Id.* Also, it's sort of nice for shareholders to be able to see if the company is paying a fair price for the acquisitions. Shareholders enjoy policing this kind of thing.

361. The accounting investigation continues and involves 50 accountants and 8 lawyers who are working in 45 offices of Tyco and its subsidiaries around the world. The investigation was 40% complete in September 2002. Andrew Ross Sorkin, *Tyco's Chief Says Earnings Will Be Lower Than Expected*, N.Y. TIMES, Sept. 26, 2002, at C1, C9. By the end of October 2002, Tyco announced that it expected only minor restatements. Andrew Ross Sorkin, *Tyco Inquiry Mostly Clears Its Accounting*, N.Y. TIMES, Oct. 25, 2002, at C4. In the author's mind, it all depends on the definition of "minor." How minor is minor? By December, Tyco acknowledged that it had used "accounting tricks," but the amounts of the adjustments remained uncertain. Andrew Ross Sorkin and Alex Berenson, *Tyco Admits Using Accounting Tricks To Inflate Earnings*, N.Y. TIMES, Dec. 31, 2002, at A1. Minor remains undefined. The admissions to date have been that while there was no systemic fraud, there were a number of accounting entries and treatments that were incorrect and that Tyco engaged in aggressive accounting to increase earnings. Mark Maremont and Laurie P. Cohen, *Tyco's Internal Inquiry Concludes Questionable Accounting Was Used*, WALL ST. J., Dec. 31, 2002, at A1, A4. The report makes the Kozlowski statement in October 2000, "We are very, very confident of our accounting," eerie. Stephen Barr, *2000 Excellence Awards: Mark Swartz*, CFO.COM, Oct. 1, 2000, available at [www.cfo.com](http://www.cfo.com).

362. Mark Maremont, *How Is Tyco Accounting for Its Cash Flow?* WALL ST. J., Mar. 5, 2002, at C1. An accounting professor explains it this way, "[If] Tyco had acquired its customers through in-house marketing efforts, different accounting would have applied – and, as a result, the company would have shown much lower upfront earnings and free cash flow from the new customers. Tyco 'is effectively buying earnings and operating cash flow' with the purchase of the alarm contracts" as part of its acquisitions, which, as we know, were not disclosed. *Id.* at C2. The issue in the reporting is one that allows investors to determine whether the earnings that are posted, and in this case they were phenomenal earnings for Tyco, are sustainable.

363. *Id.* In other words, it would have been nice for investors to know that (a) Tyco was making acquisitions; (b) how much the acquisitions were costing; and (c) how Tyco went about booking the expenses and revenues from acquisitions. Revenue growth rate for Tyco over the period of its acquisitions was 24% per year. Herb Greenberg, *Does Tyco Play Accounting Games?*, FORTUNE, April 1, 2002, at 83. One of the acquisitions, that of Flag Telecom, has now revealed that it was a bad deal, but that the accounting that was used showed it to be a profitable deal which meant that the executives tied to the deal received \$24 million in bonuses based on a false profit of \$79.4 million. The value of Flag stock was overstated in

The nondisclosure of the acquisitions also helped with another accounting strategy. When Tyco made acquisitions, its goal was always to make the company acquired look as much like a dog as possible. Referred to as spring-loading, this process has the company look worse in terms of earnings than it really is and when it just continues as normal the following year, Tyco enjoys a boost in terms of growth and respect for its management acumen.<sup>364</sup> Spring-loading is easily accomplished by having the company being acquired pay everything for which it has a bill, whether that bill is due or not. When Tyco acquired Raychem, its treasurer sent out the following e-mail:

*At Tyco's request, all major Raychem sites will pay all pending payables, whether they are due or not . . . I understand from Ray [Raychem's CFO] that we have agreed to do this, even though we will be spending the money for no tangible benefit either to Raychem or Tyco.*<sup>365</sup>

Tyco employees, when working with a company to be acquired would also pump up the reserves with one employee of Tyco asking an employee of an acquired firm, "How high can we get these things. How can we justify getting this higher?"<sup>366</sup> The final report of a team led by David Boies indicates that Tyco executives used both incentives and pressure on executives in order to get them to push the envelope on accounting rules in order to maximize results.<sup>367</sup>

The SEC is currently investigating the settlement of a lawsuit between Tyco and U.S. Surgical, a company it took over in 1998. Documents that have emerged in the case include memoranda between Tyco financial executives in which they discuss methods whereby U.S. Surgical could slow growth in between the time Tyco announced its acquisition and when the

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the accounting for the acquisition by 53%. Floyd Norris, *Tyco Took Profit on Bad Deal, Then Paid Bonuses to Executives*, N.Y. TIMES, Sept. 25, 2002, at C1. The Flag transaction occurred in June 2001 and was uncovered by David Boies and his team. See *infra* notes 378, 416, 430 for more information on David Boies and his investigation.

364. *Id.*

365. *Id.* at 86. Lars Larson, the Raychem treasurer wrote a follow-up memo, "The purpose of this effort is, at Tyco's request, to cause cash flows to be negative in the 'old' Raychem, and more positive in the new company." *Id.*

366. *Id.* at 86. As the author reads these thoughts on accounting and its flexibility she is no longer ashamed of dropping out of intermediate accounting and switching her major to finance. There was no way to learn rules in a profession and science in which auditors are asking, "What number do we want and how can we get it there?" If I'd known we could make numbers up, see *supra* note 73, and *infra* note 563, I would have stuck it out.

367. Kurt Eichenwald, *Pushing Accounting Rules To the Edge of the Envelope*, N.Y. TIMES, Dec. 31, 2002, at C1, C2. The language from the report, "Tyco pursued a pattern of aggressive accounting that was intended, within the range of accounting permitted by GAAP, to increase current earnings above what they would have been if a more conservative approach had been followed." *Id.* at C1.

actual transfers were made. Just prior to the closure of the deal, U.S. Surgical took a one-time hit of \$322 million in miscellaneous charges.<sup>368</sup>

*What Went Wrong: A Profligate Spender and Cheapskate CEO*

Odd that the two descriptors would go together, but Tyco was graced with a CEO whose profligate spending cost the company dearly, in dollars and reputation and whose tight fist with his own money got him indicted. The revelation of these qualities of its CEO, along with the accounting mumbo jumbo just discussed caused the free fall of Tyco's stock.

Dennis Kozlowski was a scary CEO whose philosophy was not unlike that of Milken and Boesky.<sup>369</sup> His favorite saying was, "Money is the only way to keep score."<sup>370</sup> Before Tyco took its dive, Mr. Kozlowski had accumulated 3 Harleys, a 130-foot sailing yacht, a private plane, 4 homes in New York City (13 rooms, Fifth Avenue, purchased in 2000 for \$18.5 million),<sup>371</sup> New Hampshire, Nantucket and Boca Raton (15,000 square feet, purchased in 2001) and was a part owner of the New Jersey Nets and the New Jersey Devils.<sup>372</sup> Perhaps most famously, he had an insatiable appetite for art. Mr. Kozlowski was an active player in Manhattan's art market and in

368. Laurie P. Cohen and Mark Maremont, *Secret Payment by Tyco Is Target Of Investigation*, WALL ST. J., Sep. 30, 2002, at A2. The memo refers to the process of slowing growth as "financial engineering." These memos emerged in a lawsuit by shareholders of Progressive Angioplasty Systems, Inc., a company that U.S. Surgical had acquired and which experienced slower growth during the period in which the alleged "financial engineering" is said to have occurred. Tyco settled the suit with the shareholders for a \$40 million payment, but the parties in the case all signed a confidentiality agreement and no one will disclose the terms of the settlement other than the amount. *Id.* The allegation that has emerged is that the \$40 million was hush money for the "financial engineering." The SEC is also investigating whether data and documents were withheld from a regulatory agency during the initial investigation. Laurie P. Cohen, *SEC Asks Tyco if It Withheld Data in Earlier Inquiry*, WALL ST. J., Nov. 25, 2002, at C1. Mr. Mark Belnick, Tyco's general counsel, *see infra* notes 378079 and 396-402 and accompanying text for more information about Mr. Belnick and his role in Tyco, received a \$2 million bonus for wrapping up the earlier SEC investigation without any action being taken. *Id.* at C9.

369. *See supra* note 4 and accompanying text.

370. Daniel Eisenberg, *Dennis the Menace*, TIME, June 17, 2002, at 47.

371. It is actually a 10<sup>th</sup>-floor duplex in a Prewar building with Georgian architecture. There are 4 bedrooms, 3.5 baths and 7 hall closets (which explains the need for the \$2,900 in coat hangers, eh?). *See infra* note 371 and accompanying text. Large windows allow a magnificent view of Central Park and the New York skyline. The author slipped into Realtor mode for a moment. Theresa Howard, *Tyco Puts Kozlowski's \$16.8M NYC Digs on Market*, USA TODAY, Sept. 19, 2002, at 3B.

372. *Id.* Information on Boca Raton home is from Laurie P. Cohen and Mark Maremont, *Tyco Relocations to Florida Are Probed*, WALL ST. J., June 10, 2002, at A3. Information on the New York apartment is from Alex Berenson and William K. Rashbaum, *Tyco Ex-Chief Is Said to Face Wider Inquiry Into Finances*, N.Y. TIMES, June 7, 2002, at C1. Interestingly, although Tyco has seized most of Mr. Kozlowski's assets, it has had great difficulty selling them both because of the price ranges and the taint of scandal. The yacht has been particularly troublesome to sell because it is symbolic of the excess. Kris Maher, *Scandal and Excess Make It Hard to Sell Mr. Kozlowski's Boat*, N.Y. TIMES, Sept. 23, 2002, at A1.

June 2002 the *New York Times* reported that Mr. Kozlowski was being investigated by the district attorney's office in Manhattan for sales tax evasion of \$1 million on \$13 million in art sales over a ten-month period.<sup>373</sup> Mr. Kozlowski resigned from Tyco immediately following the emergence of the report and before an indictment was handed down.<sup>374</sup> In fact, the indictment was handed down the following day.<sup>375</sup>

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373. Alex Berenson, *Investigation Is Said to Focus on Tyco Chief Over Sales Tax*, N.Y. TIMES, June 3, 2002, at C1. The art included paintings by Monet and Renoir. He may have been fast and loose with the tax code, but the man did have taste in art. Robert Morgenthau, the Manhattan District Attorney, has proven to be one tough cookie when it comes to corporations, CEOs and crimes. See *supra* note 348 wherein Morgenthau used the obscure Martin Act to nail a Tyco director. Rumor has it that Morgenthau has been working with the Treasury Department on the issue of off-shore companies such as Tyco as well as the possibility that such set-ups allow money laundering to escape detection. Eisenberg, *supra* note 370, at 47. A wire transfer from a Tyco bank account in Pittsburgh to a New York account of art dealer, Alexander Apsis, is what began the sales tax investigation because the Banking Department monitors such transfers and the transaction was investigated for possible money laundering. Laurie P. Cohen and Mark Maremont, *Expanding Tyco Inquiry Focuses on Firm's Spending on Executives*, WALL ST. J., June 7, 2002, at A1, A5. The investigator was Irwin Nack, great first and last name, and he discovered the company involved in the transfer and brought in the DA's office. Nanette Byrnes, *Online Extra: The Hunch That Led to Tyco's Tumble*, BUSINESS WEEK, ONLINE, Dec. 23, 2002, available at [www.businessweek.com](http://www.businessweek.com).

374. Mark Maremont, John Hechinger, Jerry Markon and Gregory Zuckerman, *Kozlowski Quits Under a Cloud, Worsening Worries About Tyco*, WALL ST. J., June 4, 2002, at A1. A market that was already reeling from Enron and WorldCom dropped 215 points in one day and Tyco's stock fell 27% that same day. Adam Shell, *Markets Fall as Tyco CEO's Resignation Adds To Woes*, USA TODAY, June 4, 2002, at 1B. "When a CEO steps down for (alleged) tax evasion, it sends the message that all of Corporate America is crooked." *Id.* "It makes you think, 'Why did he do it? Is there another shoe to drop?'" *Id.* Following Mr. Kozlowski's resignation, former CEO and board member, John F. Fort III, took over as interim CEO for about 6 weeks before the board appointed Edward D. Breen, former president of Motorola, as CEO and Chairman. Andrew Ross Sorkin, *Tyco Appoints Chief in Effort To Calm Wall St.*, N.Y. TIMES, July 26, 2002, at C1. Even the appointment of a new CEO was not the end, because Tyco still had Mark Swartz as its CFO and Mark Belnick as its general counsel. See *infra* for more information on these two additional shoes dropping.

375. Thor Valdmanis, *Art Purchases Put Ex-Tyco Chief in Hot Water*, USA TODAY, June 5, 2002, at 1B. The \$13 million in sales included Renoir's \$4.7 million *Fleur et Fruits*, a \$3.9 million Claude Monet landscape, a Gustave Caillebotte for \$1.3 million, an Osias Beert the Elder at \$2 million, a John LaFarge at \$425,000, and a Sir Alfred Munnings at \$800,000. Mark Maremont and Jerry Markon, *Former Tyco Chief Is Indicted For Avoiding Sales Tax on Art*, WALL ST. J., June 5, 2002, at A1. The indictment indicates that in order to avoid paying sales tax in New York, Mr. Kozlowski shipped empty crates from New York to Tyco's headquarters in New Hampshire and then brought the paintings back and forth between New York and New Hampshire so as to dupe sales tax authorities. Alex Berenson and Carol Vogel, *Ex-Tyco Chief Is Indicted in Tax Case*, N.Y. TIMES, June 5, 2002, at C1. Mr. Kozlowski was charged with 11 felony counts and one misdemeanor and he entered a not-guilty plea before flying to one of his homes in Boca Raton. Valdmanis, *supra* note 375, at 1B. Interestingly, the investigation was a very broad one of the art world and the rings that were operating to help art dealers and buyers avoid the sales tax. Mr. Kozlowski just happened to be part of the ring that was being investigated and charged as the market and Tyco were experiencing their difficulties. The confluence of the events and the stars meant the monumental depression of

The indictment was the beginning of a spool unwinding. Both the Tyco board and state and federal investigators began a general probe into Mr. Kozlowski's finances and financial arrangements with Tyco.<sup>376</sup> Initially, the board uncovered the fact that Tyco had purchased Mr. Kozlowski's \$18 million Fifth Avenue Manhattan apartment with Mr. Kozlowski listed on the contract as the "nominee."<sup>377</sup> Even the investigation got ugly as the company's general counsel, Mark Belnick, was terminated for "impeding an internal probe into whether corporate funds were used to enrich senior executives and board members."<sup>378</sup> Within days of his termination, Tyco filed suit against Mr. Belnick as well as Frank Walsh for attempting to conceal from the board \$35 million in undeclared compensation to Mr. Kozlowski.<sup>379</sup>

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Tyco stock as well as the market. David Cay Johnston, *A Tax That's Often Ignored Suddenly Attracts Attention*, N.Y. TIMES, June 5, 2002, at C1. The shipping-out-of-state scam is neither new nor unique to the art world. During the 1980s, Bulgari, Cartier and Van Cleef & Arpels were charged with sales tax evasion by shipping empty boxes out of state so that their customers could avoid paying New York sales tax. *Id.* In the art world, the "enormously widespread" practice was a means of bending rules to get repeat clientele. Brooks Barnes and Alexandra Peers, *Sales-Tax Probe Puts Art World In Harsh Light*, WALL ST. J., June 5, 2002, at B1, B3. However, the case is unique in that it was the first time a buyer was charged with sales tax evasion, past cases having zeroed in on sellers. Susan Saulny, *Tyco's Ex-Chief to Seek Dismissal of Indictments*, AUG. 15, 2002, at C3. On June 26, 2002, Mr. Kozlowski was charged with 2 additional felony counts for tampering with evidence. Mark Maremont and Laurie P. Cohen, *Former Tyco CEO Is Charged With Two New Felony Counts*, WALL ST. J., June 27, 2002, at A3. The new charges accused Mr. Kozlowski of removing a fraudulent bill of lading from a file in Tyco offices at Boca Raton. The bill of lading falsely showed that five paintings were shipped from Tyco offices in New York to Tyco offices in New Hampshire. Mr. Kozlowski allegedly removed the bill of lading as a secretary was preparing to turn over documents pursuant to a request from the district attorney. He called it "personal," but apparently his secretary called it something different when the grand jury hauled her before it for testimony in the case. Andrew Ross Sorkin and Susan Saulny, *Former Tyco Chief Faces New Charges*, N.Y. TIMES, June 27, 2002, at C1.

376. Laurie P. Cohen and Mark Maremont, *Expanding Tyco Inquiry Focuses On Firm's Spending on Executives*, WALL ST. J., June 7, 2002, at A1.

377. *Id.* There were conflicting reports as to when the board knew of the purchase. Actually, there are conflicting reports on the price. Some board members claimed they were told post-indictment while others indicated they were aware of the purchase. *Id.* The initial response was that the apartment was carried in Mr. Kozlowski's name because of the rules of the co-op board of the building. Alex Berenson and William K. Rashbaum, *Tyco Ex-Chief Is Said to Face Wider Inquiry Into Finances*, N.Y. TIMES, June 7, 2002, at C1.

378. Thor Valdmanis, *Tyco Drops Its Top Lawyer*, USA TODAY, June 11, 2002, at 1B. Ironically, Mr. Belnick represented Michael Milken, *see supra* note 4 for more information on Mr. Milken. And, in more of a six degrees theme, the internal probe was being conducted for Tyco by David Boies, the man who worked for the government in its prosecution of Microsoft for antitrust violations, represented Al Gore in *Bush v. Gore*, 531 U.S. 98 (2000), Shawn Fanning in Napster and himself in some litigation. Mr. Boies also represented Drexel Burnham Lambert when Mr. Belnick was representing Mr. Milken, one of the firm's principals.

379. Thor Valdmanis, *Tyco Sues Former Counsel, Director*, USA TODAY, June 18, 2002, at 1B. The suit also accuses Mr. Belnick of concealing compensation to himself in the form of interest-free loans (totaling \$10 million) and a "relocation loan" that was used to buy a home near Park City, Utah. *Id.* The loans were also not disclosed on SEC filings for the company and Mr. Belnick is accused of manipulating those documents so as not to have to

And both the SEC and the New York District attorney's office were investigating the use of company funds by Mr. Kozlowski and his possible failure to disclose such and perhaps resulting failure to pay income taxes on the use of company funds and additional perks not previously revealed.<sup>380</sup> In short, a decade of creative accounting initiated, and, at once, masked by years of massive acquisitions coupled with a CEO largely concerned about himself and the avoidance of taxes, from the corporate relocation to the Bermudas to the art shell game using the company's various locations for the confusing shipment of empty crates and carting about of Renoirs and Monets. As we descend downward in this exploration of the Yeehaw Factors, the scandal creativity decreases as the roguishness of the players increases.<sup>381</sup>

### What Went Wrong – The Yeehaw Culture of Tyco

#### *Cultural Factor 1 – Pressure to Maintain Those Numbers*

Tyco's performance was, like the other companies, nothing less than phenomenal. From 1992, when Mr. Kozlowski took over as CEO, through 1999, the stock price had jumped 15-fold.<sup>382</sup> In January of 2002, BUSINESS WEEK, in praising Mr. Kozlowski's performance wrote, "Kozlowski vows Tyco's earnings will once again grow by more than 20% a year. That would bring him closer to his ultimate goal: inheriting the mantle once worn by Jack Welch."<sup>383</sup>

The culture of numbers made it all the way down to even the factory workers. One employee noted, "Tyco is so big, they don't even know where Rock Hill is."<sup>384</sup> They just know the numbers. All we hear is, "If we don't hit these numbers, we're in trouble."<sup>385</sup>

Perhaps the numbers pressure was most evident when Tyco acquired ADT Security Services Inc.<sup>386</sup> A burglar alarm dealer who worked for ADT

disclose the loans. Alex Berenson, *Tyco Sues Ex-Lawyers and Director*, N.Y. TIMES, June 18, 2002, at C1, C5.

380. Mark Maremont, Laurie P. Cohen and Jerry Markon, *Probe of Ex-Tyco Chief Focuses On Improper Use of Company Funds*, WALL ST. J., June 6, 2002, at A1. Additional details on Mr. Kozlowski's use of company funds is found *infra* at notes 369-75 and accompanying text.

381. If the author were to be crystal clear in this assessment, the summation of the fall of Tyco would be, "Tyco had a crook in charge." Note – author's opinion and thereby not considered slander except in the UK and some parts of the Ninth Circuit.

382. Alex Berenson, *Ex-Tyco Chief, A Big Risk Taker, Now Confronts the Legal System*, N.Y. TIMES, June 10, 2002, at B1.

383. BUSINESS WEEK ONLINE, Jan. 14, 2002, available at [www.businessweek.com](http://www.businessweek.com).

384. "Rock Hill" refers to an AMP factory in South Carolina. Tyco acquired AMP in 1999. Julie Flaherty, *Tyco Workers Say Faith In Company Is in Shambles*, N.Y. TIMES, July 6, 2002, at B1.

385. *Id.*

386. For information on the accounting issues surrounding ADT, see *supra* notes 360-61 and accompanying text.

prior to the Tyco acquisition summarized the change in culture post-acquisition as one of wanting sales people to target "the scummiest neighborhoods possible, . . . neighborhoods where there were problems, where Mookie was standing on a corner selling rock (crack cocaine). Tyco kept pushing. They wanted numbers. They didn't give a crap if the accounts fell off the books later."<sup>387</sup> About 20% of the contracts signed during the initial Tyco era were of customers with very poor credit.<sup>388</sup> The company pushed so hard for expansion and continuing sales that it awarded dealerships to convicted felons, something company policy prohibited, and had alarm service cancellation rates because of the low-credit quality of customers, of about 50% in many areas.<sup>389</sup>

The number pressure became apparent to even outside counsel for Tyco during the 1999 SEC investigation of the company. In a May 25, 2000, e-mail from William McLucas of Wilmer Cutler to Mr. Mark Belnick, general counsel for Tyco, is the following admonition on the accounting practices of Tyco and what pressure the managers were experiencing, "We have found issues that will likely interest the SEC . . . . [C]reativeness is employed in hitting the forecasts . . . . There is also a bad letter from the Sigma people just before the acquisition confirming that they were asked to hold product shipment just before the closing . . . ."<sup>390</sup> The e-mail goes on to state that overall Tyco's financial reports suggest "something funny which is likely apparent if any decent accountant looks at this."<sup>391</sup>

Mr. Kozlowski also had a strategy for getting the type of people he needed to succumb to the pressure for numbers achievement. He told BUSINESS WEEK that he chooses managers from the "same model as himself. Smart, poor and wants to be rich."<sup>392</sup> Meeting numbers meant bonuses; exceeding those numbers meant, "the sky was the limit." The CEO of one of

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387. Daniel Golden, Mark Maremont and David Armstrong, *How Tyco Pushed ADT Dealers Into Poor Areas to Boost Growth*, WALL ST. J., Nov. 15, 2002, at A1. The accounting for worthless alarm contracts, the ones that did indeed fall off the books, is the subject of the SEC inquiry into Tyco's accounting. *Id.*

388. *Id.* The customers also apparently had very poor skills in discernment. The scripts for the salespeople are like a bad *Saturday Night Live* skit. Really, is there any other kind of skit on that show, post-Dan Akroyd and Bill Murray? For example, if, when selling in a high-crime area, the potential customers said, "The Lord will protect me," the ADT salesperson was to say, "Yes, I know. That's why He sent me here today." *Id.* at A7. They were also not above using the September 11, 2001, attacks as a fear factor in inducing sales of alarm systems.

389. *Id.*

390. Laurie P. Cohen and Mark Maremont, *E-Mails Show Tyco's Lawyers Had Concerns*, WALL ST. J., Dec. 27, 2002, at C1.

391. *Id.* Ironically, accountants and analysts all over the world continued to look at Tyco's financials for 3 more years before they spotted anything amiss.

392. William C. Symonds and Pamela L. Moore, *The Most Aggressive CEO*, BUSINESS WEEK ONLINE, May 28, 2001, available at <http://www.businessweek.com>.



Tyco's subsidiaries had a salary of \$625,000, but when he boosted sales by 62%, his bonus was \$13,000,000.<sup>393</sup>

### *Cultural Factor 2 – Fear and Silence*

There was a different type of fear and silence at Tyco. While Mr. Kozlowski was known for being autocratic and prone to temper flare-ups,<sup>394</sup> he was able to create a unique sort of fear and silence through two loan programs that got most of the executives inextricably intertwined to him and Tyco. Tyco had a Key Employee Corporate Loan Program (the "KELP"), which was a program established to encourage employees to own Tyco shares by offering them loans to be used to pay taxes due when their ownership of shares granted to them under Tyco's restricted share ownership plan vested. There was no way to pay the taxes except to sell some of the shares for cash, and the loan program permitted the officers to pledge their shares in exchange for cash that was then used to pay the income tax that was due on this employee benefit.<sup>395</sup> Mr. Kozlowski made it clear that the loan program was available to all of his new hires including Mark Swartz, the CFO, and Mark Belnick, Tyco's general counsel and executive vice president.<sup>396</sup>

The second loan program was a relocation program, which was established to help employees who had to move from New Hampshire to New York. The idea was to provide low-interest loans for employees who had to relocate from one set of company offices to another in order to lessen the impact on their budgets of the move to a much costlier housing market.<sup>397</sup> One of the requirements of the relocation program was the employee's certification that he or she was indeed moving from New Hampshire to New York, or, in some cases, to Boca Raton.

Mr. Belnick has explained through his lawyer that he was entitled to the loans from the "relocation program" because he had such in writing from Mr. Kozlowski. Mr. Kozlowski offered this perk to Mr. Belnick despite the fact that Mr. Belnick was a partner in a New York City law firm and he

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393. *Id.* Of course, Mr. Kozlowski's bonus for that same year was \$125 million. *Id.*

394. When he was CEO of Tyco's Grinnell Fire Protection Systems Co., Mr. Kozlowski had an annual awards banquet where he presented awards to the best warehouse manager as well as the worst warehouse manager. The worst manager would have to walk to the front of the room in what other managers described as a "death sentence." Anthony Bianco, William Symonds, Nanette Byrnes, and David Poleck, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>.

395. This information was obtained from the SEC's press release issued when it filed suit against Mark Swartz, Dennis Kozlowski and Mark Belnick for the return of the loan amounts. Available at <http://www.sec.gov/litigation/litreleases.shtml> (last visited April 15, 2003).

396. In an 8-K filed with the SEC on Sept. 17, 2002, Tyco outlined the loans, the spending, and its plans for the future. The 8-K is available at <http://www.sec.gov/edgar.shtml> (last visited April 15, 2003). A synopsis of the information filed in the 8-K is available at [http://www.tyco.com/tyco/press\\_releases.asp](http://www.tyco.com/tyco/press_releases.asp) (last visited April 15, 2003).

397. The rate as disclosed in the 2002 proxy was 6.24%.

would be working in New York City for Tyco. He received the relocation fee for a difference of 25 miles between his home and Tyco's New York offices, and despite the fact that he had never lived in New Hampshire as the relocation loan program required. Since he actually didn't need to move, Mr. Belnick borrowed \$4 million anyway and used it to buy and renovate an apartment in New York City and later borrowed another \$10 million to construct a home in Park City, Utah, because he was moving his family there and would divide his time between the two locations and the extensive international travel his job required.<sup>398</sup> Mr. Belnick got Kozlowski's approval for both loans, but he didn't do the corporate paperwork for relocation. Mr. Kozlowski had Mr. Belnick fettered with the relocation program loans and their propriety.<sup>399</sup>

Mr. Belnick told friends from the time that he began his work with Tyco that he was uncomfortable because he was not in the loop with information from either Mr. Kozlowski or the board. However, Mr. Kozlowski offered him more lucrative contracts and additional loans and Mr. Belnick remained on board.<sup>400</sup> However, there are e-mails from Tyco's outside

398. Nicholas Varchaver, *Fall From Grace*, FORTUNE, Oct. 28, 2002, at 112. Mr. Belnick defiantly insists that he was trying to uncover the loans and documents, not hide them. Mr. Belnick has had a distinguished career, right up until his indictment, actually right up until he let Kozlowski hire him away from his partnership at Paul Weiss. A graduate of Cornell and Columbia Law School, Belnick worked for the U.S. Senate in its Iran-Contra investigation where he encountered Warren Rudman. Following a few-weeks stint as general counsel at Cornell, he returned to law practice at Paul Weiss when Mr. Rudman suggested he talk to Tyco and Kozlowski who were looking for general counsel. Mr. Kozlowski served as the chair of the audit committee of Raytheon, Inc., board. Mr. Rudman is now the lead director at Raytheon and Raytheon was sanctioned by the SEC last year for violation of securities disclosure requirements and is now under SEC investigation for its accounting. Amy Borrus, Mike McNamee, Williams Symonds, Nanette Byrnes, and Andrew Park, *Reform: Business Gets Religion*, BUSINESS WEEK ONLINE, Feb. 3, 2003, available at <http://www.businessweek.com>. He was guaranteed \$2.5 million in salary, 100,000 in Tyco shares, and 500,000 options. In 2000, Belnick earned \$20 million. Nicholas Varchaver, *Fall From Grace*, FORTUNE, Oct. 28, 2002, at 112. The apartment was on Central Park West, and Mr. Belnick already owned a home in Connecticut at the time he obtained the loan for the relocation to New York? In fairness to Mr. Belnick, he does remain one of the few officers who still owes the money to Tyco. He was not part of the loan forgiveness program, according to statements from his lawyer. Jonathan D. Glater, *A Star Lawyer Finds Himself The Target Of a Peer*, N.Y. TIMES, Sep. 24, 2002, at C1. Mr. Rudman said, when told of Mr. Belnick's fall from grace, "I don't understand. Ethical, straight, cross the t's, dot the i's - that's my experience with Mark Belnick." *Id.* at C8.

399. The "relocation program" is confusing inside and outside Tyco. The loans were disclosed to the auditors and board minutes show they were revealed to the board in February 2002. The loans were not disclosed in any SEC filing because the KERP loans were not just available to the officers, such as Belnick and Swartz, but to a total of 51 employees, thus taking them out of the required officer compensation disclosures of the SEC. *Id.* at 120. Just as with Enron, compliance with the rules may be present. Overall, however, there is the question of full and fair disclosure.

400. "He was something of an outsider in the Tyco hierarchy, sort of viewed as an outsider and not taken into the confidence of the other executives or certainly the board." Jonathan D. Glater, *A Star Lawyer Finds Himself The Target Of a Peer*, N.Y. TIMES, Sep. 24, 2002, at C1.

counsel, the Wilmer Cutler firm, that indicate some information was seeping through to Mr. Belnick, and that outside counsel had concerns that were kept silent once transmitted to Mr. Belnick. For example, on March 23, 2000, partner Lewis Liman at Wilmer Cutler sent an e-mail to Mr. Belnick that read, "There are payments to a woman whom the folks in finance describe a Dennis's girlfriend. I do not know Dennis's situation, but this is an embarrassing fact."<sup>401</sup> From this e-mail, we know that not only were outside counsel and general counsel aware of an issue, but that employees within the company were making the payments and said nothing.<sup>402</sup>

Mr. Swartz was fettered with the same reins, but to a larger extent. During the same period, Mr. Swartz availed himself of \$85 million of KELP loans. However, he used only \$13 million for payment of taxes and spent the remaining \$72 million for personal investments, business ventures, real estate holdings and trusts.<sup>403</sup> Mr. Swartz used more than \$32 million of interest-free relocation loans, and, according to SEC documents, used almost \$9 million of those relocation loans for purposes not authorized under the program, including purchasing a yacht and investing in real estate.<sup>404</sup>

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Not being a securities lawyer did not help the situation. The guys were able to pull the wool over Mr. Belnick's eyes, if that is indeed what happened and he was but a babe in the Tyco woods. One has to ask the question, who on earth would hire a general counsel who was a litigator and knows nothing about securities law? Apparently, it was a good thing for the guys. *Id.* And isn't it the job of general counsel to sort of become familiar with securities law? Please refer to all registration statements, proxy materials, 10-Ks and 10-Qs filed during Mr. Belnick's tenure at Tyco and you can find his signature on the introductory letter to all. See <http://www.sec.gov/edgar.shtml> (last visited April 15, 2003). Turn to Tyco and pull up any document during the 1998-2002 period. Mr. Belnick signed off. Just by reading a few of the documents he might have become schooled in securities law.

401. Laurie P. Cohen and Mark Maremont, *E-Mails Show Tyco's Lawyers Had Concerns*, WALL ST. J., Dec. 27, 2002, at C1. The payments were made to Karen Mayo (then-girlfriend, now wife, who can't be happy about the ex-wife posting the bond) from the Key Employee Loan Account in 1997. Ms. Mayo was obviously not a key employee. Heck, she was not an employee. Then again, when you are relocating from New York to New York using a relocation loan, these pieces of information are just a bit of a quibble.

402. Mr. Liman suggested that the documents on the payment to Ms. Mayo be disclosed to the SEC. Mr. Belnick declared that such documents were "non-responsive" to SEC requests and did not send that documentation along when the SEC was conducting its 1999 investigation for which he received a bonus for having settled without any legal or public action. See *supra* note 401 and accompanying text. I could have been a Wall Street lawyer as well. If you can withhold the documents showing all manner of loosey-goosey fund use, I could earn a bonus, too.

403. Available at <http://www.sec.gov/litigation/litreleases.shtml>. The SEC has also filed suit against Mr. Swartz seeking the return of these funds. Mr. Swartz was also indicted by the state of New York and spent some time in jail as his family scrambled to post his bail.

404. Available at <http://www.sec.gov/litigation/litreleases.shtml>. Mr. Swartz also never lived in New Hampshire, but still availed himself of the relocation loans. In the company summary of the 8-K filed September 17, 2002, is the following summary: "Under the program, Mr. Kozlowski improperly borrowed approximately \$61,690,628 in non-qualifying relocation loans to purchase real estate and other properties, Mr. Swartz borrowed approximately \$33,097,925 and Mr. Belnick borrowed approximately \$14,635,597." The company

The issue of board approval on the loans remains a question, but compensation committee minutes from February 21, 2002, show that the committee was given a list of loans to officers and also approved Mr. Belnick's new compensation package. There was no public disclosure of these developments or the committee's review.<sup>405</sup> Further, in grand jury testimony, Patricia Prue indicated that board member Joshua Berman pressured her in June 2002 to change the minutes from that February compensation committee meeting.<sup>406</sup> Mr. Berman denies the allegation. However, Ms. Prue did send a memo on June 7, 2002, to John Fort, Mr. Swartz and the board's governance committee with the following included, "As a result of the fact that I was recently pressured by Josh Berman to engage in conduct which I regarded as dishonest – and which I have refused to do – I will decline to have any personal contact with him in the future. In addition, I ask that Josh not go to my staff with any requests for information or directions."<sup>407</sup>

### *Cultural Factor 3 – The Young 'Uns and Bigger-than-Life CEO*

Dennis Kozlowski made no bones about the fact that he wanted to turn Tyco into another General Electric.<sup>408</sup> His purchase for \$9.2 billion in

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indicated that it would release the names of all employees who had benefited from the loans, but the list was not included in the company releases and on the 8-K, the amounts are there, but the names, except for Kozlowski, Swartz, and Belnick, are redacted. The names are redacted from all other types of perquisites discussed, including the auto allowances. However, in an exhibit listing the properties purchased through the program, the names of the officers do appear, although these would only be the officers with loans at that time. Someone forgot to redact on that part of the document. These exhibits and lists are found in the 8-K for September 17, 2002. Available at <http://www.sec.gov/edgar.shtml>. Andrew Ross Sorkin and Jonathan D. Glater, *Tyco Planning To Disclose Making Loans To Employees*, N.Y. TIMES, Sep. 16, 2002, at C1. It was reported that the seizure of their property as satisfaction for the loans would become a prosecutorial tool in the sense of obtaining information from the lower-ranking employees who had benefited. Tyco has seized Mr. Kozlowski's properties in New York, Nantucket and Boca Raton. *Ex-Chief of Tyco Posts \$10 Million in Bail*, N.Y. TIMES, Sep. 21, 2002, at B14.

405. Andrew Ross Sorkin and Jonathan D. Glater, *Some Tyco Board Members Knew of Pay Packages, Records Show*, N.Y. TIMES, Sept. 23, 2002, at A1. Mr. Belnick does claim that the auditors knew and he has filed an arbitration claim through the American Arbitration Association against Tyco for breach of his \$10.6 million retention agreement and employment contract that applied if he were terminated before Oct. 1, 2002. The only exception to the requirement of payment was a felony conviction that caused his dismissal. Mr. Belnick was fired before he was indicted on felony charges. Laurie P. Cohen, *Tyco Ex-Counsel Claims Auditors Knew of Loans*, WALL ST. J., Oct. 22, 2002, at A6.

406. Ms. Prue testified before the grand jury in exchange for immunity. *Id.* at A22. See *infra* notes 429-431 and accompanying text for more information on Ms. Prue.

407. Cohen, *supra* note 405. at A22. Both sides acknowledged the authenticity of the memo from Ms. Prue.

408. In May 2001, Mr. Kozlowski told *Business Week*, "Hopefully, we can become the next General Electric." Author(s), *Spin Decoder*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>. He also said that he wanted to be remembered as the world's greatest business executive, a "combination of what Jack Welch put together at

2001 of CIT Group, a company that specialized in lending to small and mid-size businesses caused a drop of 8% in Tyco's stock because the acquisition was so far afield from Tyco's core business competencies.<sup>409</sup> However, to build another GE, Mr. Kozlowski knew that Tyco had to jump into the lending business.<sup>410</sup> These types of risky moves paralleled Mr. Kozlowski's personal derring-do.<sup>411</sup> Mr. Kozlowski was a helicopter pilot, a Harley-

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GE and Warren Buffett's very practical ideas on how you go about creating return for shareholders." Anthony Bianco, William Symonds, Nanette Byrnes and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>. Business writers compared Mr. Kozlowski to Mr. Welch. Floyd Norris, *Now Will Come the Sorting Out Of the Chief Executive's Legacy*, N.Y. TIMES, June 4, 2002, at C1. He differed significantly from his predecessor, John Fort, who drove a Pontiac with no air conditioning, and drove himself. When Mr. Fort took over as interim CEO following Mr. Kozlowski's resignation, Mr. Fort immediately grounded all the Tyco aircraft, eliminated the executive dining room and prohibited employees from taking each other out on the company tab. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

409. Alex Berenson, *Tyco Cleared To Sell Unit To the Public*, N.Y. TIMES, June 13, 2002, at C1, C12. CIT was sold to investors in an IPO that was approved by the SEC during the turmoil with Mr. Kozlowski and the indictments.

410. When accounting difficulties and questions emerged, the commercial paper market dried up for both CIT and Tyco, and Tyco had to borrow money to keep CIT afloat. It immediately sought a buyer, taking the price down to \$6.5 billion without any takers before the SEC approved its sale as a stock offering to investors in an IPO for CIT. The sale was conducted on the QT, ASAP, EBITDA aside. See *supra* notes 180-81 and accompanying text for some acronymical explanations.

411. Also like the other CEOs, Mr. Kozlowski came from humble beginnings, Newark (really, does it get much humbler?), He claimed he was the son of a police detective, but actually his father was a private investigator who, on occasion, worked for the FBI and the local prosecutor. His mother, Agnes, worked for the Newark Police Department as a school crossing guard. Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002. "Koz," as he became known, was raised in a working class neighborhood. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1, A6. In fact, the neighborhood was destroyed by race riots in 1967. Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>. Oddly, or perhaps by way of explanation of Tyco's books, Mr. Kozlowski is an accountant by training. Alex Berenson, *Investigation Is Said to Focus on Tyco Chief Over Sales Tax*, N.Y. TIMES, June 3, 2002, at B1. Even more odd is the fact that he was the director of audit for SCM Corporation before being hired away by Tyco. Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>.

Davidson rider, and a self-described risk-taker.<sup>412</sup> The trappings of wealth were important to Mr. Kozlowski.<sup>413</sup>

Mr. Kozlowski made it clear to those close to him that he wanted to be the next Jack Welch.<sup>414</sup> And he clearly had Mr. Welch's lifestyle.<sup>415</sup> His Fifth Avenue apartment cost \$16.8 million to buy, \$3 million in renovations, and he spent \$11 million on furnishings.<sup>416</sup> His life was lavish in the hope of attracting attention for his business acumen. He was remarried in 2001,<sup>417</sup>

412. Alex Berenson, *Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System*, N.Y. TIMES, June 10, 2002, at B1, B6. However, he lived at home during college to save money and paid his way through school by playing guitar in a band that played mostly Jersey weddings. Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>.

413. Indeed, Mr. Kozlowski was one of the country's highest paid CEOs. In 2001, his compensation package of \$411.8 million put him at #2, even as Mr. Welch was only #5. (Number 1 was Sanford Weill at Citigroup). Gary Strauss, *CEO Paychecks: Fair or Foul?* USA TODAY, April 6, 2001, at 1B, 3B. Mr. Kozlowski slipped to #8 in 2002. Gary Strauss, *Pay Remains Robust Even As Shares Languish*, USA TODAY, Mar. 25, 2002, at 1B. Lawrence Ellison of Oracle was #1 and John Chambers of Cisco was #2. *Id.*

414. For business novices, Jack Welch was the CEO at GE during its period of smooth earnings and phenomenal growth. Upon his retirement, Mr. Welch proceeded to have an affair with the editor of HARVARD BUSINESS REVIEW, Suzie Wetlaufer, who was fired for a conflict of interest because at the time the affair began she was doing an interview with Mr. Welch for the Ivy League B School's magazine. Jane Welch, wife of Jack Welch for 13 years, ratted Ms. Wetlaufer out, reporting the conflict to her superiors at Harvard. James Bandler, *Harvard Editor Faces Revolt Over Welch Story*, WALL ST. J., March 4, 2002, at B1, B4. Then Jane filed for divorce from Jack, asking for one-half of his billions because the prenuptial agreement she and Mr. Welch had signed expired after 10 years of marriage. The divorce proceedings have not been pretty and Jack ended up being more like Mr. Kozlowski and vice versa than either could imagine because both had phenomenal perks from their companies that the shareholders knew nothing about until indictments came (in Kozlowski's case) and divorce lawyers for Jane Welch began filing documents on spending habits (in Welch's case). One hopes that the message is coming through loud and clear: CEOs with a taste for wine, women and art (no songs are evident) are not the best material for running corporations dependent on trust. Gary Stoller, *Welches Disclose Finances In Divorce Court*, USA TODAY, Oct. 31, 2002, at 1B. Rachel Emma Silverman, *Here's the Retirement Jack Welch Built: \$1.4 Million a Month*, WALL ST. J., Oct. 31, 2002, at A1.

415. Interestingly, Mr. Kozlowski bristled at the suggestion that CEOs were high-rollers. In May 2001, he told BUSINESS WEEK, "We've been made out to be freewheeling jet-setters, playboys reliving our adolescent years . . . . For me, and for most CEOs, that irresponsible image really rankles." *Spin Decoder*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>. Mr. Kozlowski was partially correct. He didn't relive his adolescent years; it was the college years. See *supra* notes 369-75 and accompanying text.

416. The information comes from a report done by David Boies, *supra* note 378, for the company. Mr. Kozlowski was less generous with his ex-wife. She lived as a pauper in a \$7 million New York City co-op. Andrew Ross Sorkin, *Tyco Details Lavish Lives of Executives*, N.Y. TIMES, Sept. 19, 2002, at C1.

417. His first marriage was falling apart at about the time he took over as Tyco's CEO (1992) and his second wife was "a tall, athletic blonde who was then a waitress at Ron's Beach House, a waterfront restaurant on the New Hampshire coast." Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1. Ms. Mayo, described as a "statuesque Kim Basinger," was married at the time to Richard Locke, a

and for his new wife, Karen Mayo's 40<sup>th</sup> birthday, flew Jimmy Buffet and dozens of her friends to a villa outside Sardinia for a multiple-day birthday celebration.<sup>418</sup> He had several \$20,000 Harley-Davidson motorcycles and appeared to be financing the lifestyle through the KERP and relocation loan programs. According to SEC documents, Mr. Kozlowski borrowed more than \$270 million from the KERP program "but us[ed] only about \$29 million to cover taxes due as a result of the vesting of his restricted shares of the company. He used the remaining \$242 million of supposed KERP loans for personal expenses, including yachts, fine art, estate jewelry, luxury apartments and vacation estates, personal business ventures and investments, all unrelated to Tyco."<sup>419</sup>

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lobsterman, and the affair with Kozlowski went on until 2000 when she divorced her husband and he divorced his wife, described as "Laura Petrie come to life." Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>.

418. Don Halasy, *Why Tyco Boss Fell*, N.Y. POST, June 9, 2002, at 27. Mr. Kozlowski divorced his first wife in July 2000 and remarried shortly after. Laurie P. Cohen, *Ex-Tyco CEO's Ex To Post \$10 Million For His Bail Bond*, WALL ST. J., Sept. 20, 2002, at A5. The tab for the party was allegedly \$2.1 million. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1. A memo on the party is attached as an exhibit to Tyco's 8-K filed for September 17, 2002, in which the process for the receiving of guests and the party schedule are described in detail, right down to what type of music will be playing and at what level. You can even learn that the waiters were dressed in Roman togas and that there was an ice sculpture of David through which the vodka flowed. The author leaves it to the anatomical imagination as to the location of the spigot. And this man was an art aficionado? Degradation of Michelangelo's David? This man was a frat boy. The memo includes a guest list and space for the crew of the yacht that the Kozlowskis sailed to Sardinia. Available at <http://www.sec.gov/edgar.shtml> (8-K, Sept. 17, 2002).

419. Available at <http://www.sec.gov/litigation/litreleases.shtml>. The items were delineated in the press and the following were charged to Tyco for Mr. Kozlowski's apartment: \$6,000 shower curtain; \$15,000 dog umbrella stand; \$6,300 sewing basket, \$17,100 traveling toilette box, \$2,200 gilt metal wastebasket (the country bumpkin author does not know what "gilt metal" is, heck, she is not sure what a gilt is, although she suspects it is the only gilt anywhere near Mr. Kozlowski and his spending), \$2,900 coat hangers, \$5,960 for two sets of sheets, \$1,650 for a notebook, and \$445 for a pin cushion. Kevin McCoy, *Directors' Firms on Payroll at Tyco*, USA TODAY, Sept. 18, 2002, at 1B. These items are also listed in the 8-K for Sept. 17, 2002. Ironically, Mr. Kozlowski told a BUSINESS WEEK reporter in 2001, on a tour of the humble Exeter, NH offices of Tyco, "We don't believe in perks, not even executive parking spots." Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK, ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>. Parking spots, no. \$15,000 umbrella stands? Not a problem. The worst part is that when Tyco began trying to unload some of this stuff it discovered, no surprise to the rest of us, that Mr. Kozlowski had overpaid for most of the goods in his haste to have an impeccably decorated NYC highfalutin apartment. In other words, this CEO was an idiot when it came to bargains on his own stuff. Companies he could bargain down the price; dog umbrella stands, he didn't even look at the price tag or shop E-Bay. Theresa Howard, *Tyco Puts Kozlowski's \$16.8M NYC Digs on Market*, USA TODAY, Sept. 19, 2002, at 3B. Another great irony is that Tyco has a subsidiary that makes plastic hangers. What the company stuff wasn't good enough for Fifth Avenue? Mark Maremont and Laurie P. Cohen, *Tyco's Internal Inquiry Concludes Questionable Accounting Was Used*, WALL ST. J., Dec. 31, 2002, at A1. Tyco also paid Mr. Kozlowski's American Express bill, which was \$80,000 for

Without board approval, Mr. Kozlowski paid \$56 million in bonuses to executives eligible for the KERP program, then gave them \$39 million to pay the taxes on the bonuses, and then forgave the KERP loans given to pay taxes on the shares awarded in addition to the bonuses. A report commissioned by the Tyco board following the Kozlowski departure refers to the Tyco culture as one of greed and deception designed to ensure personal enrichment.<sup>420</sup>

The relocation loan program was a source of \$46 million for Mr. Kozlowski and SEC documents allege that he "used at least \$28 million of those relocation loans to purchase, among other things, luxury properties in New Hampshire, Nantucket and Connecticut as well as a \$7 million Park Avenue apartment for his then (now former) wife."<sup>421</sup>

Mr. Kozlowski's officer team was small and obedient.<sup>422</sup> Tyco had only 400 employees at its central offices and Kozlowski only interacted with a few, a means of keeping information close to the vest.<sup>423</sup> Mark Swartz, Tyco's former CFO, was 40 years old at the time of Tyco's fall and his indictment on 38 counts of grand larceny, conspiracy and falsifying business

one month. A later report uncovered a \$110,000 bill Tyco paid for a 13-day stay by Mr. Kozlowski at a London hotel. Alex Berenson, *Changing the Definition Of Cash Flow Helped Tyco*, N.Y. TIMES, Dec. 31, 2002, at C1. Are you like me? Are you wondering whether this guy was ever at work? Between Sardinia, Nantucket, Boca Raton, the yacht and London, he couldn't have logged more than a few days a month at the office. Andrew Ross Sorkin, *Tyco Details Lavish Lives of Executives*, N.Y. TIMES, Sept. 18, 2002, at C1. The lawsuit filed by Tyco against Mr. Kozlowski also seeks recovery of the company's payment of \$52,334 for wine and \$96,943 for flowers. These numbers appear in the civil complaint filed by the company against Mr. Kozlowski and the complaint is incorporated as an exhibit to the company's 8-K filed on September 17, 2002. Available at <http://www.sec.gov/edgar.shtml>.

420. Andrew Ross Sorkin, *Tyco Details Lavish Lives of Executives*, N.Y. TIMES, Sept. 18, 2002, at C1. These bonuses are from the year 2000. Kevin McCoy, *Tyco Spent Millions On Exec. Perks, Records Say*, USA Today, Sep. 17, 2002, at 1B.

421. *Id.* Ironically, Mr. Kozlowski's former wife pledged her property in order to secure his bail and release from jail when he was indicted. How the mighty art fallen back into the arms of scorned women. Angeles Kozlowski posted \$10 million in cash for her ex-husband's \$100 million bond. Laurie P. Cohen, *Ex-Tyco CEO's Ex To Post \$10 Million For His Bail Bond*, WALL ST. J., Sept. 20, 2002, at A5. So confusing were all the financial records on the various belongings and real estate holdings that the prosecutor in the New York case objected to their use to post bond, calling them "proceeds of the crime." Andrew Ross Sorkin, *Tyco Details the Lavish Lives of Many of Its Executives*, N.Y. TIMES, Sep. 18, 2002, at C1. The judge allowed the assets to be used for posting bond indicating that he was unable to sort through it all either. *Id.*

422. Brad McGee, an executive vice president indicated that only 3 officers had contact with investors. "[They] saw Dennis, they saw Mark, and they saw me." Alex Berenson, *Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System*, N.Y. TIMES, June 10, 2002, at B1.

423. Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>.



records.<sup>424</sup> However, this young 'un's career tops those of Enron's Fastow and WorldCom's Sullivan. Tyco hired him in 1991, away from Deloitte & Touche's due diligence team. By 1993, he was head of Tyco's acquisitions team and by 1995, he was Tyco's CFO, at age 33. He was possessed of the Fastow confidence, granting an interview to CFO.com in October 2000 in response to investigations about Tyco's accounting in light of the ongoing burst bubble of the dot-com era. "We were very, very confident of our accounting. Despite all that people were saying and what was happening to the stock price, we knew what the truth was." said a 38-year-old Mr. Swartz.<sup>425</sup> Mr. Kozlowski nominated Mr. Swartz for a CFO award that year and CFO MAGAZINE honored Mr. Swartz that year with its 2000 Excellence Award.<sup>426</sup> Indeed, Mr. Kozlowski and Mr. Swartz were inextricably intertwined, with Mr. Swartz even serving as trustee for one of Mr. Kozlowski's trusts for holding title to real property.<sup>427</sup> Both men also used a loophole in securities law to sell millions of shares of Tyco stock even as they declared publicly that they were not selling their shares in the company.<sup>428</sup>

Patricia Prue, the vice president for HR at Tyco and the one responsible for processing the paperwork for the forgiveness of the officers' loans and who had benefited from the loan forgiveness program herself,<sup>429</sup> ap-

424. Nicholas Varchaver, *Fall From Grace*, FORTUNE, Oct. 28, 2002, at 112. The assets of Mr. Kozlowski, Swartz and Belnick were frozen as part of the indictment process. Andrew Ross Sorkin, *2 Top Tyco Executives Charged With \$600 Million Fraud Scheme*, N.Y. TIMES, Sep. 13, 2002, at A1, C3.

425. Stephen Barr, *Not Even Investor Scrutiny Or An SEC Investigation Could Slow Tyco's Frenetic Deal Making*, CFO.COM, Oct. 1, 2002, available at <http://www.cfo.com>.

426. *Id.*

427. Alex Berenson, *From Dream Team at Tyco To A Refrain of Dennis Who?*, N.Y. TIMES, June 6, 2002, at C1. The characters are, of course, eerily similar to the situation at WorldCom with Ebbers and Sullivan, see *supra* notes 238-43 and accompanying text. See also *supra* notes 56-57 for discussion of Fastow and Lay. Again, note the generational difference here. Mr. Kozlowski was a generation apart from Mr. Swartz.

428. Alex Berenson, *From Dream Team at Tyco To A Refrain of Dennis Who?* N.Y. TIMES, June 6, 2002, at C1.

429. Ms. Prue had received a loan of \$748,309, had the loan forgiven, and then was given \$521,087 to pay the taxes on the loan forgiveness. Andrew Ross Sorkin, *Tyco Details Lavish Lives of Executives*, N.Y. TIMES, Sep. 18, 2002, at C1. This amount paled in comparison to her bonuses of \$13,534,523 and \$9,424,815 to pay the taxes on the bonuses. The author is wondering how long it will take the IRS to figure out that these officers still owe taxes on the money given to them to pay the taxes. Oh, sure, they don't owe as much because the taxes are less than the bonus, but it's a bit of a vicious circle – so long as Tyco keeps giving them money for taxes, they owe on the money they get for taxes, which is also taxed. BUSINESS WEEK offers the following explanation, indicating that the practice is not just limited to Tyco:

How does it work? First, there's the perk itself. Let's say a company makes \$100,000 in payments into a supplemental retirement plan on the executive's behalf (perk No. 1). This has tax consequences, but often companies will pay their top executives extra to cover the expense. These are called "gross-up" payments. So a CEO will get an extra \$67,000 -- \$40,000 to pay the 40% tax rate on the retirement plan contribution (perk No. 2) and \$27,000 to pay the taxes on the \$67,000 (perk No. 3).

proached Mr. Kozlowski in September 2000 and asked for documentation that the board had indeed approved all the loan forgiveness for which she was doing the paperwork. Mr. Kozlowski, without ever producing a board minute wrote a memo to Ms. Prue, "A decision has been made to forgive the relocation loans for those individuals whose efforts were instrumental to successfully completing the TyCom I.P.O."<sup>430</sup>

#### *Cultural Factor 4 – Weak Board*

Tyco's board was a study in weakness. The clear consensus of outside evaluators is that the board members were far too "unquestioning" of Mr. Kozlowski.<sup>431</sup> One business writer described the board as "an assemblage of Kozlowski associates and insiders, led by ex-CEO John Fort."<sup>432</sup> Tyco had an atmosphere in which subordinates could not question top executives, and there was no contact between the board and the second-tier managers.<sup>433</sup> One investigator described his experience in looking into just the property and Kozlowski home ownership issues as follows, "The reality is the board wasn't really functioning the way they should. They approved a lot of stuff. Now, having gone through this trauma, the company says it's conducting an internal investigation and one wonders how thorough it will be."<sup>434</sup> Within two months of Mr. Kozlowski's indictment for the art sales tax issues, investor groups were proposing a proxy battle to oust the board

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*Helping Fatcats Dodge the Taxman*, BUSINESS WEEK ONLINE, June 20, 2002, available at <http://www.businessweek.com>.

430. *Id.* David Boies would find a memo from Kozlowski in the loan relocation file that indicated that Phil Hampton, the former chair of the Tyco board's compensation committee, had approved the loan forgiveness programs. Mr. Hampton died in 2001 and is unavailable for comment presently. The author suspects, however, that he may be spinning in his grave. Mr. Hampton had served on the board since 1997. He had been a Tyco employee since 1985. Tyco Section 14 Proxy Materials, filed Jan. 29, 2001, available at <http://www.sec.gov/edgar.shtml>. Mr. Hampton's widow has indicated that Mr. Kozlowski's statement that Mr. Hampton approved of the compensation packages was "not true at all." Mrs. Hampton apparently arranged all meetings and phone calls for her husband between 1997 and his death from cancer because of his poor health. Tyco aircraft logs reflect no visit by Mr. Kozlowski to Mr. Hampton's home during this period. Mr. Kozlowski has indicated he met with Mr. Hampton "a few times a week for breakfast" and that Mr. Hampton kept the board informed. Mrs. Hampton strongly disputes that such meetings ever took place, given her husband's health. Kevin McCoy, *Kozlowski's Statement In Question*, USA TODAY, Jan. 9, 2002, at 1B.

431. One expert referred to the board as "asleep at the switch" because "The stock price was up. The profits were up. No one wanted to rock the boat." Joann S. Lublin and Jerry Guidera, *Tyco Board Criticized on Kozlowski*, WALL ST. J., June 7, 2002, at A5.

432. William C. Symonds, *Tyco's CEO: Time to Walk the Plank*, BUSINESS WEEK ONLINE, May 13, 2002, available at <http://www.businessweek.com>.

433. Louis Lavelle, *Rebuilding Trust in Tyco*, BUSINESS WEEK ONLINE, Nov. 25, 2002, available at <http://www.businessweek.com>.

434. Alex Berenson and William K. Rashbaum, *Tyco Ex-Chief Is Said to Face Wider Inquiry Into Finances*, N.Y. TIMES, June 7, 2002, at C1.

that was in place during his tenure, noting that a board that had allowed such things to occur on its watch could not be held to accountability.<sup>435</sup>

The board also had issues of possible self-dealing, disclosure and conflicts. Warren Musser, a director of TyCom, had borrowed \$14.1 million from Mr. Kozlowski because he and his wife were having significant financial difficulties and the loan was not disclosed in the documents for either Tyco or TyCom.<sup>436</sup> Michael A. Ashcroft, an international tycoon from Britain, joined the Tyco board in 1997 following the merger of his company, ADT Ltd. (an alarm and security firm).<sup>437</sup> Mr. Ashcroft, at the time he joined the board, owned a home in Boca Raton, Florida. That home was sold in October 1997 to his wife for \$100. Mrs. Ashcroft then sold the same home that same day for \$2.5 million to Byron S. Kalogerou, who was a Tyco vice president at that time.<sup>438</sup> When the matter was first investigated by New York's DA office, it was dropped because the company explained that the house was in poor shape, purchased by Tyco, put in Mr. Kalogerou's name, fixed up at Tyco's expense, and used as an executive residence.<sup>439</sup> The investigation was reopened, following the disclosure of Kozlowski's and Tyco's difficulties, for possible securities fraud implications in that the transfers were done so as to avoid having to disclose the transactions between the board and officers.<sup>440</sup>

There was a significant loan program and that infamous "relocation" program, going on between the Tyco board and Kozlowski, Mark Belnick and CFO, Mark Swartz.<sup>441</sup> The loans were granted and few questions asked,

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435. Joann S. Lublin, *Tyco Shareholders Plan Proxy Fight To Oust Directors*, WALL ST. J., Aug. 21, 2002, at A3. Mr. Ralph Whitworth, a principal in Relational Investors, LLC, a firm holding 7,000,000 Tyco shares, began the movement for the ouster.

436. Alex Berenson, *Board Member Of Tyco Unit Owed Millions To Two Executives*, N.Y. TIMES, Mar. 29, 2002, at C1.

437. Laurie P. Cohen and Mark Maremont, *Tyco Relocations to Florida Are Probed*, WALL ST. J., June 10, 2002, at A3.

438. *Id.* Lord Ashcroft had purchased the home in 1990 for \$2.3 million. William K. Rashbaum and Alex Berenson, *Sale of Home Of Tyco Figure Gets 2<sup>nd</sup> Look, Prosecutors Say*, N.Y. TIMES, June 8, 2002, at B1. Records reflects that ADT paid the water utilities bills during Lord Ashcroft's ownership and that Mr. Kozlowski had paid other utility bills on the house. *Id.* at B3.

439. Mr. Kalogerou was in Luxembourg on business on the day of the purchase, which leads us to the question of how Tyco was able to have its officers participate in such transactions when they were out of the country and unaware that they were taking title to houses purchased by the company. Those who live in the area indicate that Mr. Kalogerou never lived in the home and that it was paid for by Tyco. Jerry Guidera and Marc Champion, *Tyco Probe Ensnare A Peer*, WALL ST. J., June 13, 2002, at B11.

440. *Id.* The transactions would fall under "related party transactions" and would be required to be disclosed under SEC rules. The rules on related party transactions and disclosures are found at 17 C.F.R. § 210.4-08 (2003).

441. Information taken from Tyco's proxy statements for 2001 and 2002 is available at <http://www.sec.gov/edgar.shtml>. All three of these officers have been indicted by the state of New York for various crimes ranging from fraud to falsification of documents. In addition,

including to the point of loan forgiveness, because the board could have been called Dennis's board.<sup>442</sup> The following data summarize the nature of the board in 2001:

- Of the 12 board members, 8 were current or former Tyco employees
- The board's lead director, Frank Walsh, was a former Tyco employee<sup>443</sup>
- Four of the board members had served at least 10 years on the board, with two serving almost 20 years
- With the exception of Wendy Lane, added in 2000, new board members came only through acquisition of their companies by Tyco<sup>444</sup>

In its lawsuit against Mr. Kozlowski in which it seeks to be paid back for the spending, loans and bonuses, the new board alleged that Mr. Kozlowski appropriated funds and that he concealed the nature of his compensation and that of the senior officers from the board and the board's compensation committee.<sup>445</sup> With Tyco's ethical collapse, one money manager noted that the Tyco board "poorly served the 240,000 employees and shareholders. Being a director of a corporation isn't an honorary position

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Tyco has filed suit and arbitration claims against the officer for the repayment of loans as well as for the return of bonuses earned during the periods of alleged malfeasance, referred to as breach of fiduciary duty in the complaints filed by Tyco. The amounts reflected in the 2001 proxy are \$12.7 million to Mr. Kozlowski, \$1 million to Mr. Swartz, and \$3 million to another officer, a Mr. Garvey. Mr. Belnick is alleged to have received a \$10 million relocation interest-free loan for the purchase of a home in Park City, Utah. Tyco's suit against Mr. Belnick asks for \$35 million in repayment. Thor Valdmanis, *Tyco Sues Former Counsel, Director*, USA TODAY, June 18, 2002, at 1B. Mr. Belnick has protested mightily to the allegations and suit.

442. As of the proxy filed in January 2003, all of the board members who held their offices during the Kozlowski years have left. The new Tyco board is striking in its depth and its proxy is also an eye-catcher for its candor about past events as well as its goals and mission for the company as it goes forward. In short, there's some good folk running this company now.

443. You may also recall that Mr. Walsh was indicted for taking the \$20 million finder's fee for arranging a Tyco acquisition of CIT for \$9.2 billion without telling the board so and without obtaining board approval. He entered a guilty plea and restitution to the company of the fee is part of his sentence. See *supra* note 349.

444. All of this information was mined from the company's Section 14 filing for 2001, available at <http://www.sec.gov/edgar.shtml>.

445. The suit was filed on the same day that Mr. Belnick and Mr. Swartz were indicted and arraigned. Andrew Ross Sorkin, *Two Top Tyco Executives Charges With \$600 Million Fraud Scheme*, N.Y. TIMES, Sep. 13, 2002, at A1.

designed to dress up one's obituary. It is essential that we add new independent voices to the board."<sup>446</sup>

The director of securities regulation in New Hampshire, who conducted its own investigation into Tyco's failure to disclose material financial information, placed public pressure on Tyco to settle charges brought by his division and noted, "How do you have a situation where hundreds of millions of dollars were taken and the board and the auditors seemingly didn't know?"<sup>447</sup> Tyco settled the charges through a consent decree that did not admit guilt for \$5 million.<sup>448</sup>

### *Cultural Factor 5 – Culture of Conflicts*

The loans to the officers without disclosure to the board constituted a conflict. Even with disclosure to the board, there are inherent conflicts in loans to officers.<sup>449</sup> However, the nuanced conflicts of the loans were just the beginning of the incestuous relationships that governed the Tyco board. Director Frank Walsh owned two firms that leased aircraft to Tyco for a total of \$3.5 million per year.<sup>450</sup> Director Stephen Foss owned a company that was paid \$751,000 by Tyco for a pilot and Cessna aircraft.<sup>451</sup> Director Joshua Berman was paid \$360,000 per year between 2000 and 2002 for "legal, regulatory and other professional services."<sup>452</sup> Director Richard Bodman was "Of Counsel" for the law firm that performed most of Tyco's legal work.<sup>453</sup>

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446. Gregory Zuckerman, *Heralded Investors Suffer Huge Losses With Tyco Meltdown*, WALL ST. J., June 10, 2002, at C1.

447. Kevin McCoy, *Regulators Press Tyco To Settle*, USA TODAY, Oct. 17, 2002, at 2B. Mr. Mark Connolly, the New Hampshire director of securities regulation, had also asked that the Tyco board resign. He referred to what had transpired as "gross misconduct." Mark Maremont and Laurie P. Cohen, *Tyco Nears Pact With Regulators In New Hampshire*, WALL ST. J., Oct. 21, 2002, at A3. Mr. Connolly also noted, "[I]t is apparent there existed a sufficient lack of controls that, in effect, allowed such egregious activity to occur." *Id.*

448. Pretty much the cost of a couple of Kozlowski parties. Kevin McCoy, *Tyco Settles Suit For \$5M Without Admitting Guilt*, USA TODAY, Oct. 24, 2002, at 1B.

449. See *supra* notes 290-95 and accompanying text for a discussion of the conflicts and issues in loans in the context of the WorldCom loans to Mr. Ebbers.

450. Kevin McCoy, *Directors, Firms On Payroll At Tyco*, USA TODAY, Sept. 18, 2002, at 1B.

451. There were competitive bids on this service prior to awarding the contract to Foss's company, but the contract was not disclosed in any of the company's SEC filings and was not made public until the SEC noted that such constituted "related party transactions" and should have been disclosed. Under SEC rules, any transactions between board members and the company of \$60,000 or more must be disclosed in the annual 10-K.

452. Mark Maremont and Laurie P. Cohen, *Interior Design On a Budget – The Tyco Way*, N.Y. TIMES, Sep. 18, 2002, at B1.

453. This information was taken from the proxy statement filed for 2001, available at <http://www.sec.gov/edgar.shtml>.

Apparently, the conflicts issues with analysts extended beyond WorldCom as well. One of the allegations in the indictment against Mr. Kozlowski is that he used gifts to try and persuade a brokerage house to hire a new analyst who would be more favorable to Tyco.<sup>454</sup>

Mr. Kozlowski saw to it that friends were awarded contracts that Tyco paid. For example, Wendy Valliere was a personal friend of the Kozlowskis and was hired to decorate the New York City apartment. Her firm's bill was \$7.5 million.<sup>455</sup> However, Ms. Valliere was not alone in personal employees.<sup>456</sup> Mr. Kozlowski also hired Michael Castania, a consultant who had helped Mr. Kozlowski with his yacht, in 1996 as an executive who was housed at Boca Raton. He is an Australian yachting expert who went on to lead Team Tyco, a corporate yachting racing team, to fourth place in the Volvo Challenge Race in June 2002.<sup>457</sup> Tyco also hired Ms. Mayo's personal trainer from the days when she was still married to her ex-husband and Mr. Kozlowski was still married to his ex-wife, but Mr. Kozlowski was supporting Ms. Mayo in a beach condo in Nantucket.<sup>458</sup>

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454. Andrew Ross Sorkin, *2 Top Tyco Executives Charges With \$600 Million Fraud Scheme*, N.Y. TIMES, Sep. 13, 2002, at A1. The firm is not named in the indictment, but sources identify it as Merrill Lynch. Merrill Lynch has denied the allegation and indicated that acceptance of "thousands of dollars in gifts" would be against firm policy. *Id.*

455. Ms. Valliere says the \$7.5 million figure is "too high." However, she had no other figure and indicated that what the Kozlowskis spent was "so midrange compared to what a lot of people do." Like, whatever. Mark Maremont and Laurie O. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

456. Not alone, but in a class by herself. When asked about the \$6,300 sewing basket and \$445 pincushion and \$5,960 sheets, Ms. Valliere said these items, and others listed *supra* note 180 and accompanying text, are "perfectly normal accoutrements" for the Upper East Side and that, "I was hired to do a job, and I did a beautiful job." Mark Maremont and Laurie P. Cohen, *Interior Design On a Budget – the Tyco Way*, WALL ST. J., Sep. 18, 2002, at B1. Ms. Valliere indicated that Mr. Kozlowski called her when the stories about the accoutrements broke because it made it seem as if he was traveling with the \$17,100 toilette box that was itemized. Of all the things to worry about, image-wise, Mr. Kozlowski chose poorly. Focusing on the embezzlement might have been a wiser PR choice. *See infra* note 457 for the name of Mr. Kozlowski's image consultant and Boca Raton PR guy. Ms. Valliere was also disturbed about the undue publicity for the \$1,650 notebook in the apartment. She assured that the notebook held photos as well as documents for verifying the authenticity of the antiques she purchased for the apartment. Think OfficeMax binders. One gets the idea that Ms. Valliere is a piece of work. She also added that the \$2,900 figure for wooden coat hangers purchased "dozens of hangers." We must give credit to the bargain hunter in her. *Id.*

457. When asked about Team Tyco and the yachting executive, a spokesperson said that Team Tyco served to build teamwork among the employees of the global Tyco. It is unclear how all 270,000 fit on the yacht for participation. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

458. Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK ONLINE, Dec. 23, 2002, available at <http://www.businessweek.com>. Are you like me and thinking, "How on earth do these people get any work done with all the peripheral obligations?"

*Cultural Factor 6 – A Culture of Innovation Like No Other*

Mr. Kozlowski prided himself on being a market leader in traditional business, not the newfangled dot-com businesses. In fact, he denounced stock options saying, “Options are a free ride . . . a way to earn megabucks in a bull market.”<sup>459</sup> He took great pride in his innovation of moving the company headquarters to Bermuda for the off-shore tax breaks as part of Tyco’s acquisition of ADT in 1997. The deal was structured as an ADT takeover of Tyco so that the company could remain based in Bermuda.<sup>460</sup>

Like Enron, this was a company that was head and shoulders above the rest of business with breakfasts delivered to employees on china, a massage available every Friday, and opulent offices in Boca Raton.<sup>461</sup> Tyco and its executives have been referred to as “darlings of American investors.”<sup>462</sup> Mr. Kozlowski was featured on the cover of BUSINESS WEEK and called “the most aggressive dealmaker in Corporate America.”<sup>463</sup> He was included in the magazine’s top 25 managers of the year. Indeed, when Tyco’s problems and accounting issues emerged, many of Wall Street’s “superstar” money managers were stunned.<sup>464</sup>

Even as Kozlowski was being indicted and Tyco was sinking, there was an attitude on Wall Street about the whiz kid nature of Mr. Swartz and concerns that he not leave the company because of the need for investor confidence.<sup>465</sup>

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459. Mark Maremont and Laurie P. Cohen, *How Tyco’s CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1. Mr. Kozlowski uttered those words to a WALL STREET JOURNAL reporter in 1997. Those words did not stop him from accepting options in 1998 – 2001. In fact, Mr. Kozlowski traded in his restricted shares for options during this time frame.

460. *Id.* at A6. Tyco had hired 5 lobbying firms when the issue of offshore tax breaks struck a Congressional nerve in early 2002. One member of one of the lobbyists groups was former Senator Bob Dole. The total amount spent for the lobbyists was \$270,000 in 2002. Interestingly, Tyco worked with Arthur Andersen’s Accenture in lobbying to retain the off-shore tax benefits. Kevin McCoy, *Tyco Paid Big Bucks To Lobby For Offshore Tax Havens*, USA TODAY, Nov. 5, 2002, at 3B.

461. *Id.*

462. Jonathan D. Glater, *A Star Lawyer Finds Himself the Target of a Peer*, N.Y. TIMES, Sep. 24, 2002, at C1.

463. BUSINESS WEEK ONLINE, Jan. 14, 2002, available at <http://www.businessweek.com>.

464. Gregory Zuckerman, *Heralded Investors Suffer Huge Losses With Tyco Meltdown*, WALL ST. J., June 10, 2002, at C1.

465. “Investors definitely like him and regard him highly. It’s very important that he stays.” Alex Berenson, *From Dream Team at Tyco To a Refrain of Dennis Who?*, N.Y. TIMES, June 6, 2002, at C1.

*Cultural Factor 7 – A Culture of Social Responsibility*

Mr. Kozlowski was on the board of the Whitney Museum of Art and had Tyco donate \$4.5 million to the traveling museum shows that Whitney sponsored.<sup>466</sup> He was an avid fund-raiser for various philanthropic endeavors. In fact, he was at a fundraiser for the New York Botanical Garden when the news of his possible indictment first spread.<sup>467</sup> Tyco donated \$1.7 million for the construction of the Kozlowski Athletic Complex at the private school, Berwick Academy, that one of his daughters attended and where he served as trustee<sup>468</sup> and \$5 million to Seton Hall, Mr. Kozlowski's alma mater.<sup>469</sup> Over the 10-year period, from 1992-2002, when Mr. Kozlowski served as CEO of Tyco, the company gave \$35 million to charities designated by Mr. Kozlowski.<sup>470</sup>

Mr. Kozlowski also donated personally, particularly to charities in the Boca Raton area where he had retained a public relations executives and where Mr. Kozlowski had been given a fair amount of coverage in the *Palm Beach Post* for his contributions to local charities.<sup>471</sup> There is even some confusion about who was donating how much and from which tills. Kozlowski had pledged \$106 million in Tyco funds to charity, but \$43 million of that was given in his own name.<sup>472</sup> He had donated \$1.3 million to the Nantucket Conservation Foundation in his name with the express desire that

466. Don Halasy, *Why Tyco Boss Fell*, N.Y. POST, June 9, 2002, at 27.

467. *Id.* Mr. Kozlowski hired Christine A. Berry, formerly the assistant registrar at the Whitney Museum, as his personal adviser for the purchase of art. She is now the art director of Fine Collections Management, a company with offices in Palm Beach and New York City whose purpose is to advise clients on the purchases of art, wine, sculpture and other collectibles. Carol Vogel, *Kozlowski's Quest for Entrée Into the Art World*, N.Y. TIMES, June 6, 2002, at C1.

468. When the construction went over budget by \$200,000, Mr. Kozlowski paid the amount personally, we believe. The students refer to the building as the "Koz Plex." *Id.* Perhaps the complex should be renamed the "Greed Gym," or the "Tyco Tower."

469. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1. Actually he had donated about \$10 million since 1992 to Seton Hall, but folks there are unclear whether the donations were from Tyco or Mr. Kozlowski. A classroom office building was named for him when he donated \$5 million during its construction. The confusion in the charitable giving could also be due to a program at Tyco that matched charitable giving of its employees. *Id.* Seton Hall has had a tough go of it. Mr. Kozlowski spoke to the business students at Seton Hall in 2001 on the importance of integrity and professionalism in business. It named its recreation center for Robert Brennan, who contributed \$11 million and was convicted of bankruptcy fraud and money laundering in 2001. Mother Elizabeth Ann Seton must also be turning in her grave. John Byrne, *Seton Hall of Shame*, BUSINESS WEEK ONLINE, Sept. 20, 2002, available at <http://www.businessweek.com>.

470. Maremont, *supra* note 469, at A1.

471. *Id.* at A6. Barry Epstein, a Palm Beach PR executive said, I represented Dennis personally. I reported to him and guided him on community involvement." *Id.* Mr. Epstein has conceded that most of the money was Tyco's, not Mr. Kozlowski's.

472. Kevin McCoy and Gary Strauss, *Kozlowski, Others Accused Of Using Tyco As 'Piggy Bank'*, USA TODAY, Sept. 13, 2002, at 1B.



the land next to his property there not be developed.<sup>473</sup> Tyco gave \$3 million to a hospital in Boca Raton and \$500,000 to an arts center there. United Way of America gave Mr. Kozlowski its “million-dollar giver” award.<sup>474</sup>

As he entered the courthouse to enter his plea on felony charges that included larceny Mr. Swartz sported an AIDS ribbon on his lapel.<sup>475</sup> Frank Walsh has the library at Seton Hall named after him.<sup>476</sup> Mr. Belnick had long done *pro bono* work for Cornell and was a long-time president of the Jewish Community Center of Harrison (New York).<sup>477</sup> Upon his conversion to Catholicism, Mr. Belnick joined the Catholic Foundation of Utah Board and the board of Thomas Aquinas College.<sup>478</sup>

### A FEDERALIST PAPER: RESTORING VIRTUE AND ELIMINATING THE YEEHAW CULTURE

“... the genius of capitalism is to pacify a destructive human characteristic, greed, into benign self-interest – something we know as ‘incentive.’”<sup>479</sup>

One of the dangers of the three-case-study review of a phenomenon is that those digesting the analysis will conclude that the conduct is limited or the phenomenon is unique to those three corporate cultures. However, Enron, WorldCom and Tyco are simply the biggest falls from grace to date.

473. *Id.* at 2B. The annual report of the Nantucket Historical Association for 2000 lists Mr. Kozlowski and Ms. Karen Lee Mayo (who was not yet Mrs. Kozlowski because the marriage to the first Mrs. Kozlowski had not yet been dissolved) as having given between \$2 million and \$5 million. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

474. Most of the money given to United Way was given by Tyco. Mark Maremont and Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

475. *Id.* at 2B. Mr. Swartz remains an incredulous character. He initially tried to post the money from his deferred compensation plan as his bond (\$50 million). *Tyco Executive Offers Pay for Bail*, N.Y. TIMES, Oct. 5, 2002, at B1. When the judge saw the notion of filthy lucre in all of this, Mr. Swartz then offered stock. When the judge indicated Mr. Swartz could not prove that the stock was also not tainted, Mr. Swartz's parents, in-laws, and aunt posted his bond. Andrew Ross Sorkin, *Bail Granted for Ex-Tyco Official*, N.Y. TIMES, Oct. 12, 2002, at B1. Forty-years old and mom and dad are still bailing you out of jail. Further, the judge hauled the parents, in-laws and aunt into court and asked them where they got the \$5 million to post as security for a \$50 million bond. The bond came from their own non-Tyco stock holdings and real estate. One can only imagine what Thanksgiving was like at the Swartz extended family gathering in 2002. “Turkey” perhaps was a label for more than the food fare. Andrew Ross Sorkin, *\$5 Million Bail Accepted for Tyco Executive*, N.Y. TIMES, Oct. 12, 2002, at B2.

476. Byrne, *supra* note 469, at [http://www.businessweek.com/bwdaily/dnflash/sep2002/nf20020920\\_9297.htm](http://www.businessweek.com/bwdaily/dnflash/sep2002/nf20020920_9297.htm).

477. Varchaver, *supra* note 398, at 118.

478. *Id.* Perhaps you are wondering, like me, “What kind of man moves to Utah and converts to Catholicism?” This is one independent soul, given that he was living at Ground Zero for the Mormon faith, a religion not known for its restraint when it comes to proselytizing.

479. John Byrne et al., *Restoring Trust in Corporate America*, BUSINESS WEEK, June 24, 2002, at 30.

There were other rumblings about them as they collapsed, and the Yeehaw culture has felled organizations long before these three behemoths, just with less popular press coverage. In fact, the author has been studying the Yeehaw Culture since 1996.<sup>480</sup> While many specific examples are incorporated in the discussion of reforms for the Yeehaw Culture that follows, it is worth noting that the same time frame that saw Enron, WorldCom and Tyco also witnessed the fall of Adelphia Communications and the indictment of the principals in that company.<sup>481</sup> A brief summary of the Yeehaw Culture at Adelphia includes the following key factors:

- John Rigas, the founder and CEO, was known around the small town of Coudersport, PA, the headquarters of Adelphia, as a big spender;<sup>482</sup>
- John Rigas was referred to as “a Greek god” by the people of Coudersport and the WWII vet was a local hero who paid employees well and lifted the town up economically;<sup>483</sup>

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480. See Marianne M. Jennings, *The Five Warning Signs of Ethical Collapse*, WALL ST. J., Nov. 4, 1996, at A22.

481. Adelphia filed for bankruptcy after revelations that its accounting had concealed \$2.5 billion in debt and other monies that the Rigas family (founders of the company) had misappropriated. John Rigas and his two sons, Timothy and Michael, were charged with conspiracy, securities fraud, wire fraud and bank fraud. Adelphia was forced to file for Chapter 11 bankruptcy protection. The story is basically an Ebberts margin call kind of deal. For an explanation of the problems associated with CEOs pledging stock for loans and the exacerbated problems when the value of the stock declines and the CEOs face margin calls, see *supra* notes 290-95 and accompanying text. The Rigas family faced the same situation and kept borrowing to cover the margin calls and concealing the borrowing from the company financials. There was no one else in charge at Adelphia except the father and two sons and no one to force them to resign, as was the case with Mr. Ebberts. Geraldine Fabrikant, *Indictments For Founder Of Adelphia and Two Sons*, N.Y. TIMES, Sept. 24, 2002, at C1. The company's tailspin began in March 2002 when a footnote in the company's financials disclosed that the father and sons had borrowed \$2.3 billion using Adelphia assets as collateral. David Lieberman, *Former Adelphia Execs Indicted On Fraud Charges*, USA TODAY, Sept. 24, 2002, at 3B. Just a stroll through Adelphia's SEC filings is a treat. United States Securities and Exchange Commission Company Filings, available at <http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000796486>. There have been two guilty pleas in the case, Timothy Werth, 33, Adelphia's director of accounting and James Brown, the CFO. *Former Adelphia Executive Enters a Guilty Plea*, N.Y. TIMES, Jan. 11, 2003, at C3.

482. The Rigas family owned 12 houses around Coudersport. Each year at Christmas, the Rigas family brought in an orchestra from one of the cities its company served to provide music for the town Christmas party. John's wife, Doris, decorated two large Christmas trees each year, with 16,000 lights each. Devin Leonard et al., *The Adelphia Story*, FORTUNE, Aug. 12, 2002, at 136, 138. Mrs. John Rigas, Doris, was known as a profligate spender. When the local drycleaner said to Mr. Rigas, "That woman is costing you millions," Mr. Rigas responded, "Well, sometimes it's worth it. Because when she's bothering [the contractors], she's not bothering me." *Id.* at 146. The townspeople referred to themselves as serfs in comparison to the homes built by the Rigas boys. *Id.*

483. *Id.* Even as the indictments were handed down, the locals continued their unwavering support for Mr. Rigas, "Whatever has to be done to make it right, they'll do. People don't

- John Rigas was also known to have a big heart and often sent checks to those whose stories of down-on-their-luck appeared in the local newspaper.<sup>484</sup>
- The executive team consisted of John Rigas (76) as CEO and Chairman of the board, his son Michael Rigas (47) as secretary and executive vice president of operations; his son Timothy Rigas (44) as treasurer and executive vice president, and his son James Rigas (43) as executive vice president for strategic planning. They were the only officers listed in the proxy.<sup>485</sup>
- The board consisted of the executive team plus Ellen Rigas's husband, Peter Venetis (43) and four outsiders with the Rigas family controlling sufficient shares to choose those board members.<sup>486</sup>

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know the real John Rigas." David Lieberman, *Adelphia's Woes 'a Total Shock' to Many*, USA TODAY, Apr. 5, 2002, at 3B. Mr. Rigas was said to offer money without being asked, supporting the local fire department and paying \$50,000 for the refurbishment of a monument in the town to veterans because the names had been worn away. Deborah Solomon & Robert Frank, *Adelphia Story: Founding Family Retreats in Crisis*, WALL ST. J., Apr. 5, 2002, at B1. He even paid for a McDonald's and Subway to change the outward appearances of their businesses to keep them more in line with the Coudersport Main Street USA image. *Id.* He is referred to as a "father figure" for nearly everyone in the town and that it would often take him one hour to walk one block along Main Street because people stopped to greet him and talk. John Schwartz, *In Hometown of Adelphia, Pride, But Worry About the Future, Too*, N.Y. TIMES, May 28, 2002, at C1. Mr. Rigas bought the only theater in the town in 1951 and kept the prices low: Adelphia employees admitted for free; others for \$4; candy for 60 cents and popcorn in a tub for \$2.25. *Id.*

484. Leonard, *supra* note 482, at 146. One individual helped by Mr. Rigas wrote a letter to the *Wellsville Daily Reporter*, "Thanks for the article. I just got a check from John Rigas." *Id.* Mr. Rigas offered the company jet to one employee who had cancer so that he could obtain cancer treatments at a special hospital center in Cleveland. He even called the family and his employee from Europe to see how the treatment was going. Schwartz, *supra* note 483, at C1. Mr. Rigas was inducted into the Cable Television Hall of Fame for his good works in Coudersport and the other communities served by Adelphia. *Id.* One of the officers of Adelphia said that he was in "total shock" and that he "hasn't heard Rigas utter a slur or profanity in 32 years. The whole story isn't known. That's part of the problem." Lieberman, *supra* note 483, at 3B.

485. The information was taken from the company's annual reports and proxies for the year 2001 found at [http://www.adelphia.com/about/annual\\_report.cfm](http://www.adelphia.com/about/annual_report.cfm) and <http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000796486> (14 Definitive Proxy filing). Michael earned his undergraduate and law degrees at Harvard. Tim had a bachelor's degree from Wharton in economics, and James earned his undergraduate degree at Harvard and law degree at Stanford. Leonard, *supra* note 484, at 142.

486. This information was taken from the proxy for Adelphia for 2001. Mr. Venetis received his MBA and undergraduate degrees from Columbia.

- Timothy Rigas was chair of the Adelpia audit committee;<sup>487</sup>
- Mr. Rigas and his sons rarely returned calls to analysts and refused to explain how the company was financing its acquisitions, maintaining its large margins and continuing to post double-digit growth;<sup>488</sup>
- Nobody was really clear who owned what as between Adelpia and the Rigas family and when Adelpia would acquire companies, the boys or their father would sometimes keep it for themselves. The commingling of personal and corporate funds was clear to even the local tax collector who indicated that Adelpia paid its real estate taxes and those for all of the families and their 12 homes with one check;<sup>489</sup>
- The accounting was questionable with service calls being booked as capital expenses, Doris Rigas being paid \$12.8 million for her work as a designer and decorator for Adelpia offices, and the Rigas farm, thought to be selling honey for a profit, was really just a business that provided landscaping, maintenance and snow removal services to Adelpia;<sup>490</sup>

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487. Leonard, *supra* note 484, at 144. Adelpia's outside auditors were Deloitte Touche. Most reports acknowledge that Deloitte was aware of the loans, but not aware that the funds were being used for margin calls on the stock or aware of the self-dealing issues among the Rigas family members and the company. Deborah Solomon, *Adelpia Sacks Deloitte & Touche*, WALL ST. J., June 10, 2002, at A3.

488. Oren Cohen, an analyst called frequently to ask how purchases were being financed. The response from the Rigases was, "We're not telling you." Leonard, *supra* note 484, at 147. Mr. Cohen examined the various off-the-books entities owned by the Rigas family members and concluded that they were at least \$900 million to \$1 billion in debt and asked how the debt was being carried. He got the brush-off until March 27, 2002, when Adelpia filed an 8-K indicating that it could be liable for up to \$2.3 billion in Rigas family debt. United States Securities and Exchange Commission Company Filings, available at <http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000796486>. March 27, 2002, 8-K filing. Mr. Cohen is a fixed-income analysts at Merrill Lynch. Geraldine Fabrikant, *Adelpia Fails to Make Note Payment*, N.Y. TIMES, May 17, 2002, at C1.

489. Leonard, *supra* note 484, at 146. Adelpia also paid \$12.8 million for the construction of a golf course owned by the Rigas family. Jerry Markon & Robert Frank, *Five Adelpia Officials Arrested on Fraud Charges*, WALL ST. J., July 25, 2002, at A3.

490. Markon & Frank, *supra* note 489, at A3. The bottom line in all the shenanigans with the books and the borrowing was that the Rigas family did not have enough money to maintain its level of ownership and control of the company. The purchase of shares, financed by the value of the shares and the assets of Adelpia offered as security for loans for their shares, was contingent on the share price remaining high. It did not and the family and company were left with worthless shares and loans. Susan Pulliam & Deborah Solomon, *Adelpia Facesirate Shareholders*, WALL ST. J., Apr. 4, 2002, at C1. The SEC began investigating

- There were conflicts galore among officers, board members and the Rigas family with the officers and board members actually competing with the company for the purchase of cable systems and the company providing the credit, collateral and financing for the family members to make the purchases for themselves and their self-owned companies that would then contract with Adelphia;<sup>491</sup>
- Adelphia had the analyst conflicts, similar to WorldCom in that Salomon Smith Barney was its lead underwriter even as its parent, Citigroup, was a primary creditor;<sup>492</sup>
- Adelphia was an innovator, a first-mover in the cable market initially and quick to grab up good buys in the cable market to create a 7-state empire of cable subscribers, going from a couple of hundred subscribers in Coudersport to 5.8 million.<sup>493</sup> By the middle of 1999, Adelphia shares were at \$85.98 each. By the time of the first announcement of the debt and the delay in the financials, Adelphia's stock had experienced the usual market battering and was at about \$25

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Adelphia's accounting in spring 2002. Geraldine Fabrikant, *Market Place: A Family Affair at Adelphia Communications*, N.Y. TIMES, Apr. 4, 2002, at C1. Adelphia is further down the sophistication chain in terms of the debacles. As one expert has explained, Adelphia was just "plain-vanilla-old-fashioned self-dealing." Geraldine Fabrikant, *New Questions On Auditors For Adelphia*, N.Y. TIMES, May 25, 2002, at C1. Wayne Carlin, the regional director for the SEC's northeast division said, "The things that makes this case stand out is the scope and magnitude of the looting of the company on the part of the Rigas family. In terms of brazenness and the sheer amount of dollars yanked out of this public company and yanked out of the pockets of investors, it's really quite stunning. It's even stunning to someone like me who is in the business of unraveling these kinds of schemes." Markon & Frank, *supra* note 489, at A3. It is a classic "personal piggy bank" case. *Id.* Just a little lower on the sophistication scale than Tyco.

491. Nel Minow of The Corporate Library described Adelphia as follows, "Even the existence of a credit line that allows the family to buy cable systems raises conflict-of-interest questions because the company was actually funding the family's ability to compete for properties." Fabrikant, *supra* note 490, at C1. And the board was not shy about self-serving investments. Adelphia invested \$3 million in "Songcatcher," a film produced by Ellen Rigas Venetis, the wife of a board member as well as the daughter of John Rigas. The film did not go on to box office success or even a mention at the Sundance Film Festival. *Id.* Referred to as "co-borrowing agreements," they are a red flag for investors and auditors. In fact, the issue in much of the litigation is whether Salomon, Deloitte and other outsiders dealing with Adelphia and the Rigases should have seen the red flags or were even able to determine that there were co-borrowing agreements. Robert Frank, *Deloitte, Adelphia Are Squaring Off In a Blame Game*, WALL ST. J., July 10, 2002, at C1. *See also* Deborah Solomon, *Salomon Draws Focus Over Work For Adelphia*, WALL ST. J., June 5, 2002, at C1.

492. Solomon, *supra* note 491, at C1.

493. The Rigas family was one of the first cable businesses in the country and grew with the financial risks that Mr. Rigas was comfortable taking in order to make acquisitions. Deborah Solomon & Robert Frank, *Adelphia Story: Founding Family Retreats in Crisis*, WALL ST. J., Apr. 5, 2002, at B1.

per share. With the announcement, the shares dropped to \$11.04.<sup>494</sup> By May 2002, the shares had dropped to \$2.62<sup>495</sup> and by June 2002, the shares were at 18 cents.<sup>496</sup>

- The loans and the off-the-books partnerships were created to keep Adelphia's books looking good for investors. The family was trying to maintain the share price for many reasons, including their extensive borrowings. Maintaining the numbers became the goal of all of the actions taken.<sup>497</sup>

### *Fixes for the Yeehaw Culture*

One of the great ironies of the Yeehaw Culture is that its characteristics and presence are so obvious in a hindsight examination of an organization, but few within that organization are willing to take the steps necessary to halt its progression within their organization even as they see it growing and developing to, as the previous analyses have shown, the point of self-destruction.<sup>498</sup> It is simply inaccurate to say that few within the organization see the characteristics developing while also understanding that these char-

494. Pulliam & Solomon, *supra* note 490, at C1.

495. Robert Frank & Deborah Solomon, *Adelphia and Rigas Family Had A Vast Network of Business Ties*, WALL ST. J., May 24, 2002, at A1.

496. David Lieberman, *Adelphia skids to brink of failure*, USA TODAY, June 11, 2002, at 3B. This share price followed on the heels of cash flow and earnings restatements. Adelphia filed for Chapter 11 bankruptcy on June 26, 2002. Bill Bergstrom, *Adelphia Files For Chapter 11*, TRIB., June 26, 2002, at B3. The total bank loan default was \$7 billion. David Lieberman, *Adelphia founder Rigas pleads not guilty*, USA TODAY, Oct. 2, 2002, at 3B.

497. The indictment filed on July 24, 2002, against the three Rigases and James Brown, the CFO, and Michael Mulcahey, the director of internal reporting, alleges that the officers "would determine a target for Adelphia's publicly disclosed Ebitda and would attempt to justify that number by creating back-dated sham transactions" between Adelphia and the off-the-books, family-owned companies. Markon & Frank, *supra* note 489, at A3. There it is, EBITDA as the root of all evil. For more information and discussion of EBITDA, see *supra* notes 110, 180-81 and accompanying text. Also, the company reported inflated numbers for subscribers. Robert Frank & Deborah Solomon, *Adelphia Inflated Customer Base*, WALL ST. J., June 7, 2002, at A3.

498. The companies studied in detail here are simply the most recent ones to fall victim to the Yeehaw Culture. There are many that came before, and, short of the fixes recommended herein being applied, many more yet to come. For example, Miniscribe, a disk driver manufacturer that saw its peak in mid-1980s, was a culture so far into Yeehaw tendencies, that its managers had employees wrap bricks in disk-drive boxes in order to dupe the auditors on inventory. Employees wrapped \$3.66 million worth of bricks, er, disk drives. Those same managers also broke into the auditors' work papers at night and altered them. Then they shipped the bricks out in order to book sales. No one wrapping bricks, shipping bricks, or using White-Out at night while crouched on the floors by auditors' trunks raised his or her hand and asked, "Exactly why are we doing this?" Indeed, no one raised his or her hand and asked, "Never mind the SEC and financial reporting and ethics, what of human dignity?" Michelle Schneider, *Firm's Exec 'Perpetrated Mass Fraud,' Report Finds*, ROCKY MTN. NEWS, Dec. 12, 1989, at 1-B. See also Andy Zipser, *Recipe for Sales Led to Cooked Books*, DENV. POST, Aug. 14, 1989, at 2B.

acteristics and issues will surely produce the organization's demise.<sup>499</sup> Each of the companies examined in detail in the previous sections had employees at all levels and in all areas who had concerns and very clearly spotted the issues and evolving characteristics of the Yeehaw Culture. However, even those employees who saw the issues and concerns and understood their consequences did little to make noise. And in many situations where they did make noise, they were rebuffed, demoted, terminated or ignored.<sup>500</sup> There were, in current SEC rule parlance, few so-called noisy withdrawals in timely fashion that might have afforded officers or board, or, in some cases, even regulators, an opportunity to step in and save the company.

Within these Yeehaw organizations, despite witnessing conduct within their companies that was painfully wrong, and despite their better judgment, indeed, despite the conduct's defiance of historical, financial and market realities, employees within these companies hoped against hope that somehow they could emerge from the creeping difficulties they were witnessing in silence, or at least in quiet. Hope springs eternal as employees within such a culture succumb to management's belief that they really are true innovators, possessed of an ability to defy market principles, odds and economic cycles. Employees of these companies surrender their better judgment and begin to believe the perpetrators of the innovation myth. Enron employees had a name for it; they referred to the belief that the company was different and that they could defy all odds, as being "Enronized."<sup>501</sup> Having drunk the Kool-Aid, they gradually became immune to common sense, the reality of markets, the rules of accounting, and, finally, the laws of the land.<sup>502</sup>

The solution, therefore, for these ethical collapses in Yeehaw companies is not found in criminalizing officer conduct or increasing penalties for existing corporate crime by cajoling wrong behaviors out of those who

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499. For discussion of employees at these organizations who knew about the evolving concerns and issues and understood their significance, but still opted to remain silent, see *supra* notes 32-48, 225-37, 394-407 and accompanying text.

500. Again, the pattern is not new to this era or this group of companies. In the collapse of Phar-Mor, Inc., the discount drug store chain, managers were aware that there were two sets of books, one referred to as "cookies." And the other as "cookies with raisins." Again, a little human dignity for grown men (mostly) going to work and speaking in a code language as if they were in a cereal commercial! One employee notified the officers of the company, anonymously, of one transfer of \$100,000. The officers and the auditors couldn't find the \$100,000 and by the time the employee got work to them, the company was already in its downward spiral from the excessive spending of its president as well as the company's support of the cash-draining World Basketball League. Gabriella Stern, *Chicanery at Phar-Mor Ran Deep, Close Look at Discounter Shows*, WALL ST. J., Jan. 20, 1994, at A1.

501. Barringer, *supra* note 53, at A11 (discussing McLean's story).

502. "Drinking the Kool-Aid" was another phrase used by the Enron employees as a substitute for being "Enronized." "Drinking the Kool-Aid" is a reference to the Rev. Jim Jones and his followers who drank Kool-Aid with deadly poison at their colony in Guyana with all followers, along with Mr. Jones, perishing as a result.

run companies. There are no indications that any of those indicted or any of those involved or aware of the missteps of these companies made their errors out of ignorance of the law or the accounting rules.<sup>503</sup> Rather, the problem in these companies is curbing behaviors as they begin. Curbing the Yeehaw Culture requires use of inside sources who find a way to get the message about ethical and legal breaches to those who will implement change. What is sorely lacking in the Yeehaw Culture is ethical gumption among employees, the first and best source of information about a company. In the companies discussed in detail earlier, as well as in many other examples cited, those employees who saw the problems, issues, and conduct of their superiors said nothing, except in the form of humorous e-mails or comments whispered in passing in the coffee room or at lunch outside of the earshot of supervisors, managers, officers and well beyond their boards' ken.<sup>504</sup> These were cultures of silence and fear. In some cases, not only was gumption to speak up about the conduct lacking, many employees just went along and joined in for fear of losing their jobs and, perhaps the ride to the top with the stock.<sup>505</sup>

How can the corporation create an atmosphere and mechanisms that afford employees who see the issues the avenues for getting that information to those who can correct the decline into a Yeehaw Culture before the damage to the company is done? What are the current barriers to ethical gumption that cause otherwise rational adults to sit idly by as an organization implodes? What motivates gumption in a corporation? What mechanisms provide appropriate responses when gumption does rise up and speak?

There are three points at which the progression of the Yeehaw Culture can stop. The culture can be halted internally through certain structural and educational changes to be discussed in the next sections. However, very often, and as was the case with these companies, despite the traditional in-

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503. Mr. Belnick, Tyco's general counsel, is the only one of the crowd who has raised the defense of, "Gee, I thought it was okay. The chairman said so." For a discussion of his background and criminal charges, *see supra* notes 379, 395 and accompanying text. Mr. Belnick, a general counsel charged with knowledge of securities laws, is either telling the truth, in which case Tyco has a heck of a malpractice case against him, or, and this is more likely, he is pleading ignorance in the hope of mitigating the intent part of the violations with which he is charged. In preliminary procedural hearings, the prosecution in the Tyco officer cases has admitted that the Tyco officers sought the approval of the outside auditors for the nondisclosure of loans and other uses of company funds that are now the subject of criminal indictment. However, seeking such approval, which they obtained because the transactions were not "material" under GAAP rules, does not, as the judge noted, eliminate the intent, their motives or the fact that the loans and bonuses were unknown to the board of Tyco. Andrew Ross Sorkin, *Court Is Told Tyco Deals Had Backing of Auditors*, N.Y. TIMES, Feb. 8, 2003, at C2.

504. *See supra* note 42 and accompanying text (discussing information on the Enron e-mails).

505. *See supra* notes 165, 179 and accompanying text (discussing how Buford Yates of WorldCom actually wrote an e-mail indicating the accounting decisions being made had no support in accounting rules).



ternal precautions designed to prevent or stop fraud (a common problem that goes hand-in-hand with the Yeehaw Culture), there is nothing any employee could do within an organization to stop the Yeehaw Culture from taking hold once it has consumed even those whose job it is to stop the Yeehaws. There is, therefore, the need for a second checkpoint for halting the Yeehaw Culture. This second checkpoint for Yeehaws consists of quasi-internal/quasi external mechanisms. These mechanisms, primarily the board and auditors, are comprised of those who have one foot inside the corporation, but that foot is not so much inside that those with the feet lack perspective for spotting the issues and concerns of the Yeehaw Culture as they evolve, but before they consume.

Should the quasi-internal mechanisms fail, the third and final checkpoint for Yeehaws consists of external mechanisms. The third external ring encircling Yeehaw Cultures has many sublayers including regulators, analysts, and professional associations. When those in the internal or quasi-internal spheres fail to or cannot come forward with critical information about their company's shortcomings or breaches, then these external forces should be a force available and brought to bear upon the Yeehaws and their culture until the situation is corrected.

These three fixes for the Yeehaw Culture, and the specifics in each area, are patterned after the principles of *The Federalist Papers* in ways that should be obvious. The layers begin with individual rights – every employee has the right to work in a company that fulfills not just the role of the corporation in society, but also honors societal norms of honesty and fairness, as well as compliance with the law.<sup>506</sup> Human dignity demands that no employee be required to perform the kinds of tasks for which we see indictments such as the booking of expenses as capital expenditures or to endure the humiliation of being referred for counseling when he or she raises questions about the propriety of the corporation's accounting. As was the case in the founding of a new country, and in what would become the constitution for a new continent, the founders, who wrote of their political philosophy in THE FEDERALIST PAPERS, began with individual rights and human dignity, and then structured a three-branch government for the preservation of those rights with each layer having some ability to check the other. In the case of

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506. A great deal of work to date on corporate governance has focused on shareholder rights. Indeed, were it not for the 401(k)s of many of the employees of these companies, the role of employees would be largely ignored. The employee as shareholder has been the focus of much analysis and many reforms. Those discussions are monetary in nature and too late for the employees' financial survival. The reforms proposed herein focus on their dignity, and, as a result, will save them as shareholders and even non-employee shareholders. Sandra Block, *House Passes Bill to Boost Retirement Plan Safety*, USA TODAY, Apr. 11, 2002, at 1B. Eventually, Sarbanes-Oxley did impose some restrictions on pension black-out times and officer trading. See 15 U.S.C. § 7244 (2002). For a discussion of more recent attitudes on 401(k), employees and their employers, see Christine Dugas, *Former Enron Workers Carry On – Without Much Help*, USA TODAY, Mar. 16, 2003, at 1B.

the corporation, the reforms before and through this iteration of fraud, have been top-down: changing the board structure, imposing additional penalties on officers, forcing officers to certify financials, and reducing conflicts of outside audit firms.<sup>507</sup> These types of top-down changes are too late for the Yeehaw Culture. One of the revelations of the detailed analysis of the companies in this piece should be the overarching observation: do we understand how far gone these corporate officers, boards, and auditors had to be for such monumental collapses? Yes, but the better question is: how did they get that far? Why didn't the checks and balances work? Existing checks and balances in corporate structure and governance failed because these existing mechanisms rely on the wrong input and actors for prevention. These mechanisms do not focus on those within the corporation who are most knowledgeable. As was the case when *The Federalist Papers* were drafted, existing governance in these companies was comparable to that of England's rule of the colonies: remote, autocratic and devoid of checks and balances.<sup>508</sup> The top-down governance of the American colonies ignored the wisdom of the citizen and assumed that wisdom in leaders ensured proper governance.

In Federalist One, Alexander Hamilton wrote of the need to curb the quests for power and truth's role in its conquest. The proposed structure of the new Union was one designed to retain power in individual citizens, not in autocratic leaders.<sup>509</sup> Even in seeking the ratification of the Constitution, Hamilton encouraged the citizens to rely on truth. These companies noted here had lost sight of truth and ignored their citizens: the employees of these companies who were possessed of truth and full information that was being concealed. These companies' failures illustrate an old business management adage: The collective wisdom of employees always exceeds the collective wisdom of management.<sup>510</sup> Employees are not just the most reliable source

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507. A review of Sarbanes-Oxley is beyond the scope of this piece because the main thesis of this piece is that such legislation will not solve problems of the magnitude at Enron, WorldCom, Adelphia and Tyco that inspired the legislation. The Act does provide protection for employees who provide information (section 806) and measures for increasing the likelihood that the quasi-internal and external checkpoints will remain independent (*see* sections 201-209 on auditor independence and section 501 on analysts' independence). However, the author's point is that all of these curbs may be too little too late in terms of the damage the Yeehaw Culture can inflict before an independent auditor gets hold of the information. And the idea is not to have an employee who needs whistleblower protection, but a company that listens to and investigates the concerns of employees so that whistleblower protection is not necessary.

508. ALEXANDER HAMILTON, *THE FEDERALIST* (Jacob E. Cooke ed. 1961).

509. *Id.* at 3-7.

510. The author quotes from a management professor of some 30 years ago, whose name she cannot recall, who taught a course whose title she can't remember. However, the use of this quote indicates that the author did pick up meaningful information in this course. The phrase was used in the context of his teaching us respect for employees, regard for their ideas, and requests for their input. The three "r's" I remember as well. The literature in the field does document that one of the obstacles to ethical behavior in the organization is a manager's

of information within a company; they are the key to prevention of abuses. Cracking the Yeehaw Culture then begins with the radical notion of finding the mechanisms for protecting employees, who are the first to see Yeehaw Culture evolution and are possessed of the information that could establish for the quasi-internal and external layers that the Yeehaw Culture exists.<sup>511</sup> The result of not fixing the Yeehaw Culture is that employees begin to feel pressure and assume that the decisions the officers in charge are making are the standards for the company and they succumb to the pressure, there being no outlet for them to relieve that pressure. According to a study by the Ethics Resource Center, when pressure mounts, Yeehaw behavior increases:

*Another finding from the 2000 NBES strongly links pressures to compromise an organization's ethics standards with employee observations of misconduct. Among employees who did not feel pressured, about one in four observed misconduct at work within the last year. In contrast, among employees who did feel pressure to compromise an organization's ethics standards, nearly three in four observed misconduct during the same period. This link suggests that ethical pressure on employees can be an important warning sign of potential or ongoing misconduct in your organization. As part of broader discussions or surveys relating to workplace ethics, executives may want to ask employees about perceived pressures to compromise ethics standards.*<sup>512</sup>

Fixes for the Yeehaw Culture have as their sole purpose finding the means for employees, whose rights to dignity in the corporation should be preserved, to weave their ways through the controlling Yeehaw Culture using the three checkpoints. The delicate balance to be found here is one in which the corporation can still function as a social organization as employees do succumb to some authority in the form of management, but also to provide those employees with the means for raising their concerns in the event they are asked, as noted by Dr. Milgram, to inflict pain on others.<sup>513</sup>

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defensiveness about employees raising ethical issues, i.e., the manager believes that he or she is quite capable of sorting out ethical dilemmas and concerns without the assistance of employees. That attitude ensures that employees will not come forward and also gives the manager free rein to do as he or she pleases. Muel Kaptein, *Guidelines for the Development of an Ethics Safety Net*, 41 J. BUS. ETHICS 217, 219 (2002).

511. While "Yeehaw Culture" is the author's creation, there is a body of work that documents well the fact that cultures in organizations can develop that preclude employees from raising ethical and/or legal issues, and, in fact, those employees who do become perceived as the evil ones. See generally Kaptein, *supra* note 510.

512. Joshua Joseph et al., *What Association Leaders Should Know*, EXECUTIVE UPDATE ONLINE (Oct. 2000), at [www.gwsae.org/ExecutiveUpdate/2000/October/ethics.htm](http://www.gwsae.org/ExecutiveUpdate/2000/October/ethics.htm).

513. For a discussion of Milgram and his work, see *supra* note 7 and accompanying text

### Layer One – Internal Controls for the Yeehaw Culture

Most corporations and corporate governance theorists have held the mistaken belief that the presence of any or all of the following elements traditionally associated with the ethical firm offer protection from the Yeehaw Culture. Indeed, most experienced in corporate governance and organizational ethics will recognize the components as derivatives of the carrot-and-stick approach manifest in the federal corporate sentencing guidelines.<sup>514</sup>

- Code of ethics<sup>515</sup>
- Training in ethics and/or the company code of ethics<sup>516</sup>
- Company statements and philosophies on stakeholders, diversity, environment, philanthropy<sup>517</sup>
- Managers and officers who speak of their high ethical standards and commitment to community<sup>518</sup>
- Hotline for reporting violations<sup>519</sup>
- Ombudsperson or ethics officer for employees to contact with concerns<sup>520</sup>

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514. 28 U.S.C. § 994(a) (2003) (granting authority for the guidelines). The guidelines themselves are found at 18 U.S.C. app. Ch. 1 *et seq.* The guidelines were promulgated pursuant to the Sentencing Reform Act of 1984 (title II of the Comprehensive Crime Control Act of 1984).

515. The National Business Ethics Survey (NBES), conducted by the Ethics Resource Center, found, in 2000, that nearly 90 percent of employees say their organizations have written standards of ethical conduct. Joseph et al., *supra* note 512, at [www.gwsae.org/ExecutiveUpdate/2000/October/ethics.htm](http://www.gwsae.org/ExecutiveUpdate/2000/October/ethics.htm).

516. According to the NBES 65 percent of employees say their organizations provide some form of ethics training. *Id.*

517. One of the assumptions made by Calpers (California Public Employees' Retirement System), the largest and most courted retirement fund in the investment community and a change agent in terms of corporate governance, is that companies that are agents for social change are the best investment vehicles. There is a rather large equation between social responsibility by companies and their integrity and financial performance, according to the Calpers board. For example, Calpers will not invest in tobacco company stocks because of these companies' lack of social responsibility. As noted earlier, the companies studied here were models of social responsibility and also models of how to send a stock price down to about 88 cents. On the other hand, tobacco companies are doing quite well. Mary Williams Walsh, *Calpers Wears a Party or Union, Label*, N.Y. TIMES, Oct. 13, 2002, § 3, at 1. The reader might want to go to the Philip Morris stock chart and note that its price was climbing as the dot-coms and the companies here were falling. It remains at about \$38 per share. See [www.altria.com/investors/02\\_00\\_investorsOver.asp](http://www.altria.com/investors/02_00_investorsOver.asp) for stock price information. Philip Morris was renamed Altria because of the backlash against tobacco.

518. An interesting monologue occurred on April 9, 1999, when the author shared a conference speaker platform with Mr. Ken Lay, former CEO of Enron, who spoke at length of the importance of ethics and a "not too strong board." Conference is noted at [www.basil.stthom.edu/cbes/conferences/kenneth\\_lay.html](http://www.basil.stthom.edu/cbes/conferences/kenneth_lay.html). A copy of the remarks is on file.

519. According to the Business Ethics Resource Center, 40% of companies have some type of hotline for employees to report concerns. [www.ethics.org](http://www.ethics.org).

These components are all integral parts of the internal protections for employees from the infiltration and conquest of the Yeehaw Culture. But, all of the companies analyzed herein had these elements in their internal checks and balances.<sup>521</sup> What can be done differently to make these theoretical components of preventing the Yeehaw Culture work better at affording employees the opportunity to speak up about evolving problems? Obtaining synergy from these individual components and increasing the efficacy of these very traditional elements of an ethics program in a corporation require some additional steps or the Yeehaw Culture takes hold. The collapsed companies studied here teach that these elements alone are not enough and follow-through for each is required. Companies seeking to curb Yeehaws should be asking: what does each of these elements accomplish?

### *Internal Changes: The Hotline*

Nearly all companies have a hotline, but the next step in preventing Yeehaw development is asking what is done with the information that is gleaned from the hotline? If the information is reviewed internally and investigated internally, employees develop a reluctance to use this type of an outlet for their gumption. Worse, some employees witness other employees being terminated shortly after reporting a matter on the hotline and a component of fear sets in for one of the few internal steam valves that employees have for disclosing the evolution of the Yeehaw Culture.<sup>522</sup> For example, at Miniscribe, a disk drive company that collapsed under earnings fraud, the CEO would have employees stand in meetings and fire them.<sup>523</sup> At Columbia Health Care, one of the employees who would later become a whistleblower against the company with regard to Medicare fraud was keeping two sets of books and yet had no internal mechanism for raising his concerns.<sup>524</sup>

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520. Nearly all Fortune 500 companies have ethics officers, but they vary in location, authority, reporting lines, and even whether it is a full-time or part-time assignment. For a detailed look at ethics programs, officers and components, see Joshua Joseph, *Integrating Ethics and Compliance Programs: Next Steps for Successful Implementation and Change* (2001), available at <http://www.ethics.org/fellows/integrating.pdf>.

521. See *supra* notes 7-501 and accompanying text.

522. For examples of the fear in each of these companies' cultures, see *supra* notes 32-48, 225-37, 394-407 and accompanying text.

523. Upon firing employees in such a public fashion, CEO Q.T. Wiles would utter, "That's just to show everyone I'm in control of the company." Zipser, *supra* note 498, at 2B. Even Mr. Wiles own lawyer described him as "fairly autocratic and very demanding of the people who work for him." *Id.* You know you're autocratic when your own lawyer won't even mince words about you.

524. Interestingly, James Alderson, a hospital accountant, was not at all sure that there was fraud underlying what he was doing, he just really wanted to talk with someone about the issues and concerns. There was no internal avenue for him to pursue. Kurt Eichenwald, *He Blew the Whistle, and Health Giants Quaked*, N.Y. TIMES, Oct. 18, 1998, § 3, at 1. Four executives were fired when he eventually blew the whistle, two were convicted of defrauding the government, one was acquitted and another had a hung jury. The company paid a \$745

Every company needs some form of anonymous reporting system. Even the best supervisors may not be able to inspire disclosure by employees.<sup>525</sup> There are several key elements to making the anonymous reporting system effective. The first is having a strong individual responding to the calls, not a voice recording. The individual positioned to receive the anonymous reports must have access to information and must have an avenue for pursuing matters raised. The avenue this individual has is particularly strong when a relationship with the board, preferably the audit committee, is established. One effective means for giving the individual authority and for ensuring that there is follow-through on concerns raised is having a report to the audit committee on the type of calls coming into the reporting line, what required follow-up, what was done to correct any situations, and even reporting those cases in which the employees were either disgruntled or just mistaken about what they saw or reported. An audit committee finger on the reporting line's pulse is something that gives the committee, and, as a result, the board, an accurate and detailed picture of the culture of the organization.

#### *Internal Changes: The Ethics Officer*

Another implementation issue in the traditional components of an ethics program is the type of person filling the ethics officer slot as well as the reporting line for that ethics officer.<sup>526</sup> One of the mistakes that many companies make in choosing an ethics officer is choosing one who is well versed in issues of social responsibility, but not schooled in financial reporting.<sup>527</sup> At the heart of each of the company's collapses outlined here was a financial reporting issue, use of funds issues and the propriety of accounting choices. Employees who sense that an ethics officer is unlikely to understand the magnitude of the choices being made on financial reporting, accounts receivable or booking of revenues are not likely to approach them with the concerns.

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million penalty. Julie Appleby, *Columbia Agrees to \$745M Penalty*, USA TODAY, May 19, 2000, at 1B.

525. In a survey conducted for the Lutheran Brotherhood, an insurance group, only 38% of the respondents said that they would talk to their supervisors about an ethical dilemma they were facing in the company. Twenty-three percent said they would do nothing, quit or were unsure what they would do. The largest group (40%) said they would try to find some way to resolve the problem without losing their jobs. The assumption by the employees is that the burden is on them to find a way because the organization does not provide a means either through the supervisors or some other reporting mechanism. *Workplace Ethics Dilemma*, USA TODAY, Feb 15, 1999, at 1B.

526. For a full discussion of the types of ethics officers chosen and reporting lines, see *supra* note 520 and accompanying text.

527. For more background on the nature of ethics officers, see Joshua Joseph, *Integrating Business Ethics and Compliance Programs: A Study of Ethics Officers in Leading Organizations*, 107 BUS. & SOC'Y REV. 309 (2002).

The credibility of trustworthiness of the ethics officer is also critical. Those who are performing the job as a part-time assignment or an additional assignment in addition to their regular jobs at the company run the high risk of losing credibility themselves as well as for the company's ethics program. Such a dual role has the potential for conflicts, but also sends the signal to employees that their ethics concerns are only a part-time subject, not worthy of full-time attention.

There are several key components to utilizing an ethics officer:

- Individual with credibility
- Generally been with the company for 10 years or longer
- Assigned full time as the ethics officer
- Reporting line is critical but options include CEO, general counsel, with some having a dotted line to the audit committee, chairman or the board<sup>528</sup>
- Individual with knowledge about financial reporting and accounting

#### *Internal Changes: Codes of Ethics*

One of the great weaknesses of most codes of ethics for corporations as well as their ethics training is that the focus tends to be on those elements mandated by the corporate sentencing guidelines: antitrust, insider trading under securities law, bribery, and a host of violations even the CEOs of these companies never approached.<sup>529</sup> The Yeehaw Culture does not start with price-fixing, and it does not follow the patterns the corporate sentencing guidelines lay out for corporate misconduct. The guidelines were based on the criminal misconduct of companies that predated the 90's market mentality.<sup>530</sup> And, to a large extent, the guidelines and the presence of these compliance codes of ethics have accomplished their purpose.<sup>531</sup> With the exception of the Archer Daniels Midland and Sotheby's and Christie's interna-

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528. See *supra* notes 550-55 and accompanying text.

529. See Bruce R. Gaumnitz & John C. Lere, *Contents of Codes of Ethics of Professional Business Organizations in the United States*, 35 J. BUS. ETHICS 35 (2002); B. Stevens, *An Analysis of Corporate Ethical Code Studies: Where Do We Go From Here?* 13 J. BUS. ETHICS 63 (1994); Mark S. Schwartz, *A Code of Ethics for Corporate Code of Ethics*, 41 J. BUS. ETHICS 27 (2002).

530. For more information on codes of ethics, see Muel Kaptein & J. Wempe, *Twelve Gordian Knots When Developing an Organizational Code of Ethics*, 24 J. BUS. ETHICS 853 (2000).

531. For more background and information on the role of the Federal Sentencing Guidelines in corporate compliance programs, see Marie McKendall et al., *Ethical Compliance Programs and Corporate Illegality: Testing the Assumption of the Corporate Sentencing Guidelines*, 37 J. BUS. ETHICS 367 (2002).

tional price-fixing schemes, we don't witness the types of cartels and scheming that wrought the federal invasion of corporate governance.<sup>532</sup> Employees know a price-fixing suggestion and they know that managers, officers, and even ethics officers in la-la land will listen up when they start spouting information about fixed prices. However, in the companies analyzed here, and in others yet to be revealed or ongoing, employees are not wrestling with violations of the law, but gradual movement of the line from legal, but edgy, to illegal.

For example, in Rite-Aid, those employees were wrestling with the Yeehaw Culture when they were first asked to postpone payment to suppliers.<sup>533</sup> That piece of information does not reflect illegal conduct nor is it the type of conduct listed in any company's code of ethics. Rather, such a mandate from management is an indication not just of an ethical degradation, for stiffing suppliers does not earn a badge of honor in any study of virtue ethics, but also an indication of financial difficulty being hidden or a direction for the company that is not providing the returns expected. Either way, the company has a problem that any officer, director or shareholder would want to know. That the company may recover from this temporary strategy of postponing payment to suppliers, ergo there is no need to disclose it to the market, is not the issue. The line of demarcation is crossed when a company uses methods that are less than fair or honest. Employees witness such conduct and assume, whether senior management knows or not, that such manipulations are expected and acceptable.

Instead of focusing only on compliance, companies need to develop for employees the philosophy and training for spotting cultural change issues. There is work to date on the nature of culture and these are some of the factors that reflect concerns about a company's culture because they are indicative of the authoritative nature of the company that allows the Milgram phenomenon of inflicting pain pursuant to authority to set in:

- No room for personal morals
- Follow company rules
- Stick to company rules

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532. Interestingly, ADM also follows the pattern of the Yeehaw Culture with the sons of the CEO running the company and sitting on the board. Sotheby's and Christie's both had autocratic chairmen of their boards who were heavily involved in the community and managed to recruit sycophantic CEOs who did as they were told to do, including fixing commissions for the sale of art, antiques and the estates of the likes of Jackie O and Diana. For information on ADM, see Kurt Eichenwald, *Former Archer Daniels Executives Are Found Guilty of Price Fixing*, N.Y. TIMES, Sep. 18, 1998, at A1. For information on Sotheby's and Christie's, see Kathryn Kranhold, *Likely Evidence at Taubman Trial Boils Down to 'He Said, She Said'*, WALL ST. J., Nov. 8, 2001, at B1.

533. Mark Maremont & Robert Berner, *Leaning on Suppliers, Rite Aid Deducts Cash at Bill-Paying Time*, WALL ST. J., Mar. 31, 1999, at A1.



- Comply with the law
- Obey company rules
- Concern with the company's best interests
- Strictly follow legal standards
- View decisions in terms of profit
- Primary concern is for the organization
- Efficient way is always the right way<sup>534</sup>

### *Internal Changes: Curbing Culture*

One innovation for curbing Yeehaws that any company can begin immediately is offering employees the following list as reminders that they may have reached a time for raising concerns. Employees need to know when to come forward and a company-sanctioned list of "we need to know when" affords them the opportunity and gumption to come forward. The misconduct of these companies and, indeed, most companies in the 90s, was more nuanced.<sup>535</sup> Employees need guidance on when to speak up and, in some cases, out. One of the critical issues the author confronts in working with companies is that of a disconnect between the professed integrity of management and what they are being asked to do in the bowels of the company. These employees are wrestling with decisions on what gets booked when and where and many feel that their decisions are fundamentally dishonest, but the company seems to be clicking along and the CEO and other officers, and even the employees' supervisors seem to believe that despite the reporting decisions made on finances, that they are paragons of virtue. Again, the employees see the questionable nature of the calls being made, but are hesitant because of their perceptions about managers and officers.

- Have I been asked to do something because a bonus is on the line?

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534. Dane K. Peterson, *The Relationship between Unethical Behavior and the Dimensions of the Ethical Climate Questionnaire*, 41 J. BUS. ETHICS 313, 317 (2002). For earlier work, see David J. Fritzsche, *Ethical Climates and the Ethical Dimension of Decision Making*, 24 J. BUS. ETHICS 125 (2000).

535. For example, in the case of the collapse of Sunbeam, the sham contract for the sale of the parts in a warehouse for \$11 million was not reported because, under accounting rules, the amount was not material in a quantitative sense. The interpretation of the rules was correct and the amount was minimal, in comparison to Sunbeam's overall numbers. However, the reasons for the sham contract fell into the Yeehaw categories as a time for speaking up because the contract was entered into for the purpose of meeting quarterly numbers. Floyd Norris, *They Noticed the Fraud but Figured It Was Not Important*, N.Y. TIMES, May 18, 2001, at C1.

- Have I been asked to do something so that we could meet quarterly numbers?
- Have I been asked to do something so that the information need not be disclosed to the public, on SEC reports or to the shareholders?
- Has someone in the company said something to a reporter, analyst or shareholder that I knew was not correct?
- Am I concerned that those around me who have expressed concerns about the company's conduct are being terminated or are departing on their own?
- Am I being asked to postpone reporting expenses, accelerate reporting expenses or do the same with sales in order to meet a goal or bonus?
- Have I been asked not to disclose what I have done?
- Am I doing something similar to the employees in the companies we have studied?<sup>536</sup>

*Internal Changes: Ethics Training*

The presence of these questions and the cultural factors requires that ethics training for the company be revamped. Ethics training in corporations has generally been abysmal. There are several different approaches that companies take in providing training, along with combinations of any of these muddled together for enriched employee boredom and confusion. The first type of program is one grounded in philosophy. In this program, employees actually learn about utilitarianism and stakeholder model.<sup>537</sup> Such training is not the best approach for either keeping employees awake or generally for teamsters. In the second type of approach, employees are trained on the laws.<sup>538</sup> AT&T had a dramatic ethics training tape in which a manager walked through all the examples and nuances of the Foreign Corrupt Practices Act. Neither training helps employees with the issues that bother them. For example, many employees witness the affairs married executives have, sometimes among themselves. Their concern is about honor, the repu-

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536. The real question here is, "Am I behaving as WorldCom, Enron, Tyco, and Adelphia employees and officers did?" Perhaps one of the more interesting aspects of the field of business ethics is the enormous sense of immunity businesses feel from falling into the same trap as these Yeehaws did.

537. For a discussion of the stakeholder approach in decision-making, see Anthony J. Daboub & Jerry M. Calton, *Stakeholder Learning Dialogues: How to Preserve Ethical Responsibility in Networks*, 41 J. BUS. ETHICS 85 (2002).

538. The flavor for ethics training programs in companies can be obtained through their Websites. For example, Raytheon Corporation's Website offers full and complete detail on its code of ethics. Its segment on the Foreign Corrupt Practices Act is grounded in the statutory language.

tation of the company, and the possible conflicts and other issues that arise when such conduct surrounds them and the company. What do they do? How do they handle that situation?

Employees rarely face the kind of shoot-out at the ethical or legal corral that involves avoiding federal prison. Instead, employees are asked to book one expense as a capital expenditure. The amount involved is clearly immaterial in a financial reporting sense, but they are uncomfortable with such an interpretation of accounting rules. Where do they go? To whom do they turn? Who can discuss the issue with them? More importantly, what happens when they and co-workers have a series of questionable decisions and calls on financial reporting? How do they stop their companies from trotting down the path of deception in financial reporting?

These day-to-day issues and concerns require discussion in ethics training and forums that permit the exchange of concerns about choices they are asked to make or decisions that are forced upon them by managers. Employees catch on fairly quickly about the impropriety of falsified travel expenses. What troubles them is the way the company is reporting its expenses, ala WorldCom, and how do they go about voicing their concerns? Training should focus on issues they raise prior to the session and the responses they should make and to whom.

#### *Internal Changes: Example*

The dissection of these companies that collapsed also illustrates that no matter how good the code of ethics or the accompanying training, employees will make poor ethical choices if managers do not honor the values and principles the company has written in its code and explains via training. At one company for which the author did culture consulting, the code of ethics spelled out that employees could not take gifts from suppliers or others with whom the company did business if those gifts were valued at over \$25. The rule was clear, part of new employee training, and pervasively violated. Management wanted an explanation for the failure of the rule. A very quick discussion with several employees yielded the answer. Employees knew that the executive team accepted a golf trip to Scotland each year, a trip paid for by a supplier. The cost was about \$15,000 for each officer. When confronted with the inconsistency of their behavior with the policy that executive team indicated that \$15,000, given their salary and bonuses, was really "chump change," and the equivalent of \$25 to them, in relative terms.

#### *Internal Changes: Terminations*

A poor ethical culture breeds when rules are not enforced, or, perhaps worse, when they are selectively enforced. For example, those issuing the checks and providing services for board members at WorldCom were

aware that directors were taking advantage of corporate resources. Yet no action was forthcoming to stop the practices, let alone end the company's relationships with those who were taking advantage of corporate resources. Several studies have concluded that those who are performers within a company are far less likely to be disciplined or terminated for violations. In these companies, CFOs were violating accounting rules (Sullivan), asking for waivers of the company code of ethics (Fastow), and borrowing money from the corporation (Cross), but continued in their positions with great rewards and recognition. They had brought the companies to their pinnacles of success and no one stepped in to halt behaviors that were egregious even under the most lax standards of corporate ethics.

Employees who witness these behaviors, or hear of them, will not only say nothing about this conduct because of their perception that their efforts would be futile; but they will also say nothing about other types of unethical behavior because their perception of corruption continues its inexorable march over the company, consuming those with virtue. Even those employees with high personal standards and, perhaps even at one time, company standards, will succumb to the gradual descent of the culture because they cannot see that those who should set the tone for the corporation are subject to the same standards or rules.

*Internal Changes: Curbing the Social Responsibility Equation*

Many companies have become so steeped in social responsibility and the feel-goodism of everything from donations to volunteer work that the external activities become a substitute or perhaps even penance for the decisions made internally that may violate the law, the code of ethics or basic standards of virtue in terms of honesty or fairness. While the author intends no negative commentary on such beneficence, it is dangerous for companies to tout "good works" as evidence of goodness in operations, quality and financial reporting. The companies analyzed here have taught us that goodness in the sense of social responsibility does not necessarily mean honesty in financial reporting, transactions and decisions and conduct. The risk of such a heavy focus on philanthropy, community involvement and social responsibility is that the employees and officers become so convinced of their goodness that they use that goodness to justify decisions internally. So often the companies, officers and employees involved in good works are told of their goodness that they come to equate the praise with goodness. Indeed, they may even be tempted to move the line even more because of that goodness.

In the movie *Changing Lanes*,<sup>539</sup> Ben Affleck plays a young lawyer (29) who works as a partner in his father-in-law's law firm and comes to

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539. CHANGING LANES (Paramount Pictures 2002).

realize that the firm has embezzled from a client, forged a power of attorney and generally committed every felony a lawyer can commit in the course of representing a client. He confronts his father-in-law and asks how he can live with himself after pulling such stunts. His father-in-law reminds him of the firm's *pro bono* work, its contributions to scholarships, and its construction of museums and music facilities for children. "At the end of the day, I add up what I have done that is good and what is bad. If the good outweighs the bad, I'm happy." In other words, the goodness in a philanthropic sense makes up for the embezzlement. This balancing act is far more prevalent than is realized. Rankings on the companies discussed here among social responsibility funds demonstrate that a free pass on virtue ethics comes to those who can be counted on for philanthropic contributions and socially responsible decisions.

*Internal Changes: Hire Over 40*

The strength required for ethical gumption does not come easily to those who are young and eager. Mr. Ebbers and Mr. Kozlowski described it best when they indicated that they hired the young and hungry. At the heart of these debacles as well as many others to be noted is generally a person between the ages of 28 and 35. Scott Sullivan was 32 when he was made a board member, the CFO and the secretary and treasurer of the board. Andrew Fastow was barely 30 when he began putting together the off-the-books partnerships and LLCs. Mr. Cross was the same age when he began serving at Tyco's CFO. This common element of those under the age of 40 is revealing. Their discernment and experience at that age are limited and they are often used by CEOs who are a full generation older in order to get tasks done to which the CEO would rather not have his name attached. The dot-coms were manned by those in their 20s who rarely had any outside expertise on their boards, let alone those with the wisdom of the business cycle and the preparation for the downturn.

In hiring, one screen to watch for is the MBA degree. Despite the author's affiliation with a graduate school of business, she is the first to confess that the students trained in the MBA are trained in financial wizardry with few absolutes to constrain those dynamics of high finance.<sup>540</sup> Ironically, Mr. Kozlowski's daughters earned MBA degrees from Harvard and Columbia.<sup>541</sup>

This factor has been discussed extensively in a previous work.

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540. One study shows that 76% of MBA students indicated that they would commit fraud by understating write-offs that cut into their companies' profits. The figure for top executives is 47% and for controllers is 41%. Dawn Blalock, *For Many Executives, Ethics Appear to Be a Write-Off*, WALL ST. J., Mar. 26, 1996, at C1.

541. *Resume: L. Dennis Kozlowski*, BUSINESS WEEK ONLINE, May 28, 2001, at [www.businessweek.com](http://www.businessweek.com).

*Internal Changes: The Role of Counsel*

Mr. Belnick's indictment for Tyco misconduct is unique in that it brings lawyers onto the corporate hot seat with the CEOs and CFOs.<sup>542</sup> However, the indictment, whether it stands or falls and regardless of conviction or acquittal, raises what is a critical duty on the part of legal counsel for a corporation, "All corporate officials owe their employer – the company – fiduciary duties. But general counsel have the highest duty because they're supposed to know what the law requires because others will follow their example and because their job is to protect the company from everyone else."<sup>543</sup> Regardless of the provisions under current SEC guidelines and the eventual outcome of the so-called "noisy withdrawal" provision currently under review by the SEC, Mr. Belnick's conduct, whether criminal or simply a gross lack of judgment, teaches important lessons about the role of legal counsel in a company. These lawyers are a point at which employees should have an outlet. That is, employees should have an ear in the form of legal counsel who serve their client, the corporation. Their clients are not the CEO or even the chairman. Their clients are the shareholders and when conduct compromises the interest of those shareholders, they have a duty to take steps to stop that conduct, whether it be through informing the board or by reporting ongoing violations. Their critical role has not changed with any of the Sarbanes-Oxley provisions or even the SEC rules. Their duty remains, first and foremost, to the shareholders.

*Internal Changes: Controlling Employee Investment in Company Stock*

One of the differences between the impact of Enron's and World-Com's collapses and Tyco's is that employees did not lose as much. Tyco had self-imposed a limit of only 20% of its retirement plan assets were invested in Tyco stock.<sup>544</sup> Such limitations not only serve to insulate employees from the cyclical nature of markets and the buffetings of economic systems, but they also serve to reduce the temptation for them to succumb to questionable choices the Yeehaw Culture produces. When employees are heavily invested in the company's stock, they become Yeehaws, willing to risk all in a decision-making process flawed by the failure to see risk.<sup>545</sup>

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542. Laurie P. Cohen, *Tyco's Former Top Lawyer Joins CEO on Hot Seat*, WALL ST. J., Sept. 13, 2002, at C1.

543. *Id.*

544. Christine Dugas & Stephanie Armour, *Rule Saves Tyco Workers' 401(k) Plan From Tragedy*, USA TODAY, June 5, 2002, at 3B.

545. Messick and Bazerman call this ignoring the probability of events, particularly what they would classify as "low risk" events and ignoring the possibility that the public will find out the poor choices that have been made in the interest of preserving the stock's value. Messick & Bazerman, *supra* note 10, at 10.

*Internal Changes: Curbing Aggressive Accounting*

This pattern of creative accounting followed by restatements has been a recurring problem over the past five years.<sup>546</sup> There are three basic accounting areas that cause all the problems: reporting transactions that did not happen or did not generate revenue; recognizing revenue before one should; and failure to follow accounting rules on how much revenue can be recorded and at what time.<sup>547</sup> These companies have offered painful lessons on what can be done in these areas of accounting, and can be done legally, to alter the financial picture of a company for a quarter or a year. Now that these areas of potential abuse are known, companies should develop policies for reporting and reviewing financial numbers in terms of these areas. Because the potential for and ease of abuse are there, companies should have specific policies on reporting in these matters and should establish a means for reviewing the decisions made on booking the transactions.

*Quasi-Internal Changes: The Board*

The quasi-internal changes are easier to make. Shareholder activist and investor Ralph Whitworth notes that companies need to avoid “pet rock directors.”<sup>548</sup> Companies need a crotchety board; that is, they need a board of individuals not afraid to challenge the CEO and managers on their decisions. They are not there to micromanage the company, but they are there for a healthy skepticism. Ross Perot, when he had a position on the GM board, was a gadfly, a bit of a loose cannon. However, Mr. Perot was able to shake up GM sufficiently that the management changed and so did the direction of the company.<sup>549</sup>

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546. Warren Buffett, Chairman of Berkshire Hathaway and called the “Oracle of Omaha” for his ability to see business issues, concerns and invest without losses, says “In recent years its has seemed that no earnings statement is complete without [one-time charges]. Andy Serwer et al., *The Oracle of Everything*, FORTUNE, Nov. 11, 2002, at 20. The origins of these charges, though, are never explored. When it comes to corporate blunders, CEOs invoke the concept of the Virgin Birth.” Clifford, *supra* note 152, at 98. One-time write off frequent flyers are Kmart and Sunbeam. *Id.* Accounting mumbo jumbo such as this “makes things look better than they actually are. It creates a big liability with lousy visibility for investors.” *Id.*

547. Therese D. Pritchard & Sarah P. Swanz, *SEC targets false revenue reports*, NAT’L L.J., Apr. 9, 2001, at C1, C10.

548. Maremont & Cohen, *Ex-Tyco CEO Is Likely to Face Charges Over Unauthorized Pay*, WALL ST. J., Sept. 12, 2002, at A1.

549. For a history of Mr. Perot’s service as a board member at GM, see *Grobow v. Perot*, 539 A.2d 180 (Del. 1988). A flavor for Mr. Perot’s approach to being a board member, “Until you nuke the old GM system, you’ll never tap the full potential of your people.” The GM Board paid Mr. Perot \$745 million to go away and never criticize GM again. The shareholders then sued for the payment. *Id.* Mr. Perot may have been just a tad too crotchety.

The author served on a panel with Mr. Ken Lay in the spring of 1999 in which the topic was corporate governance.<sup>550</sup> Mr. Lay indicated what a CEO expects from a board, "Giving a lot of really good advice, but not too much of it."<sup>551</sup> The philosophy here should be like the saying you can never be too rich or too thin. There can never be too much board input, not meddling, and not managing, but input on the company. There was a telling lack of independence among these companies' boards in everything from their contracts with the corporations, to their use of company jets, to donations to their charities.<sup>552</sup> Those conflicts are not always obvious in the disclosure of their affiliations but necessarily introduce a lack of independence or at a minimum, a compromise of that independence.<sup>553</sup> Board members should be devoid of conflicts in charities, contracts and consulting.

*Quasi-Internal Changes: Separating the Chairman and CEO Positions*

These companies suffered from a structural problem in that, with the exception of Enron, the CEO and Chairman of the Board were one and the same. Separating out those functions provides employees with an authority figure who is not part of the internal management responsible for evaluation, terminations and promotions. In other words, the split function of CEO and chairman is a means of checks and balances for both the board and managers. A CEO who is also chairman controls the board's oversight function and has the ability to control what information comes to the board as well as what is filtered from the board back to the officers, managers and employees. A chairman has control of committee structure on the board, the hiring of the audit firm, and a host of other duties that enable him or her to curb inquiries into issues at the company. Mr. Ebbers, Mr. Kozlowski, and Mr. Rigas were not going to order investigations into issues and concerns raised by employees or hotlines in the companies they were running. This separation of chairman and CEO is akin to separation of powers. While the suggestion of the bifurcation of these duties is hardly new, the lack of companies following such is indicative of its lack of emphasis in corporate govern-

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550. *Corporate Governance: Ethics Across the Board*, Proceedings of the Ethics Conference of the University of St. Thomas, April 1999, at 23.

551. *Id.*

552. See *supra* note 59 and accompanying text.

553. One of the newer potential conflicts is the purchase of multi-million dollar insurance policies on directors so that when they pass on, the insurance proceeds are used to make a donation to the directors' designated charity in his or her name. Some of the nonprofits are even asking corporations to insure directors as a donation. It's all rather morbid with one nonprofit carried as the beneficiary on 1,230 director policies. One can easily see the gaming that could go on with this type of a perk. Heck, one could see zealous members of a Yeehaw Culture as a nonprofit bumping directors off. It would be like *A Pelican Brief* for corporate boards. THE PELICAN BRIEF (Warner Studios 1993); Theo Francis & Ellen E. Schultz, *Dying to Donate: Charities Invest in Death Benefits*, WALL ST. J., Feb. 6, 2003, at B1.



ance.<sup>554</sup> Indeed, AOL Time Warner just announced its new CEO and chairman of the board, and they are one person.<sup>555</sup> A company with that much difficulty in terms of management as well as concerns about its financial reporting has just placed one person in charge of both the internal and quasi-internal functions.

### *Quasi-Internal Changes: Auditors*

Auditors have likewise become inextricably intertwined with their clients on issues that extend beyond the audit functions. It is impossible for an auditor to conduct consulting services and act as an independent auditor.<sup>556</sup> They defy human nature in denying that there is no conflict and only the efficiencies of one company knowing all the systems. There is also the downside of one company being able to conceal its own ineptitude in these systems. While the SEC has tightened the rules, companies with best practices should not permit their auditors to perform any function other than the audit. While Sarbanes-Oxley, the profession, and SEC regs now provide more controls over these conflicts, it remains very much the province of the board to curb the proposed activities of the company auditors even when those proposed tasks fall within the new guidelines.<sup>557</sup>

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554. Charles Schwab relinquished his CEO slot, remaining only as chairman in early 2003, despite his company being successful and quite immune from all the investment banker, broker and analyst scandals of 2002. Cheryl Winokur Munk, *Schwab Gives CEO Post Solely To David Pottruck*, WALL ST. J., Feb. 3, 2003, at C7.

555. This is a company already reeling from losses and so, of course, it bucks the current conventional wisdom and puts one man as CEO and Chairman, Dick Parsons. The stock has gone from over \$60 per share in 2001 to \$14.81 in February 2003. "You've got losses!" Lisa Takeuchi Cullen, *Dialing Up a Departure*, TIME, Jan. 27, 2003, at 46, 47.

556. The most recent conflict revealed was that of Ernst & Young's dual role at Sprint. It served as Sprint's outside auditor, but also served as its tax advisor and created tax shelters for the executives (who are now ousted) of the company because their options placed them into tax brackets that were extraordinary. When the stock crashed, their tax liability still remained the same, thereby placing them in an Ebberts situation in which they had to unload shares to satisfy the tax debt, which meant the dumping of shares on the market which meant further decline in the share price and an impact on all shareholders. Ernst & Young was terribly conflicted on this advice in terms of its loyalty to the company vs. its loyalty to the executives and their personal tax liability. The result has been devastating to all involved. Elliot Blair Smith, *Tax debt piled up for Sprint Execs*, USA TODAY, Feb. 7, 2003, at 1B.

557. Title II of Sarbanes-Oxley is devoted to auditor independence. Section 206 addresses conflicts of interest. 15 U.S.C. § 7213. The SEC's final rules on auditor independence are promulgated at 17 C.F.R. sections 210, 240, 249, 274. They were adopted on January 26, 2003. There are nine categories of services that are deemed to compromise the auditor's integrity with the ninth being a loophole for the SEC to determine anything else it finds is a conflict: The nine categories of prohibited non-audit services included in the Act are:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

### External Changes

When the internal and external forces in a company fail, all should not be lost. There are analysts and a business press that work outside the company and should have the resources and the microphone for honest disclosures about the companies that they cover. While the issues surrounding analyst independence, research, compensation and brokerage are beyond the scope of this piece, they are clearly an external force, which, if operated correctly, could have served to curb the Yeehaw Cultures of these companies even with the complete failure of the internal checkpoints. The reforms, changes and litigation related to analysts continue.<sup>558</sup>

#### *External Changes: Healthy Skeptics in All Quarters*

At least two external groups lacked the skepticism that should be a hallmark of their professions. A sycophantic culture among analysts and the business press is at least partially responsible for investors' continuing reliance on these firms' financial reports and investors' resulting beliefs in their continuing stellar performance. CFO MAGAZINE touted both Fastow<sup>559</sup> and Mark Swartz with its obsequious description of this fallen company as, "Tyco's tightly structured acquisition approach has been an unqualified success, one§ having no need of smoke-and-mirrors accounting."<sup>560</sup>

Here's another fawning description offered by an analyst, "Tyco is a well-oiled machine when it comes to M & A. and Swartz is the one who supplies the grease."<sup>561</sup> It was the short sellers who uncovered the problems at both Enron and Tyco, long before the market adjusted and clearly before any indictments and investigations. Those who stand to make money when

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- Actuarial services;
  - Internal audit outsourcing services;
  - Management functions or human resources;
  - Broker or dealer, investment adviser, or investment banking services;
  - Legal services and expert services unrelated to the audit; and
  - Any other service that the Board determines, by regulation, is impermissible.

See 17 C.F.R. § 210.2-01(c)(4) (2003).

558. For a discussion of reforms, see Patrick McGeehan, *The Crux Of Reform: Autonomous Stock Rating*, N.Y. TIMES, Oct. 7, 2002, at C1.

559. The short sellers were the truly honest ones when it came to Enron, WorldCom, Tyco and Adelphia. Gretchen Morgenson, *The Enforcers of Wall St.? Then Again, Maybe Not*, N.Y. TIMES, June 20, 2002, at C1.

560. Stephen Barr, *2000 Excellence Awards: Mark Swartz*, CFO.COM, Oct. 1, 2000, at <http://www.cfo.com/printarticle/0,5317,1002,00.html>.

561. *Id.* The author once again finds a calling missed. If I'd known bad metaphors would have gotten me a stint as an analyst, I'd be on Wall Street today, with or without intermediate accounting. For background on author and intermediate accounting, see *supra* note 73 and accompanying text. For background on being a Wall Street lawyer, see *supra* notes 366, 563 and accompanying text.

the truth about a company is revealed were the only candid voices in the throngs and they were not well received.<sup>562</sup>

Analysts for these companies and many others really were what Mr. Olson described, schnuckels, who failed to note the evolving problems and fell short for several reasons and combinations thereof.<sup>563</sup> There were clearly conflicts of interest. Even if the internal and quasi-internal checks and balances failed, the analysts should have been a type of judicial branch that was able to step back and provide an accurate assessment of a company's situation that was devoid of the passion of management while fair, yet cognizant of the investors' interests. That review required independent research and evaluation. Yet, the judicial figure in this federal model had conflicts of interest. First, there were the problems with pressures from the investment banking portions of these businesses putting pressure on researchers to release positive information. Often the conflicts were more subtle as in the Ebbers' case in which the investment bankers were giving the CEO first shot at IPOs in exchange for more underwriting business. And the conflicts were even layers deep as in Mr. Grubman's case when he touted a stock in exchange for a CEO's influence in getting his children into an exclusive preschool.<sup>564</sup> In some companies, researchers' compensation was tied to the retention of certain clients, and those clients would not stay put if the analysts issued negative recommendations.

In short, the market lost one of its fundamental checks and balances when analysts became conflicted and failed to use candor in their evaluations of these companies and many others. Changes in this industry are absolutely necessary if this external check and balance is to be restored. There are many proposed solutions, but the key is the independence of the researchers. There is some resistance to changes that would make the researchers separate entities because their compensation would necessarily be reduced because they would not have performance measures tied to the other portion of the firm that does investment banking. However, analysts risk losing relevance and surrendering their function to those who proved effec-

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562. David Tice of Prudent Bear wrote in 2000 that Tyco was taking restructuring reserves that were too large, and James Chanos (also spoke up on Enron) wrote that Tyco played "stub" games or the practice of making the acquired firms look like dogs so that performance improves dramatically. Herb Greenberg et al., *Does Tyco play accounting games?* FORTUNE, Apr. 1, 2002, at 83, 85. For more information on acquisition accounting, see *supra* notes 352-66 and accompanying text.

563. See *supra* note 14 and accompanying text (discussing all four companies of folks buying these shares in these companies for more information on schnuckels, aka, dupes).

564. Charles Gasparino et al., *Citigroup Now Has New Worry: What Grubman Will Say*, WALL ST. J., Oct. 10, 2002, at A1. Mr. Grubman promised to be kind to AT&T in his evaluations as an analyst for Sanford Weill, the CEO of Citigroup, the parent of Salomon, Mr. Grubman's investment firm. The CEO of AT&T served on Weill's board, and the author does mean Weill's board. Mr. Grubman's take was a recommendation for his twins to attend a swank Manhattan preschool.

tive arbiters of financial hocus pocus – the short sellers. There were short sellers who positioned themselves well when it came to Enron, WorldCom and Tyco. Their simple questions about cash, meeting numbers with such precision, expenses that were opulent and not possible on thin margins put them in the position of knowing that the stock price for these companies would eventually decline.<sup>565</sup>

*External Changes: Academics*

It is ironic that Professor Michael Useem would be chosen to head up Tyco. Mr. Useem is the director of the Center for Leadership and Change at the Wharton School, but he was also a man who was so enamored of Dennis Kozlowski when he interviewed him in the lunch room at Tyco's humble New Hampshire headquarters in 1992, that he called Mr. Kozlowski a "superstar" and "miracle maker."<sup>566</sup> Useem even attended a boot camp for CEOs taught by Mr. Kozlowski. A Yeehaw Culture doesn't disappear when there are those on the sidelines who genuflect at the iconic CEO.<sup>567</sup> Worse, Professor Useem writes of change at Tyco as if it were some academic exercise, "Company governance should be a matter of building an enterprise to last, and for this the chief executive must be an integral part of any board, not isolated from the independent majority on it."<sup>568</sup> Mr. Useem fails to recognize what he failed to recognize when he first interviewed Mr. Kozlowski, "I took character and integrity for granted."<sup>569</sup>

Enron also had its Samuel Bodily, a professor at the Darden School in Virginia who spent the final months prior to Enron's collapse filming a case study to be used to tout the company's magnificence and apparently never spotted the crumbling walls around him or the Yeehaw Culture that could lead to only one outcome.<sup>570</sup>

*External Changes: Investor Demands and Attitudes*

A certain amount of culpability rests with the investors in what was a phenomenal ride in the market that then crashed. Investors abandoned the basics of business and the reality of economic cycles, demanding more and more from companies. Their reactions to the slightest departure from forecasts have created enormous pressure on the internal and quasi-eternal ele-

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565. The author can only cite that what goes up like these stocks, must come down.

566. Louis Lavelle, *Rebuilding Trust in Tyco*, BUSINESS WEEK, Nov. 25, 2002, at 94.

567. Barbara Ley Toffler, adjunct at Columbia University, phrases it this way, "Major corporate figures like Kozlowski seem to attract pet academics who become cheerleaders for them. I think they become blind to the flaws. I suspect that's what Mike Useem did with Kozlowski." Lavelle, *supra* note 566, at 94.

568. Michael Useem, *What Tyco Tells Us*, WALL ST. J., June 5, 2002, at A18.

569. Louis Lavelle, *supra* note 566, at 94.

570. Samuel Bodily & Robert Bruner, *What Enron Did Right*, WALL ST. J., Nov. 19, 2001, at A20.

ments of this Federalist model. Investors need to send signals to companies that respond to the fatal crashes by implementing changes that demand honesty in financial reporting and a focus on long-term and sustained results that may be fluctuating and may not meet forecasts precisely, but do serve to provide a return for the investors. The unreasonable demands of investors pushed company executives into survival mode that resulted in poor judgment and eventually collapse. Many CEOs today still rationalize questionable accounting decisions because of their desire to preserve shareholder value. Investors push managers into treacherous territory with demands for market-defying returns. The Federalist model begins with recognition of individual rights among employees and ends with individual investors and the self-curb of their demands in order to allow the company to achieve long-term goals. Consistent with the Federalist notion, there is self-imposed restraint that has individuals curb their desire to usurp the power given to individuals within the corporation.

### **Changes for All – Watch for the Warning Signs Evidenced by These Collapses**

In addition to the Yeehaw Culture patterns, the collapse of these companies has also given up some universal warning signs that should put employees, directors, analysts and regulators on the alert for watching certain companies. *Directors & Boards* published its list of “Fifty warning signs of impending trouble.” Among the factors:

- High tech field
- Arrogant, autocratic or highly risk-taking management
- Mergers and Acquisitions
- High leverage
- High multiples
- Declining margins and increasing revenues
- Large off-balance sheet debt
- Aggressive financial posturing: derivatives, hedging, futures
- Reserves accounting issues
- Dependence on a few suppliers or customers
- Weak internal controls
- Outside directors do not meet regularly or attend meetings regularly
- More than two inside directors

- Assets vulnerable to devaluation
- Revenue without cash
- Receivables without revenues
- CEO or CFO unexpectedly leaves<sup>571</sup>

### CONCLUSION

The Yeehaw Culture in an organization breeds all manner of corruption and resulting destruction. However, it is not a culture that develops suddenly. Nor is it a culture that corrupts completely. The most compelling parts of all these companies' stories of collapse are that individuals within the company were able to see the concerns, issues and missteps. In hushed whispers in company corridors and coffee rooms and in the comfort zone of the humor of anonymous e-mail, they expressed their frustration. There were those with virtue who were still a part of these companies. They knew that saying "no" to the creeping culture and demands for exceptions to the rules was necessary. Unfortunately, they had no forum for saying, "No."

Ethical gumption, despite the oppressive nature of the Yeehaw Culture, was still present in these companies. But, there were no releases for virtue. As was the case with the Federalist papers, the belief and commitment centered on individuals and rights. The only role of government was to put systems into place that preserved and protected those rights. In these companies the Yeehaw Culture continued to grow and expand because each of the existing internal, quasi-internal and external checks and balances of corporate governance failed. With each failure, individual virtue was suppressed further. Rights are lost without protection from oppression. So also is virtue in a corporation lost without nurturing by protective corporate governance.

Implementing the three branches of checks and balances for curbing the Yeehaw Culture requires new attitudes about corporate governance, but the checks and balances proposed here serve as the outlet for the percolating virtue within employees. Rather than constraining truths about financial condition, performance and conduct of officers, checks and balances bring truth to the forefront through a full boil. The checks and balances allow the thermostat to be seen and thereby reveal the true cultural temperature. Can the Yeehaw Culture be prevented, or at least curbed? Yes, unequivocally, yes. Virtue in the corporation never died. Its existence in individual employees, on whose gumption we must rely for effective corporate governance, was simply suppressed by unchecked and, too often, unbalanced Yeehaws.

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571. To request a copy of this article, see [www.directorsandboards.com](http://www.directorsandboards.com).

