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BERNIE'S BAD IDEA

Bernie Ebbers, the founder of WorldCom, had made a very bad bet and lost. The broadband business he had so ruthlessly built with other people's money was being billed as the biggest corporate con in the history of America—even bigger than Enron. Ebbers had made the fatal mistake of believing his own hype, even as he bilked investors of their money.

It was March 2002 when it all started to unravel. The Securities and Exchange Commission (SEC) had finally caught on to the shenanigans at WorldCom and started an investigation. In a month, Ebbers would resign. Ebbers' coconspirators, WorldCom Chief Financial Officer Scott D. Sullivan and Controller David Myers, had been grilled by the Internal Audit Committee and would ultimately be fired from the company. On August 1, they would surrender to the police, knowing they faced at least five years in prison, hefty fines of $250,000 and several counts including securities fraud, conspiracy to commit securities fraud, and filing false statements with the SEC.

Bernie Ebbers, king of bandwidth, telecom titan, and corporate conqueror like none before, could be next. Every step that Sullivan and Myers would take to the police car waiting for them outside New York's posh Hotel Elysee would take Ebbers farther away from his empire.

"Fifteen unbelievable years and two very challenging years" is how Bernie Ebbers would describe his tenure at WorldCom on his 17th anniversary at the company on April 30, 2002.[1] That would also be his last day at the company he had started in a Mississippi coffee shop in 1983.

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Ebbers' story is classic American fare: an immigrant from a tiny town who made it big but in the end became the victim of his own success. Had he been manipulated by Wall Street shysters, or had the money been corrupting his soul one step at a time?

Ebbers' life began 60 years ago in a working-class neighborhood in Edmonton, Alberta, in western Canada. He attended Victoria Composite High School in Edmonton and supported himself through high school by working as a milkman and as a bouncer at a bar. It seemed like he was going to have an average working-class life, when his luck turned. Mississippi College, a small Baptist college in Jackson, Mississippi, offered the six-foot-four Canadian a basketball scholarship. He accepted, went to Jackson, got an undergraduate degree in physical education, and settled down in nearby Brookhaven. He worked as a basketball coach first, and then invested in a motel in Colonel, Mississippi, in 1974, which, after some hard work and savvy deal making, grew into a collection of Best Westerns in Mississippi and Texas. Along the way, he also acquired a car dealership in Columbia, Mississippi. By 1983, nine motels in the two states were controlled by his company, the Master Corporation.

At that time AT&T, then the largest phone company on the planet, was in the process of breaking up into AT&T and seven local phone companies. The breakup was the result of a federal action prompted by lobbying and efforts of MCI, then a small long distance provider. Now anyone, however small, was free to compete for the phone dollars. Recognizing the winds of change, in 1983, Ebbers got together with four investors to fund a long distance reseller. WorldCom folklore has it that Ebbers and the three other investors, Bill Fields, David Singleton, and Murray Waldron, hatched the blueprint of the company at a Hattiesburg coffee shop. The company's original name was apparently suggested by a waitress who inquired about what kind of company they were planning. According to WorldCom's 1998 annual report, "[the] waitress walked away for a few minutes and came back with a napkin on which she had scribbled the letters "LDDC"—Long Distance Discount Calling. Later the name was changed to Long Distance Discount Service (LDDS).

"We got in as passive investors, saw the gold at the end of the rainbow, and thought it was going to happen the next day. It didn't work out that way," Ebbers later told the *Jackson Journal of Business*.[2] Instead, the company lost large sums of money in the first two years. The investor group decided to put Ebbers in charge. He was the perfect choice: A penny-pincher, he got the company to focus on small business customers who spent less than $20,000 a year on long-distance phone calls. The big guns like AT&T and even MCI ignored this segment of the market, focusing instead on Fortune 500–type companies that ran up huge phone bills. Ebbers figured it was easier to nibble at the long distance market in untapped segments than to take on AT&T and MCI from the word go. By employing this strategy, his company was able to stay just below the radar and survive on telecom crumbs for the next decade. But soon mere crumbs would not be enough to feed Ebbers' increasing appetite.

After the AT&T breakup, several long distance discounters had the same idea as LDDS; they, too, had set out their shingles and gotten into the telecom business. But, like LDDS, most of them were struggling because they either lacked hardware expertise or were run by telecom engineers with no marketing and sales savvy.

Ebbers quickly figured out that his company, which had both of these shortcomings, needed to get outside help. He found engineers and outsourced the hardware side of the business, but he still needed a marketing whiz. At a trade conference, Ebbers happened to met Diana Day, a former copywriter for a local television station who had once also done public relations for the Mississippi Republican Party. Day was working for a telecom reseller and was bored out of her mind when she met Ebbers, who decided to give her a shot at marketing. Turns out it wasn't a bad bet. Day turned things around for WorldCom: Sales skyrocketed from less than $1.5 million in 1984 to $3.3 million in 1985 and $8.6 million in 1986.[3]

Around this time, Ebbers came up with another idea—growth through acquisition. It was a fairly simple strategy: Buy a company, keep its sales team, absorb its customers, and use LDDS's cheap infrastructure. By 1987, Ebbers' LDDS had bought five companies, mostly in the South. It was a perfect way to boost sales and become a big fish in, admittedly, a small pond, while staying away from AT&T, MCI, and Sprint.

Bernie focused on customer service. He knew that if LDDS paid attention to its customers, it wouldn't be long before more business would flow his way. While large companies typically ignored the small customers and treated them with scorn, customer service was his company's hallmark in the beginning, with the company providing affordable long distance to everyone. It soon seemed that Bernie Ebbers was on his way to becoming the Sam Walton of the telecommunications industry.

In 1989 LDDS acquired the publicly traded long distance reseller Advantage Companies of Atlanta, Georgia, and through the acquisition, LDDS became a public company. Also as a result of this acquisition, a key partner in future shenanigans, Stiles A. Kellet Jr., came into Ebbers' supernova. Kellet was the chairman of the board of Advantage and became an LDDS board member after the merger. In later years at WorldCom he would play a vital role in the great worldcon.

Ebbers was now in contact with Wall Street and its financial analysts. One of them was Jack Grubman, then an analyst at the New York investment bank Paine Webber, who was eventually to play a major part in the rise and fall of Bernie Ebbers. "We both come from the wrong side of the tracks vis-a-vis the financial community. And I can relate to him far better than most people I deal with. Bernie and I would have a strategic session in Jackson, and it usually was while shooting pool and drinking beer," Grubman would later say.[4]

Then, in December 1992, LDDS acquired another long distance reseller, Texas-based Advanced Telecommunications, for about $850 million. Ebbers' life was about to get complicated. This acquisition brought with it a man called Scott Sullivan. When LDDS bought Advanced, Sullivan signed on as assistant treasurer for LDDS and was promoted to chief financial officer of the company by 1994. At about the same time, Jack Grubman quit Paine Webber and joined Salomon Brothers.

If Grubman became the one who encouraged Bernie to grow bigger through acquisitions, then Sullivan was the one who massaged the balance sheets to make it happen. The unholy troika was complete. Ebbers soon went on an acquisition tear, and the "Bernie and Scott show," as Wall Street dubbed it, had begun. Bernie would become the face of the company, Scott would bleed the acquisitions dry, and Jack would be the shill who would tout the company's stock. LDDS shares started to go through the roof, giving Ebbers more currency to continue his shopping spree.

To the outside world, Ebbers was becoming the monster with the insatiable appetite for telecoms, but in reality it was Sullivan who did the grunt work and was the real force behind all those deals. While Ebbers pranced around like a cowboy, Sullivan was busy explaining the various mergers to Wall Street. A former General Electric executive and Klynveld PeatMarwick Goerdeler (KPMG) accountant, he was quiet, had a way with numbers, and was the exact opposite of Ebbers' aggressive, in-your-face personality. Had it not been for Sullivan, Ebbers would not have had the gumption, or the knowledge, to sell the complicated mergers to Wall Street.

Surprisingly, the two men got along famously despite their contrasting personalities. They had adjoining offices and were often seen having lunch at the company cafeteria. Ebbers was a very suspicious man and a bit of a control freak. He never hired a chief operating officer and instead relied on a mere accountant to help run his business—perhaps because he didn't want anyone to know the real facts. No one dared question Bernie and his ways. But he trusted Sullivan.

In December 1994, Ebbers bought IDB WorldCom, an independent long distance phone company, for $936 million, and changed his company's name to WorldCom—a more grandiose moniker befitting its new stature. A year later WorldCom bought Williams Technology Group, also known as WilTel, a network carrier, for $2.5 billion. By the end of 1995, WorldCom had sales of $3.9 billion and debt of $3.4 billion—the debt-to-revenue ratio was perilously high, and would remain so for the entire history of the company. But even then, no one on Wall Street dared question Bernie. He would stride into meetings with investors, his chief financial officer Sullivan at his side, put up a graph showing WorldCom's share price headed up, and smugly ask: "Any questions?" Ebbers got more audacious with every acquisition. For a while, it seemed there was no price he couldn't afford.

St. Bernie Rises

Ebbers' rise to the top and his newfound riches made him the new savior of Mississippi, one of the most underprivileged states in the country. He raised funds for local colleges, donated to charities, and employed thousands. He taught Sunday school at his Baptist church, served meals to the homeless, and helped get an economic revival going in Mississippi. In his adopted hometown, he became St. Bernie!

The company built a shiny new office in Clinton, a town of 24,000 quite close to Jackson, the state capital. Ebbers' company hired interns from local colleges and became a major sponsor of civic activities such as arts and crafts fairs and street festivals. He may have been a billionaire, but to the people of Mississippi he was one of them. Once he vowed that he would leave the state "only in a box." He drove an old, dented Ford truck that had a loose fender, wore blue denims and boots to work, and even wore a pair of jeans with a tuxedo jacket to his second wedding in 1999.

People would often see him walking about town chomping on a cigar. He would play pool, drink beer, and chat with locals as Willie Nelson music played in the background. Ebbers became so popular in the Jackson-Clinton area that people mentioned him as a possible gubernatorial candidate. But his long, flowing hair and homilies made him seem more like a country-and-western singer than a top chief executive or a possible governor. Ebbers' act worked especially well with investors. They quickly developed a cultlike following for their hero, who would say things like "I'm no technology dude."

But behind the folksy façade, Bernie cultivated a taste for the good life. He was so caught up in his image as a takeover tycoon that he bought a $60 million yacht and named it *Aquasition*. He got other trappings of success as well, such as a stake in a minor league ice-hockey team, the Bandits, and a 900-acre farm that included a 100-acre lake. He built a million dollar mansion and a stone-cedar lodge. In 1998, he acquired a 164,000-acre ranch north of Vancouver, British Columbia, for $68 million. The ranch had 11 lakes, 22,000 head of cattle, some 300 horses, and sundry businesses.[5] It was almost the size of the state of Rhode Island. According to published reports, Ebbers not only bought the ranch, but he also bought timberland in the American South and a yacht-building company in Savannah, Georgia.

Along with the wealth came arrogance. He threw out a local reporter at a stockholders' meeting because he didn't like what the scribe had written.[6] While he publicly preached Christian values, it is said he would stay up late drinking with executives at WorldCom. He left Linda, his wife of three decades, and openly courted a WorldCom saleswoman, Kristie, who was also married at the time. "It's so inappropriate the way he wears his Christian banner. The people down here refuse to accept the hypocrisy," said a local Jackson real estate agent of Bernie's antics.[7]

Increasingly, it seemed like Bernie's once folksy aspirations were taking a sharply more ambitious turn. With the advent of the technology boom in the mid-1990s, Bernie saw his chance to trade up from mere telecom crumbs to the meat and potatoes of the next telecom revolution: broadband. With all the hype surrounding the Internet's potential, the fact was that most people were stuck in a world of dial-up modems. The vision was that this narrow, slow channel would soon be replaced by a much bigger pipeline over which one could get blazing fast access to CNN.com, listen to music, or even watch movies. This high-speed connection, 50 times the speed of a slow modem, is called a broadband connection. Broadband connections need big infrastructure, the kind Ebbers was slowly acquiring.

In fact, WorldCom had stealthily become the quintessential example of an old-style phone company that got a broadband makeover. Gone was the company's customer-centric focus of yore. In a full-scale about-face, Ebbers baldly admitted that his customers were now his investors. He told *BusinessWeek*, "Our goal is not to capture market share. . . . Our goal is to be the No. 1 stock on Wall Street."[8] WorldCom shareholders loved Ebbers, and he became the king of takeovers. By the time Ebbers got the boot in 2002, he had bought about 70 companies and pushed the stock up 7,000 percent, (before it became worthless paper), making many people very rich, including himself.

Masters of the Internet

One of the driving forces in WorldCom's rising stock price was UUNet, a pioneering Internet provider that the company acquired in 1996 through its acquisition of MFS Communications.

UUNet was the brainchild of Richard Adams, a Cleveland native and an alumnus of Purdue University. Adams used to work for a Defense Department contractor called the Center for Seismic Studies (CSS), in Arlington, Virginia. CSS was connected to Arpanet, a government-owned network and a precursor to the modern Internet. Adams also became part of an organization called USENIX Association that was formed by computer geeks in Virginia and nearby Washington, D.C. What united the group was a love for UNIX, a type of high-end software operating system and programming language. Adams told the *Washington Post* in 1996 that most of them wanted to get connected to Arpanet mostly to exchange e-mails. "I do remember thinking, if people were begging you to take their money for this, that's the business I want to be in," Adams said.[9]

The association pooled together $250,000 and asked Adams to put together an experimental network that could provide USENIX members with some links. In 1987 this became a not-for-profit company that Adams named UUNet, after the UUCP, the Unix-to-Unix Copy Protocol. Eventually, in 1989, Adams quit his job, took the company out of USENIX, and moved it into his home. He had four employees and about $1 million in revenue, mostly from USENIX members. A year later UUNet became a for-profit company.

In 1992, a chance meeting with Mitch Kapor, the founder of the software company Lotus Development, resulted in the first investment in the company. By then UUNet was making about $500,000 in profit every year on sales of over $6.4 million. The pesky little start-up was getting attention. MFS Communications, a small local phone company started by James (Jim) Crowe (who would later start Level 3 Communications), came calling.

Jim, the son of a decorated World War II hero, had worked for the Omaha-based construction giant Peter Kiewit Sons. There he met Walter Scott, the company's chief executive, and in 1988 convinced Scott to back MFS. Scott put about $500 million into the company, which went public in 1993. MFS had been wooing UUNet for a while and had made an $8 million buyout offer, but Adams demurred and held out for a better price. In five years, Adams' stake would be worth $560 million (according to *Forbes*), though he didn't know that at the time.

Meanwhile, Kapor's investment resulted in the influx of more venture capital money—about $12 million from Menlo Ventures, Accel Partners, New Enterprise Associates, and Hancock Venture Partners. Adams' share fell from 98 percent to 15 percent of the company. The new investors insisted on more professional management, but that resulted in a mutiny. It was a classic suits-versus-geeks battle. The geeks, led by Michael O'Dell, who had joined UUNet earlier as the chief technology officer, were experts in networking technologies. They were the only ones who knew how to keep UUNet running, and they ultimately won the battle.

Hoping to calm things down, UUNet's backers hired John Sidgmore, a General Electric veteran, as chief executive officer. Sidgmore, who had spent 14 years at GE Information Services, had recently sold Intellicom Solutions, a telecom software company, for $100 million to Computer Sciences Corporation. He accepted UUNet's offer and joined as CEO in 1994.

The company shifted its focus from retail customers to corporations and began building a worldwide network that could service large corporations like Wall Street banks. Since most of these corporations had global operations, they needed the means to exchange data and communicate with each other. UUNet would install special phone lines that would handle data traffic at lightning speed.

UUNet also became the company that would provide the backbone for Microsoft's much-vaunted online service, the Microsoft Network (MSN). MCI, AT&T, and other smaller rivals that had started copying UUNet's business strategy were left agog. As part of the MSN deal, Microsoft bought 17 percent of the company. UUNet and John Sidgmore had arrived.

There was no one who could speak with more authority about the Internet than Sidgmore and his geeky sidekick Michael O'Dell. After all, they were the first ones to arrive at the commercial Internet, and they were building the biggest and the most cutting-edge network in the world! Everyone acknowledged their leadership.

Three months before Netscape's historic IPO, UUNet announced its initial public offering, underwritten by Goldman, Sachs & Co. On May 25, 1995, the stock was offered at $14 a share, and closed the day at $26 a share, having reached $28 a share in intra-day trading. The company raised $68 million, and John Sidgmore was richer by about $34 million. The subsequent Netscape IPO in August 1995 and ever-bullish analysts pumped the stock market higher.

The fascination with the Internet was just getting started. UUNet went on an acquisition binge in Europe, hired hundreds of people, and the stock hit $93.25 a share in November 1995. Soon UUNet was gracing the covers of magazines, and its employees became the icons of the new gilded age. In October 1996, *Forbes ASAP*, the now-defunct technology supplement of

Forbes magazine, featured a photo spread on the company, 40 of whose 700 employees were millionaires.

Ahmar Abbas remembers the halcyon days well. Now a principal at the research firm Grid Partners, he joined UUNet in May 1996 in the company's sales department. He had previously worked at Salomon Brothers, which was an early UUNet customer. There were 130 employees who worked at UUNet then, and "it was so small that you did everything," he recalls. The big moment came when UUNet signed a deal with Microsoft to build out its dial network.

Abbas called the pace frenetic. When he joined, the company was selling ten high-speed connections, known as T-1s, per month, and when he left four years later the number had risen to 2,000. The number of dial-up ports—points that most of us connect to when we try to log on to the Internet using, say, America Online—increased from 100,000 to 4 million, and the company expanded to 28 countries. But no party lasts forever, and in 1996 new competition emerged in the form of AT&T and MCI, both of which started to chip away at UUNet's almost-dominant market share by launching their own Internet initiatives. Some of the wind went out of UUNet's sails.

In addition, other competitors such as PSINet of Herndon, Virginia, and Netcom On-Line Communications of San Jose, California, were getting a lot of play in the media for their consumer-centric approaches, and their stocks were on an upswing as a result. People had assumed UUNet's dominance of the Internet access business, but tough competition made Wall Street ask tough questions. And when AT&T announced its WorldNet Internet access service, investors soured on UUNet. The company had to shelve its secondary offering, and by March 1996 the stock had sunk to the mid-$20s per share. Sidgmore needed money to complete the UUNet network and to expand, if he was to stay ahead of the game. "It was clear that we needed to go with a big company, for we didn't have the money to build out the infrastructure," recalls Abbas.

Sidgmore knew the game was up. Soon after joining UUNet, Sidgmore had tried unsuccessfully to merge the company with Netcom. Now, when MFS Communications showed up again, this time with a $2 billion buyout offer—a 100 percent premium over the UUNet stock price at the time—he decided to accept it. After all, MFS Communications had one of the best-performing stocks in the market. On May 1, 1996, UUNet was sold. Sidgmore and O'Dell still had solid reputations. They had become the gurus of the broadband world, and their words—"Internet traffic is doubling every 100 days"—became the gospel of the new economy. Even the U.S. government quoted their line in its reports.

The Great Internet Myth

Think of "Internet traffic doubles every 100 days" as an urban legend—along the lines of the Neiman Marcus cookie recipe. One of the many things the Internet has helped Americans exchange is urban legends, and a classic example of these myths, which are usually sent via e-mail, is one that tells the supposed story of a Neiman Marcus customer who accidentally bought the company's chocolate chip cookie recipe for $150. The customer allegedly took revenge on the company by distributing the recipe via e-mail.

Just like that myth that has circulated for years, during the broadband boom of the 1990s, "Internet traffic doubles every 100 days" was a legend that, instead of bringing ordinary citizens to write angry letters to a department store chain, convinced executives, analysts, venture capitalists, and retail investors to pour billions of dollars into telecom companies. The belief in this legend resulted in the mad rush of money into new start-ups, be they makers of telecom equipment, cable modems, broadband service providers, or even book retailers such as Amazon.com. Even otherwise conservative venture capitalists poured billions into broadband companies. Wall Street also got into the act and sold bad business ideas to the unsuspecting masses.

But Andrew Odlyzko, a research scientist for AT&T Labs in Florham Park, New Jersey, didn't buy it. In 1997, Odlyzko and his colleague, Kerry Coffman, decided to undertake an academic exercise to analyze data available from AT&T and other major Internet providers such as MCI and BBN Planet. UUNet, which by then had been acquired by WorldCom, kept its information under lock and key. Odlyzko and Coffman spent almost a year analyzing the traffic patterns on the Internet and wrote a paper, "The Size and Growth of the Internet," which was released to the public in October 1998. Their findings proved that the whole notion of Internet traffic doubling every 100 days was hogwash. The duo had found that Internet traffic was only about doubling each year, or, more precisely, that it was growing at between 70 and 150 percent a year.

No one wanted to believe them, and they were dismissed as two musty academics working for AT&T, a company that was scandalously late to the Internet business. Even their corporate employer didn't take them seriously. "I was discounted by everyone and the AT&T management was not supporting me, so it was no surprise that the WorldCom hype machine succeeded," said Odlyzko, who quit AT&T in 2001 and now works as the director of the Digital Technology Center at the University of Minnesota in Minneapolis.

"Over the years, every time I tried to trace the rumors of 'Internet traffic is doubling every three or four months' to their source, I was always pointed at folks from WorldCom, typically [Bernie] Ebbers or [John] Sidgmore. They, more than anyone else, seemed to be responsible for inflating the Internet bubble [until it collapsed on them]," Odlyzko noted in an e-mail.[10] "Many times, inside AT&T, when I would bring up the studies Kerry Coffman and I had done showing that Internet traffic was only about doubling each year, this work would be dismissed with remarks of the type, 'But Mike Armstrong was at XXX last month and heard Bernie Ebbers say explicitly that UUNet traffic is doubling every 100 days. We just have to try harder to match those growth rates and catch up with WorldCom,' " Odlyzko wrote in that e-mail message.[11]

Every time Odlyzko put up an argument, it was like screaming into a 100-mph gale-force wind. And even if he did get a chance to get a word in, it would immediately be countered by someone from WorldCom and its UUNet division. Odlyzko and Coffman had no chance of winning the argument. They were speaking in bits and bytes while the others were spouting the new lingo of billions, which was much more palatable.

Thanks to some great media positioning and public relations strategy, UUNet had been deemed the "Internet authority." UUNet executive John Sidgmore and his trusted lieutenant and chief scientist Michael O'Dell were the St. Paul and St. Peter of the Internet religion. Whatever they said must be true, everyone reasoned. Their sayings were just the kind of mantra the broadbandits needed to raise capital and justify their spendthrift ways. WorldCom's hype machine would issue press releases with statements like this one: "With dial access demand growing at the rate of over 10 percent every week and traffic over the backbone almost doubling every quarter, UUNet Technologies, Inc., the largest provider of Internet services in the world and a subsidiary of WorldCom, Inc., announced today that it has initiated the most ambitious network expansion plan in the company's history."[12]

In an interview with *Telecommunications* magazine in August 1997, Sidgmore touted the hypergrowth model. "We're seeing growth at an unprecedented level. Our backbone doubles every 3.7 months, which means that it's growing by a factor of 10 every year. So three years from now, we expect our network to be 1,000 times the size it is today. There's never been a technology model with such an extraordinary rate of growth like this before. So the big challenge is to deploy infrastructure fast enough to accommodate such a growth rate. We're in a supply-constrained economy for the first time in the telecom industry," he said.[13]

"Sidgmore came up with the Internet number and everyone took him at his word. He knew that UUNet bandwidth was not growing at the speed that they were telling the customers and everyone else," says Roy Bynum, who came to WorldCom in 1998 as part of the MCI acquisition. Bynum, one of the earliest champions of the Internet at MCI, along with a few dozen employees, had made MCI a worthy competitor to UUNet. "Yes, there was a period of time when commercial Internet traffic doubled every 100 days, but that is true of every new network service [since it starts from a near-zero user base] such as ATM or Frame Relay, when it was first created," Bynum continues. "Internet traffic was doubling every 100 days only during the initial commercialization and the initial rollout of the new HTML Web browser, Netscape, in 1995 and 1996 and, to some extent, in 1997.

"After 1997 and the initial surge, the whole spiel about Internet traffic doubling every 100 days became a scam. It was a very positive scam, so there were a lot of people who wanted to believe it because they could potentially make money from it," added Bynum. "Ebbers and Sidgmore were presenting to everyone that bandwidth at the core of the network was growing, but that was simply not true."

Despite all the talk about broadband and the need for fatter pipes, it was the slow and unfashionable business of dial-up Internet access that was supporting the revenue base at UUNet. It is rumored to have accounted for nearly 50 percent of total revenues. "The whole Internet protocol side of the business never really made money, and it was the dial-up network that was making money," recalled Abbas.

That might explain why MFS's head honcho, Jim Crowe, decided to sell the company to WorldCom a scant three months after it announced it was acquiring UUNet. For the first six months of 1996, MFS had a net loss of $193.5 million on revenue of $416 million. They needed to flip the company—fast. So when Bernie Ebbers came to town and offered to buy it, Crowe didn't refuse his $14 billion offer. Ebbers was looking for Internet pizzazz. The long distance business, thanks to the brutal price wars, wasn't the cash cow it had once been, and WorldCom desperately needed to boost revenue to keep its share price high. Higher share prices would give Ebbers the currency to continue his expansion binge. He had to keep gobbling up rival companies or his house of cards would come crashing down. So, after MFS, his next target became MCI.

Battle for MCI

MCI started in 1962 in Springfield, Illinois, under the name Communications Consultants. Its goal then was to sell General Electric's radical new two-way radios. The partners in this enterprise were Jack Goeken, a General Electric representative and owner of Mainline Electronics; Donald and Nicholas Philips; Leonard Barrett; and Kenneth Garthe. Since Springfield didn't have a GE dealership, the quintet decided to make the Illinois capital the headquarters.

Initially, the business did better than they expected, but they ran into trouble when another GE representative complained that they were selling radios in his territory, and GE withdrew Communications Consultants' license. Goeken then came up with the idea that the company should build a microwave network—that is, a string of microwave transmitters and receivers—to connect St. Louis to Chicago. The route between the two cities was a heavy trucking route, and a network would help the truckers continuously use their radios to stay in touch with people at their home base. On October 3, 1963, they started Microwave Communications Inc., or MCI. But in order to build the network and offer the service, Goeken needed permission from the Federal Communications Commission.

The service MCI planned to offer looked like phone service to AT&T. MCI's microwave technology could easily replicate the AT&T network, and that worried Ma Bell. It was a threat to its monopoly, and AT&T did everything it could to crush the upstart. By 1964, MCI's finances were in the doldrums and Donald Philips decided to bow out of the partnership. The company would be dragged through legal battles for the next few years, each year pushing it closer to the financial brink. They had no FCC approval, no money, and no network.

In 1968, Bill McGowan, a venture capitalist of sorts, heard about MCI. McGowan had grown up in a coal mining town in Pennsylvania, gone to college on the GI Bill, and later attended Harvard Business School. He loved the idea of taking on AT&T. He had connections on Wall Street that would help with the funds to build a network when and if MCI got FCC permission.

McGowan offered $35,000 for 50 shares of MCI. He convinced MCI's shareholders to incorporate a new company called Microwave Communications of America, Inc., in Delaware. The ownership was split four ways between McGowan, Goeken, MCI, and a new entity that eventually became Micom. In 1974, Goeken stepped down as president (he left MCI three years later), and McGowan was put in charge of operations. A new era was beginning, but it would still be years before MCI could raise money, build its network, and offer its services to customers.

McGowan desperately wanted to unseat AT&T's monopoly and make MCI a profitable company. The story goes that he kept a cracked AT&T cement block logo in his office, just to remind him of his real objective in life. His efforts eventually did result in AT&T being declared a monopoly and in its subsequent breakup in 1984. By then, MCI had employed so many attorneys to duke it out with Ma Bell that telecom wags described the company as a "law firm with antennae."

The company, now free to compete, built a nationwide network, thanks in part to liberal funding raised for the company by junk bond king Michael Milken in the 1980s. An aggressive sales strategy combined with a weakened AT&T was all McGowan needed to turn MCI into a multibillion dollar company. Its long distance phone service offerings proved a hit with corporate customers. MCI built a nationwide fiber-optic network that was more efficient than Ma Bell's networks, and this helped MCI offer even better prices to its customers. Sales boomed. McGowan was a great motivator and innovator, and he nudged the company toward making new offerings, including data services.

But with McGowan's tragic and sudden death in 1992, MCI, which used to thrive on its gonzo culture and devil-may-care attitude, started a downward slide. MCI never really recovered from McGowan's death. He had been the motivator for the entire company. Jerry Taylor, MCI's president, and Bert Roberts, MCI's chairman and chief executive, were McGowan's lieutenants, but the MCI army needed a General Patton. The long distance wars with AT&T flared up again, largely because of the efforts of Joe Nacchio, a young, cocky AT&T executive who matched MCI move-to-move.

Nacchio, who later left to become the chief executive of Qwest Communications, knew that AT&T's cash position was much stronger than MCI's, as the latter was getting crushed under the weight of the interest payments on its debt. He waged an economic war with MCI and won. MCI had also missed out on the wireless boom and didn't fully capitalize on its Internet service provider business. "There was no edge to the company, the energy was down, and it was clear to us, MCI was going nowhere," recalls Phil Jacobson, a former MCI executive and now a principal with the networking consultancy Network Conceptions. For almost two years, MCI tried to become a leader in the Internet business but was out-hyped by UUNet.

In 1995, MCI started getting involved in money-losing ventures like a toll-free service for people to listen to music before buying it. The short-lived 1-800-MUSIC-NOW service, which was shut down in 1996, cost MCI about $40 million. The company also made a disastrous foray into the Internet content business and lost close to $50 million on that project. "Everything was beginning to stagnate, and it was quite different from early days when the company was focused on taking down AT&T," recalls Jacobson. "Managers were just hanging around, the stock was sinking, and the company was just becoming very political. Backstabbing was routine," recalls Jacobson's partner Farooq Hussain, who worked in the Internet group for MCI. "McGowan did not groom anyone to take over."

MCI executives wanted to sell out, and in November 1996, British Telecom (BT) offered $24 billion for MCI. But even before the final agreements could be drawn up, there was dissension in the ranks. The executives weren't happy. British Telecom apparently didn't understand the complexities of the merger. "It was all about idiotic concerns, about empire building and management control, and not about business expansion," recalls Hussain, who worked on trying to combine the two companies.

The British Telecom bid and the ensuing negotiations sent a clear signal that MCI was ready to throw in the towel and would sell itself to anyone with a decent offer. Jack Grubman told his clients that BT was getting a bargain. On the other side of the pond, BT executives were being laughed at for paying too much. The *Financial Times* reminded them of their stupidity on an almost daily basis and wanted the British monopoly to call off the deal. BT lowered the offering price from $24 billion to $19 billion. This led to another round of negotiations. Then, extraordinarily, in October 1997, WorldCom made a $30 billion hostile bid for MCI. The business world was shocked. MCI was almost four times the size of WorldCom, which at the time had sales of merely $4.5 billion, while MCI's sales were $18.5 billion. A minnow wanted to swallow the whale!

For WorldCom executives it was the deal of a lifetime. If they could pull this one off, WorldCom could be among the top ten phone companies in the world, with revenues that could help pay off nearly $5.4 billion in long-term debt. "I thought about BT's position for making a lower bid and the marketing and cost advantages that favored WorldCom to make a successful higher bid. I was convinced that we could unseat BT as the incumbent acquiring company to a position where they would not be able to bid against us," boasted Sullivan in an interview with *Oswego*, a magazine published by the alumni association of Oswego State University, Sullivan's alma mater. Meanwhile, WorldCom decided to make a $2.5 billion bid for Brooks Fiber, another network operator.

Unfortunately, another local phone company, GTE, also decided to make a bid for MCI, and WorldCom had to increase its offer. GTE's bid started a feeding frenzy and the telecom industry, normally staid and boring, was once again in a state of upheaval. It was like the junk-bond–driven 1980s. Bernie Ebbers was the new hero on Wall Street. After all, his machinations were making investment bankers very rich. Lazard Freres & Company was counseling MCI. N. M. Rothschild of London and Morgan Stanley, Dean Witter, Discover & Company were in the British Telecom camp. Jack Grubman and Salomon Brothers were on WorldCom's team. Goldman, Sachs & Company and the Bear Stearns Companies were advisers to GTE. Lehman Brothers later joined the MCI team.

"Telecom in play; as British Telecom, WorldCom and GTE vie for MCI, merger frenzy has gripped this once staid industry," gushed *Fortune*.[14] Ebbers remained arrogant and condescending toward MCI throughout the fight, which lasted almost six months. In the end he won, but he paid dearly. It cost him $37 billion to buy MCI. The combined companies had $28 billion in annual sales. In order to finance the purchase, WorldCom took on about $20 billion in debt, got a $12 billion bank facility from NationsBank and another $3 billion in a commercial paper program through Lehman Brothers. As part of the deal, about $7 billion of the total went to BT shareholders—in cash. Having snapped up Brooks Fiber, UUNet, and MFS, Bernie had one little thing left to do: buy the network businesses of CompuServe and America Online so he could finally become a bandwidth baron.

In order for the U.S. Department of Justice to approve the MCI/WorldCom merger, MCI was required to sell off its Internet division, internetMCI. Before selling it to the British company Cable & Wireless, MCI "yanked anyone good out of internetMCI and put them into a new group called Advanced Services so they couldn't be taken by C&W," says one former employee. "Then they replaced those people with deadwood from long distance voice. C&W eventually sued WorldCom for screwing them, and it eventually got settled."

Big, Fat, and Sick

The buy-and-grow strategy that worked so well through the 1990s was to become WorldCom's nemesis. By the mid-1990s, WorldCom (which dropped the MCI name a few months after the merger closed in 1998) had acquired too many network assets. It had bought IDB WorldCom's network, and it had acquired 10,000 miles of additional fiber when it bought WilTel, MFS's network, UUNet, and eventually MCI. This forced the company to ignore its core business of long distance voice and get into the business of selling capacity to other telecom companies that didn't want to build their own networks.

Jack Grubman told *Red Herring* in 1997: "WorldCom is at the intersection of everything we like—no carrier in the world can offer the integrated set of facilities that it does. The company has nothing to lose and everything to gain."[15] He repeatedly encouraged investors to buy WorldCom stock if they didn't want to risk missing out on the best play in telecom history. At the time, his advice was welcomed by mutual fund managers and small investors looking to boost returns on their portfolios.

Meanwhile, the 1996 Telecommunications Act had brought new players into the market, and that boosted demand for these network services. In its 1997 annual report, WorldCom boasted, "WorldCom's fiber-optic networks are being built for the broadband data applications that will typify telecommunications in the next millennium."[16] The company said in its annual report that its Internet revenues had doubled in 1997 to $566 million, and its domestic data networking business was up by 35 percent to $1.575 billion.

George Gilder—writer, industry analyst, and effectively the spiritual leader for most broadbandits—was impressed by Ebbers and wrote: "He has shown the magic of entrepreneurial vision and temerity. Ebbers' fiber and Internet empire stands ready to release many more trillions of dollars in wealth and Internet commerce and communications, and threaten monopolies around the globe."[17]

What Ebbers didn't know was that he was the biggest fool in telecomville—no one was making meaningful money from bandwidth and data networks, because they were too expensive to build, manage, and upgrade. Competition was heating up from new companies like Qwest. Still, you couldn't fault Bernie for feeling smug—he thought he had finally cornered the market on bandwidth, which apparently was going to be a scarce commodity. After all, Sidgmore and O'Dell had been constantly telling him and the world that the Internet traffic was doubling every 100 days.

WorldCom and MCI had a large amount of combined debt. It was time to squeeze every last penny out of MCI. Ebbers asked MCI executives to stay in budget motels and fly coach. He got rid of the company cars. Sullivan was his hatchet guy, and he was glad to oblige. Having hitched his star to Ebbers, Sullivan rose to the top very quickly, the MCI acquisition coming as his crowning moment at the ripe old age of 36.

Oswego magazine called Sullivan "master of the mega merger." "Scott knows his numbers like no one else," Ebbers told the *Wall Street Journal* in 1998. "I don't think WorldCom would be where it is today without him."

CFO Magazine named Sullivan CFO of the year in 1998. (Ironically, a year later, it put Enron crook Andrew Fastow on the cover!) This was turning out to be a fantastic year for Sullivan. He bought a 4.11-acre plot for $2.45 million in Boca Raton, Florida where he was planning to build the castle of his dreams, but meanwhile he commuted in a private jet to Mississippi from his temporary 3,000-square-foot home in Boca Raton.

UUs versus Them

UUNet insiders had a certain arrogance. Sidgmore's gang never really thought much of the crew from the South and ran UUNet as a private club. The newest inductees to this club, which included O'Dell, were Vint Cerf, the "official father of the Internet," and Fred Briggs, the WorldCom chief technology officer (CTO). In 1998 WorldCom built a new facility in Ashburn, Virginia. The 535-acre campus was a state-of-the-art facility, with features that would have been at home in Silicon Valley. It had a 2.5-mile bike trail, a dry cleaner, a day care facility, a bank, and a gym.

The big man on campus was Mike O'Dell, chief scientist and vice president at UUNet. Notably, Sidgmore and O'Dell continued to tout their UUNet affiliation, not their affiliation with WorldCom. O'Dell had joined UUNet in 1987 as its 31st employee. He was short on people skills, but his technical brilliance made him a favorite with the nerds who were the real force at this particular facility. O'Dell's office was full of nerd gear like Ren and Stimpy dolls, and to relax he would organize balloon races on campus. He could get away with it, for UUNet was bringing in hundreds of millions in revenues for WorldCom in 1999. " 'If you're not scared, then you just don't understand' was a classic O'Dell aphorism, and he had many," said Ahmar Abbas, who worked with the company in various capacities including sales. "If you hadn't heard this a couple of times during the interviewing process, you would most certainly be parroting it by the end of your first week at UUNet. Everybody up and down the company hierarchy believed this as if it were religion."

This was an Internet operation and was being run as such. Folks were allowed their idiosyncrasies but still had to adhere to rules such as wearing khakis. Public display of underarm hair was not allowed.[18] "It's a matter of pride to [employees] that they're part of an Internet company," said Sidgmore. "I said from the beginning that as long as I'm here, we're not going to integrate it."[19]

"Sidgmore, who became vice chairman of WorldCom, had a cult following and was a pretty straightforward guy," said Abbas. But "no one wanted to stand up against O'Dell. He was a big huge guy and it was scary to be in a meeting with him." There was an inherent superiority among the UUNet employees, "a feeling of invincibility. UUNet folks thought that they were special, and many fell for that."

Expertise, Expertise Everywhere, and Not a Drop to Drink

WorldCom's acquisition of MCI and UUNet brought the company a stellar team, but UUNet folks scorned their MCI counterparts. Sidgmore and O'Dell wanted to keep a tight control on the broadband business. The only person who was spared from scorn from UUNet staff was Vint Cerf, because he was too well known and powerful in his own right. "It was an amalgamation of different companies. The atmosphere was too political, and turf battles were going on all the time," recalled MCI-alum Bynum. As a result, people were too busy pleasing their individual bosses to worry about the long-term fate of WorldCom. Brownnosing apparently was in the employee handbook, and people would bend over backwards in order to please seniors like Fred Briggs.

For instance, if CTO Fred Briggs wondered aloud whether WorldCom should stop buying class five switches, which help guide your phone calls, and replace them with software that does the same (also known as soft switches), a whole team of executives would spend months trying to come up with a way to answer Briggs' question in the affirmative. "If you told someone that the cost was going to be prohibitive, the answer would be 'Fred Briggs wants it this way'," recalled one executive.

Executives would arbitrarily tell Briggs that it cost $400 per T-1 connection, when in fact the real cost of a T-1 was much more. Briggs, in turn, would parrot those numbers to analysts, who would then base their earnings and revenue estimates on the data provided by the company.

This created a chain of escalating lies. Former executives confessed that they spent most of their time trying to figure a way out of this mess, so as to not make Fred Briggs look like a liar. One trick would be to bill the customer for the amount of bandwidth they used rather than for a T-1 connection. Another trick, as would be revealed later, would be to exclude from the final bill the costs of equipment and operating those high-speed lines.

"I was selling for UUNet in Asia, and to me it was clear that the costs were higher than the sales prices," recalls Abbas. "But in those times nobody at the company cared about profit margins—you got compensated on revenue, so you only cared about revenue." The company was buying T-1 connections from other incumbent phone companies and then selling them at a lower price later. For instance, in Japan, it cost UUNet $2,000 per month to buy a T-1 connection from the local phone company, but Worldcom would resell it to its end customers for $1,500 a month. "We were selling below cost, so we assumed the other divisions were making money—after all, we were a very small portion of a very big company," recalls Abbas.

Many insiders believe that the result of all the acquisitions was that no one really knew what was going on inside the company. A decade-long buying binge was beginning to catch up with WorldCom. While it had a decent back-end system to manage the networks and get phone circuits installed, WorldCom didn't have the front-end system that could send bills to customers. Insiders have revealed that even as the company kept buying other carriers, there was little effort made to integrate the back-office systems. WorldCom's salespeople were using one system, while MCI salespeople were using different software. It created chaos and, as a result, running day-to-day operations was a lot of guesswork. Forecasting demand was even tougher. "In reality we could not get the politics of the two entities [MCI and WorldCom] to align," added Bynum. "It was just impossible to work. For example, it would take only four hours to provision a cross-country DS-3 connection, but it took more than a month to get the account started." Simple things like credit verification would take weeks, and getting the connections to work would take months, many insiders lamented.

According to insiders, the chaos inside WorldCom grew so acute that many salespeople were competing against one another. Thanks to one of its acquisitions, WorldCom ended up acquiring telecom rights to seven buildings in Boston. Tenants (mostly corporations) in those buildings who were eager to get Internet access signed up with WorldCom. The salespeople would go out and make a sale, come back, and fill out the paperwork. WorldCom in turn would then place orders for T-1 connections with the local phone company, in this case Verizon (née Bell Atlantic). Insanely enough, someone from Verizon would call another department at WorldCom, buy T-1 connections from WorldCom at a lower price (since WorldCom had prebuilt connections into those buildings), and then resell those connections to WorldCom at a higher price.

No one could guess, however, that things were slowly decaying inside the company. Pro forma revenues for 1998 were $30.4 billion, up 15 percent from 1997, with almost $2.2 billion coming from Internet services and $5.8 billion from other data services. In 1999, WorldCom reported sales of $37.8 billion and earnings of around $4 billion. At the time, no one had any reason to suspect that WorldCom had been lying and cooking the books—those revelations would come three years later, in 2002.

The executives did their part to hype the stock. "The Internet continues to grow at 1,000 percent a year in terms of bandwidth demand, and voice's need for bandwidth grows about 10 to 15 percent each year," said John Sidgmore, then WorldCom's vice chairman, to *Red Herring* in early 1999. "By 2004, voice will be less than 1 percent of all bandwidth."[20] No one dared question those numbers—it all seemed plausible because of the incredible growth in the number of dot-coms and other Internet companies around the world. WorldCom was one of the top five phone companies in the world.

"As long as UUNet could keep up the illusion of the exaggerated traffic growth, WorldCom was a darling of the stock market. The executives of WorldCom were only interested in keeping up the value of their stock offering, not whether there were actually any customers for the Internet bandwidth facilities that UUNet was deploying based on their story of exaggerated growth," Bynum lamented later.

By the end of 1998, WorldCom was the undisputed bandwidth leader, and its success (and stock price) inspired many imitators. That ultimately became a major headache for Bernie's crew. The industry was beginning to resemble an open-air market, and by late 1998 dozens of players like Qwest and Global Crossing had jumped into the bandwidth game. Ebbers had made a big bet on bandwidth, and it was going sour. And it was only going to get worse, as 1999 would prove to be a bad year for Ebbers and Sullivan. After absorbing MCI, WorldCom sold off MCI's SHL Systemhouse unit for $1.4 billion and indicated that it would spend that money to expand the WorldCom network. The company was running out of options—it needed to compete with the imitators such as Qwest and Global Crossing that were looking to eat Ebbers for lunch.

Managing with Blinders On

But while Rome was burning, the Neros were busy with their orgies. Money flowed like champagne at company events like the one in 1998, when about 60 to 150 people gathered for a long weekend at a castle a few miles away from Windsor Castle. It was a weekend to build company morale and bring together people from different companies acquired by WorldCom. One executive who was there talks about senior executives climbing poles and breaking expensive croquet sets. Things got out of hand when some executives decided to go to London in a cab and moon the pedestrians!

Many such events took place in exotic locales like Mount Fuji, Japan; Phuket, Thailand; and Langkawi, Malaysia. "It was a great time, and everything else will be anticlimactic from this point on," said one executive. Another reported that the Teatro Opera in Buenos Aires was rented for a private showing of *Les Miserables*, and a ballroom in São Paolo was rented for another WorldCom bash.

But the company didn't have the money to pay for much of this. According to various shareholder lawsuits, the company would resort to double-billing, slamming customers, deliberately understating costs, and delaying customer credits for billing mistakes as well as payments to vendors. The cash situation at WorldCom was getting worse, and the company's cost-cutting measures weren't always prudent. For instance, in 1999, WorldCom instructed its sales and marketing teams to stop buying research from research organizations such as Gartner Group and instead use information from research reports written by stock market analysts. It was a dumb move, because most corporations need market research to predict their competitors' strategies and figure out what new product offerings could be hot sellers.

Chaos being the order of the day, it was evident to many insiders that the wheels were coming off the WorldCom express. Because of an influx of new competitors, the prices of bandwidth had been in a swoon and costs were simply going out of control. "Whenever I had discussions with planning and marketing [departments] they would hem and haw, complaining of cash flow problems. Everything was being done on credit, not cash," recalled a senior company executive.

It was around this time that WorldCom started signing long-term, fixed-rate lines leases to connect its network with the networks of companies such as Verizon and SBC Communications.[21] While WorldCom owned a lot of capacity, what it lacked, like most independent phone companies, was the connection to the customer's office—the so-called "last mile" link. That connection was, and to a large extent still remains, a monopoly of the local phone companies. It also bought fiber capacity to fill out the holes in its network, even though the company had a fairly large network itself. The company signed long-term contracts with other carriers, some extending to 20 years.

The idea was that by buying all these leases, WorldCom could easily provision services—that is, provide voice and broadband connections—to any customer who so desired. It was the logical thing to do—the faster you offer service, the faster you can start generating revenue. However, Sullivan and others at WorldCom totally overlooked the competition from other carriers such as Qwest and Global Crossing and even AT&T.

In other words, they spent too much money on equipment and contracts and could not generate enough cash. In 2000, WorldCom had \$39.1 billion in revenue and \$24.8 billion in debt. The company had been borrowing like there was no tomorrow and spending it like a drunken sailor.

Stock Addicts Anonymous

All through the acquisitions binge, WorldCom would strip the acquired companies and salt away some money for a rainy day. For some time, Ebbers and Sullivan used these seeming reserves to make up for the short fall.[22] This gave the perception that the company was growing at warp speed, and that kept the stock flying high. Bernie had made a Faustian bargain with the devil named Wall Street. WorldCom's hypergrowth attracted big investors to the company, who spent billions buying WorldCom stock. Being a growth stock, WorldCom had to show revenues that were always growing. It could not afford to show a slowdown in revenues, because that would drive down the stock.

Bernie's friend and confidante, Jack Grubman of Salomon Brothers, was doing his job by keeping his "Buy" rating on the stock. Like other high-flying Internet and broadband stocks, WorldCom's stock at the time was being valued on per-share revenues and EBITDA—earnings before interest, taxes, depreciation, and amortization. In reality, it was more like earnings boosted by irregularities, tampering, and dubious accounting. Still the stock continued to soar. It eventually hit an all-time high of $64.50 a share in June 1999, courtesy of Grubman,[23] who was one of the pivotal figures in the broadbanditry—he introduced Qwest CEO Joe Nacchio to Qwest founder and billionaire Phil Anschutz; he also advised Global Crossing founder Gary Winnick and, of course, was the informal sidekick to Bernie Ebbers.

Bernie and Jack were very close. Grubman even attended Ebbers' second wedding in Jackson, Mississippi, in 1999, racking up a bill of around $1,100 and then expensing it to his employer, Salomon Smith Barney.[24] He had been championing WorldCom for a long time, and until about July 1999 (when concerns about an industrywide slowdown in long distance voice revenues pummeled the stocks of companies such as WorldCom and AT&T), the ever-rising stock made him the rock star analyst everyone else wanted to emulate.

Grubman often attended WorldCom board meetings[25] and used to tell the company in advance what questions he would ask during quarterly conference calls with analysts and press. This way, the two could present the company in the best possible light. On August 20, 1999, Grubman released a report calling on investors to buy WorldCom and, in fact, "load up the truck!" He predicted WorldCom would double its earnings every two or three years through the first decade of the 21st century. This gave the stock a little nudge, but even he had to know that something drastic needed to be done because the company, with its expensive bandwidth leases, inept fiscal management, and inefficient processes, was running out of cash fast.

So Grubman advised Bernie: Buy Sprint, the third-largest long distance company in the world. It had a lot of revenue and lots of cash. The company even had a cell phone business—Sullivan could create a wealth machine with his accounting machinations. In October 1999, Sprint, which is based in Kansas City, became the center of a takeover war between BellSouth, a Baby Bell from Atlanta, and WorldCom. The initial offers from both companies were about $100 billion, but with the help of its friendly Salomon Bankers, WorldCom was able to up its offer to $129 billion—$115 billion in equity and $14 billion in assumed debt. The deal was announced with much fanfare, and MCI WorldCom's stock predictably surged.

On October 5, 1999, Bernie boasted on the CNBC cable network, "How in the world would we have been able to provide a competitive broadband strategy to a consumer, which is really the focus of this thing, other than through a combination of our companies where we have enough scale and scope."[26]

This distraction, if anything, was enough for WorldCom to raise more money from the markets—about $3.2 billion in debt in 2000. The noise around the merger also allowed Grubman to change the metrics with which he valued WorldCom. He would change these often, and many overlooked the changes. Jack used forceful phraseology and expressed such apparent conviction that investors forgave the sloppiness behind his ratings and price targets. Just as magicians' scantily clad beauties distract attention from the sleight of hand, Grubman's words distracted readers from his lack of rigor and objectivity.

A review of several of Grubman's recommendations and price targets in his published reports shows a seesaw nature in his ratings and in his ever-changing price target methodology. The price targets were often a "stretch," and individual investors were more susceptible to the practice. Sophisticated institutional investors often care little about the valuation methodology used by sell-side analysts, other than for the expected impact on the stock if the analysts have to change their rating or price target. Institutional buyers are highly skilled and well paid to do valuation work themselves. To the less sophisticated retail investor, though, the valuation methodology and results can be the deciding factors in whether or not to buy the stock.

Grubman referred to WorldCom's P/E-to-growth rate to justify his

$130 ($87 split-adjusted) price target in May 1999.[27] Then, 14 months later, he once again urged investors to purchase their shares, arguing that the $87 target implied a firm value-to-EBITDA ratio below that of his five-year projected EBITDA growth rate.[28] Grubman maintained his $87 price target until November 1, 2000, when, with little explanation, he slashed the price target to $45 (the stock was approximately $18.94). He came up with a new approach, and it was "based on" a 1.5 to 2.0 multiple of the five-year cash EPS compound annual growth rate of 17 percent.[29]

With stagnating revenues and increased capital expenditures that threatened to cut into WorldCom's cash flow, it was hard to justify his previous valuation of WorldCom. In the past, acquisitions always helped give an impression that revenues and cash flow were rising. And if the valuation dropped, the Sprint deal would fall apart and Salomon would miss out on a big bounty in advising fees. In addition, any slide in valuation meant the whole house of cards called WorldCom would go tumbling down.

Now, as an independent analyst, Grubman should have alerted the investors to the stalling revenues and increasing expenses. But since Grubman's loyalties were with Ebbers and Salomon Brothers, he gave the investors the shaft and again changed his valuation metrics. The new sleight of hand was called cash earnings. Cash earnings are derived by subtracting cash expenses from cash revenues. This differs from earnings in that it does not include noncash expenses such as depreciation.

But no one noticed this financial sleight of hand, because the telecom universe was focused on this gigantic merger. When the merger eventually fell apart, it wasn't because of Grubman's flawed valuation method. Instead, Ebbers, in his arrogance, had managed to piss off regulators who needed to approve the deal, first in Europe and then in the United States. As a result, the regulators created enough roadblocks to block the merger. In June 2000, eight months after the deal was first announced, the word came down: The WorldCom-Sprint marriage was off. "I think that was the end of WorldCom and Bernie," said Brian Thompson, a former MCI executive who had started and sold LCC International, another long distance company, by then. With no cash to feed the WorldCom monster, the whole Ponzi scheme was going to break down—it was only a matter of time.

Project Save Bernie

While WorldCom was publicly making a bid for Sprint, Ebbers was trying to secure his own future. In August 1999 Ebbers secured a loan of about $499 million from the Travelers Insurance Company, a Citigroup subsidiary and the former parent of Salomon. (Salomon was bought in 1997 by Travelers, which merged it with the brokerage firm of Smith Barney to form Salomon Smith Barney, a division of Travelers, which then merged with Citibank.)

Rick Olson, a Salomon broker based in Los Angeles, had been in touch with Ebbers and worked to arrange the loan, which was made out of Travelers' Chicago office to Joshua Timberlands LLC, a company owned by Ebbers. The loan was collateralized by Bernie's WorldCom stock holdings. This private company, based in Brookhaven, Mississippi, purchased about 460,000 acres of property in Alabama, Mississippi, and Tennessee for $397 million. Despite his aw-shucks "I'm a simple southern boy" act, Ebbers was simply protecting himself. In February 2000, Travelers loaned Ebbers another $180 million, bringing the total to a whopping $679 million. In addition to these loans from Travelers, Ebbers took out more personal loans. In total he had about $900 million in loans that were secured by WorldCom stock.

What did he need this money for? For buying timberlands in the American South, ranches up in Canada, and a boatyard, along with $800 million worth of WorldCom stock on margin. He also bought Angelina Plantation, a 21,000-acre property in Monterey, Louisiana, in 1998 and other farmlands that actually received a $4 million subsidy from the U.S. Department of Agriculture.[30] It was the stock purchases on margin that got Ebbers into trouble later.

Because many of Ebbers' personal loans were collateralized by WorldCom stock, it was important that the stock stay above a certain level. As long as the value of Ebbers' WorldCom stock stayed above $900 million, all would be fine. If it drifted below that, Ebbers would have to make up the shortfall, known as the margin call.

The failure to merge with Sprint had taken some of the sheen off the WorldCom stock, which, by the fall of 2000, was down 71 percent from the stock's high in June 1999. Through 2000 and 2001, the WorldCom stock kept sliding. Grubman kept saying buy, but by now, everyone on

Wall Street knew there was no point paying much attention to Grubman. The stock, which had been at $53.06 a share at the end of 1999, slid down to $14.08 per share by the end of 2001.

The situation became so bad that during 2000 and 2001, WorldCom loaned Ebbers around $400 million to cover margin calls on his loans. These loans were offered at a rate of about 2.15 percent, far below the prevailing prime bank lending rate of around 4.75 percent. Ironically, instead of using all the money for meeting his margin calls, Bernie used about $27 million for personal reasons, including a $1.8 million payment for the construction of his new house. In effect, he was getting lower-than-market rates not only to save his skin, but also to live it up. This is in addition to the more than $77 million in cash and benefits that Ebbers got from WorldCom between January 1, 1999, and December 31, 2001—during which time shareholders lost in excess of $140 billion.

When asked about these loans, the company would say that if Ebbers sold stock on the open market, it would further depress the stock price, which would not be good for WorldCom investors. In reality, the only person they cared about was Ebbers, because it was Ebbers who had made everyone who mattered—in this case, the board of directors—extremely rich.

To be kind, WorldCom's board was under Ebbers' control, even though some have said that they were outright incompetent and toothless. Ebbers had substantial influence over the board's decision-making process and actions. Anyone with questions would be put in their place and, as would later be revealed, "critical questioning was discouraged."[31] The board's compensation and stock option committee was pretty much in Ebbers' hands, and they basically did whatever Ebbers asked them to do.

The key figure on the compensation committee was Stiles A. Kellett Jr. He was the rubber stamper of Ebbers' decisions. In exchange for letting Bernie run amok, Kellett got to rent a luxury Falcon 20F-5 jet owned by WorldCom for $1 a month. While he paid the sundry expenses, he did not pay the $1.4 million or so that the lease for the plane would cost on the open market.

Others on the board were equally compromised. Since May 1999, they had been receiving stock options for being on the board of directors and were getting extremely rich. Kellett, for instance, had about 1.2 million WorldCom shares, while others had more than 100,000 shares each. In total, the board of directors and the senior executives of the company, including Ebbers, held a total of 40.4 million shares. The share numbers were high enough to create a serious conflict of interest! In reality, everything WorldCom did was to save Bernie and his bad bets. And that included the accounting shenanigans that would eventually bring WorldCom down.

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Over the years, WorldCom's modus operandi was quite simple: Buy companies, add their revenues to WorldCom's revenue stream, strip their assets, and take charges worth billions of dollars to account for the costs supposedly incurred in connection with the merger. Now, these techniques might be overlooked if a company bought a rival or two. But by the end of 1998, WorldCom had bought about 60 companies for a total of $70 billion.

In addition, WorldCom was using other dirty financial tricks. It would include in the charge the cost of the acquired company's expenses expected in the future quarters. Instead of amortizing the cost of acquisitions over several quarters, it took huge charges in a single quarter, which made the company's financials even more confusing. That way, WorldCom did not have to record these expenses in the period they were actually incurred. This helped inflate WorldCom's earnings incorrectly in future periods while deflating earnings in the period of acquisition. But investors chose to ignore that, as they assumed it was part of merger-related costs. This way, WorldCom could use the excuse of a merger to obfuscate their numbers and be assured of good future earnings. Of course, Sullivan would put something away for the rainy day in his cookie jar—accounting geeks call it merger reserves.

But by the end of 1999, even these dirty tricks could not keep up the appearances. Scott Sullivan, the accounting wizard and *CFO Magazine*'s CFO of the year, basically forgot the principles of Accounting 101 in order to save Ebbers. Sullivan was in charge of the WorldCom Finance Group. Being a close confidante of Ebbers and the de facto number two, Sullivan was the man where the buck literally stopped.

From 1999 on, Sullivan had been perturbed by the rapid erosion of

WorldCom's revenues as the company came under tough competition from its rivals. He dipped into his cookie jar of reserves, but that was not enough. WorldCom tried to buy Sprint, and that failed. The dot-com bust and degrading business were proving to be near-lethal body blows for WorldCom. Perhaps it was sometime in July 2000 when Sullivan decided to bend the accounting rules a little. He, along with sidekick David Myers, decided that the costs, or expenses, were getting out of control, and it was time to hide them.

But before he did anything, in August 2000, Sullivan sold stock worth $18 million. In October 2000, the company prepared for an earnings call, in which it would announce that it would miss earnings expectations. Inside the company, executives worried that Wall Street would now focus on WorldCom operations, now that the Sprint merger was dead. In an e-mail dated October 21, 2000, Sullivan told Sidgmore that the company was in a "really scary"[32] situation. Apparently, revenue from America Online, one of WorldCom's major clients, was up only 1 percent, mostly because the bandwidth price had fallen sharply and the Internet traffic growth had slowed. "Wow! I had no idea that the revenue growth had deteriorated that much," Sidgmore wrote back, adding that "it's going to take some pretty fancy explaining."[33]

Sullivan is the kind of guy who reminds you of this joke: A CEO looking for a new accountant asks all applicants what two plus two equals. Most answer four and don't get the job. The winner says, "Well, what do you have in mind?" Sullivan pretty much told Sidgmore that he would make some accounting changes, and that would mean better margins for some parts of the business.[34]

What Sullivan did not say was that he had it all figured out. What Sullivan was doing was capitalizing expenses. Capitalizing, according to accounting rules, is saying that the amount you paid for an item is not an expense but rather an asset of equal value to its cost. So instead of deducting it from the revenues as an expense, the company can depreciate its value over a period of time.

This is a common method of accounting for equipment like computers and office equipment, which do represent real value and whose value does depreciate over a period of time. But in Sullivan's case, he started treating regular expenses, such as those expensive leased lines mentioned earlier, as depreciable assets, or things that can be written off over a period of time. It was like going to a deli, buying $10 worth of baloney, paying for it in cash, and then coming home and saying, "Oh well, I think the baloney is an asset, and I am going to depreciate it one dollar a year over the next ten years." Never mind that the baloney will go bad in the refrigerator after a week.

For WorldCom, this scheme would create an impression of less expenditure, or, if you look at it from the other side, higher earnings. That's what Sullivan did, which netted him a $10 million special bonus from his boss in 2000. According to the *New York Post*, it seems that in 1996 America Online pulled a similar stunt but got off with a slap on the wrist. WorldCom's situation, however, was worse: At last count, the company had overstated its earnings by $9 billion.

In 2001, while Sullivan was scamming the investors, some of WorldCom's employees decided to screw the company for their own benefit. A few salespeople had figured out that since the acquisition of MCI, WorldCom had two major billing systems—one from WorldCom and one used by MCI. By switching existing customers from one billing system to another, the employees got extra commissions because the new entries into a different billing system were treated as a new account.

All of this would have gone on peacefully had it not been for WorldCom's falling stock and the worsening fundamentals of the telecom industry. By late 2001, the stock was slowly skidding toward $12 a share. On December 31, 2001, with its stock down to about $10, WorldCom's moment of truth was around the corner. It had $35.2 billion in revenues and $30.2 billion in debt.

If WorldCom's rise was spectacular, its downfall was even faster. In January 2002, Global Crossing went bankrupt. The ensuing brouhaha prompted investors, media, and analysts to look into other big broadband plays more critically—and when they looked at WorldCom, they didn't like what they saw. The media began asking questions about the loans to Ebbers, and in March 2002, WorldCom announced that the SEC was looking into accounting issues and loans to some officers and directors. On April 3, 2002, the company announced that it would reduce its work force. And on April 30, 2002, Bernie was shown the door, and Sidgmore was appointed the new CEO. But even Sidgmore could not save WorldCom—an internal audit revealed an accounting scam of gigantic proportions.

One of the first things Sidgmore did upon becoming the new CEO, however, was to reinstate free coffee for employees.

—Original Message—

From: John Sidgmore [mailto:no_replies_please@wcom.com]
Sent: Thursday, May 23, 2002 7:55 PM
Subject: Coffee Service Returns
Back, by popular demand . . .

As you know, earlier this year the Company-subsidized coffee service for employees was eliminated. I am pleased to announce that we are reinstating this service, effective immediately.

Over the next few weeks, Facilities (in the major sites) and local management teams will coordinate this effort throughout the Company.

John

—

WorldCom, Inc. Corporate Employee Communications

As Bernie taketh away, so John giveth. Nevertheless, the death spiral had begun. The company's credit rating was downgraded by rating agencies. On June 25, 2002, the company announced that it had overstated its earnings before interest, taxes, depreciation, and amortization for all of 2001 and for the first quarter of 2002. In July 2002, WorldCom went belly-up. It became the largest corporate bankruptcy in American history.

On August 1, 2002, Sullivan—who between 1995 and 2000 had sold WorldCom shares worth $45 million—was arrested on fraud charges. Too bad he would not get to live in his Florida Xanadu. Investigators are still trying to find the dirt on Ebbers, but it's proven difficult, since the man only used the phone or handwritten faxes, and his secretary answered all his e-mail. His computing skills, like his management skills, were not as good as his aptitude for screwing the shareholders. Other executives from WorldCom are also headed to the big house up the river. Some are willing to squeal in order to save their skins. Too bad they didn't think of the shareholders and investors soon enough.

In November 2002, WorldCom's life began a new chapter: The company hired Michael Capellas, the man who had sold Compaq Computer to Hewlett-Packard, as its new CEO.