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THE WORLDCOM CASE: LOOKING AT BANKRUPTCY AND COMPETITION ISSUES

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

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TUESDAY, JULY 22, 2003

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Committee met, pursuant to notice, at 2:23 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Orrin G. Hatch, Chairman of the Committee, presiding.

Present: Senators Hatch, Kennedy, Schumer, and Durbin.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

Chairman HATCH. Good afternoon. I apologize to you for being late, but we are way behind, and I got waylaid in the subway coming back, so I could not very well get here on time.

I am happy to welcome you all here to today's hearing, entitled "The WorldCom Case: Looking at Bankruptcy and Competition Issues."

I first would like to thank all of our witnesses today for their time and cooperation, and I hope that this hearing will help us better understand the WorldCom situation and its potential public policy implications.

Along with many Americans I am deeply concerned about the devastation caused by WorldCom's massive corporate fraud which has caused immeasurable harm to so many. While we cannot go back in time and undo what has already occurred, we are presented today with an opportunity. We have an opportunity to examine the WorldCom case and determine whether there are lessons to be learned with respect to our public policy going forward.

The focus of today's hearing will be two-pronged. First we will examine the WorldCom bankruptcy case and consider in light of the facts whether any changes in our current bankruptcy laws may be in order. Second, we will assess the implications of a reorganized MCI emerging from bankruptcy on competition in the telecommunications market. Here again we will examine and evaluate what impact if any this anticipated competitive landscape should have on public policy.

Some have raised fairness concerns that WorldCom will be able to emerge from bankruptcy with much of the fruits of its widespread fraudulent conduct intact. They argue that it will emerge from Chapter 11 with an enhanced market position relative to its competitors, giving it not only a fresh start, but a head start. They believe that, in view of the WorldCom case, our bankruptcy system is set up to make crime pay.

Others contend that the MCI which will emerge from bankruptcy is a new entity with new leadership. They point to the extraordinary measures it has taken to prevent the recurrence of past misdeeds. They further argue that MCI will not have a meaningful competitive advantage from its Chapter 11 reorganization. And they argue that our bankruptcy laws appropriately are not designed to punish, but rather to permit a company to reorganize and emerge from bankruptcy as a viable entity.

As we move forward, I believe we need to have a full understanding of the WorldCom case to help us determine whether our bankruptcy laws are functioning fairly and effectively. We also need to understand the WorldCom case in order to conclude whether our policies are sufficient to enable the telecom industry to enjoy robust competition under fair terms that benefits consumers. No doubt, this is a complex case containing important issues deserving of examination.

We are fortunate to have highly-respected individuals here today to testify on these important matters. We will first hear from former Attorney General Richard Thornburgh, who is the Bankruptcy Examiner in the case. We are fortunate to have you with us, General Thornburgh, and of course I personally look forward to your testimony. I think others will also. I think there would be more here—and they will come later—but Paul Bremer is testifying in closed session, and I wish I could have made that myself, but I am very happy to be able to listen to you.

On our second panel we are honored to hear former Attorney General William Barr, the Executive Vice President and General Counsel of Verizon Communications; former Attorney General Nicholas Katzenbach, who serves on the Board of Directors of MCI Telecommunications; Marcia Goldstein of the law firm of Weil, Gotshal and Manges; Douglas Baird, Vice Chair of the National Bankruptcy Conference; and Mark Neporent, the Chief Operating Officer of Cerberus Capital Management.

I appreciate all of you appearing here today, and with that, we will start with you, General Thornburgh.

STATEMENT OF RICHARD THORNBURGH, BANKRUPTCY EXAMINER, KIRKPATRICK AND LOCKHART, LLP, WASHINGTON, D.C.

Mr. THORNBURGH. Good afternoon, Mr. Chairman.

I appreciate the opportunity to appear before you today in connection with my responsibilities as the examiner int WorldCom bankruptcy proceedings, the largest bankruptcy in United States history. To date, my examination, which began in August 2002 and continues to date, has resulted in two interim reports detailing my observations concerning the conduct of WorldCom management and others affecting the operations of the company. I anticipate filing a third report this fall. Today I will limit myself to summarizing for you the observations contained in my first and second interim reports, as well as describing the examination process itself.

On July 21, 2002, WorldCom and substantially all of its direct and indirect subsidiaries filed voluntary petitions seeking relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York. These positions came just four weeks after the company publicly disclosed on June 25, 2002 that it had discovered substantial accounting irregularities that would result in adjustments to its financial statements totaling more than $3.8 billion. The company restated an additional $3.3 billion in August 2002.

The day after WorldCom filed its bankruptcy petitions, Judge Arthur J. Gonzalez, the presiding Bankruptcy Court Judge, granted the motion of the United States Trustee for the appointment of an examiner pursuant to Section 1104(c)(2) of the Bankruptcy Code. On August 6, 2002 the Court approved my appointment as examiner. The Court's order provides that the examiner—and I am quoting the order—"shall investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of [WorldCom] by current or former management, including but not limited to issues of accounting irregularities." The Court also directed me to coordinate with the United States Department of Justice, the United States Securities and Exchange Commission, and other Federal agencies investigating matters related to WorldCom so as to avoid any duplication of effort. Further, the Court ordered me to file a report regarding my examination within 90 days of my appointment.

Upon my appointment I promptly engaged professionals to assist me in discharging the broad mandate prescribed by the Court. I engaged my law firm, Kirkpatrick & Lockhart LLP, as my legal counsel, and engaged J.H. Cohn LLP as my forensic accountants and financial advisors. My professionals and I immediately set out toward our goal of assessing thoroughly, objectively and responsibly the acts and omissions of current and former management, as well as the integrity of WorldCom's management, its accounting and financial reporting processes and its corporate governance practices and internal controls.

Our investigation has been and continues to be multi-faceted. We have reviewed millions of pages of documents received from numerous sources and conducted or participated in scores of interviews of persons with relevant information. Our document collection efforts and interviews continue to date. I am pleased to acknowledge the cooperation of WorldCom and its counsel regarding these matters. I also acknowledge with appreciation the assistance provided by Hon. Richard C. Breeden, the Corporate Monitor, appointed by the United States District Court for the Southern District of New York in a proceeding commenced by the SEC against WorldCom. Further, in an effort to avoid unnecessary duplication of effort and expense, I note that we have maintained an active dialogue regarding matters related to our examination with counsel and financial advisors for the Official Committee of Unsecured Creditors in the bankruptcy proceedings, as well as the Special Investigative Committee of the Company's Board of Directors and its counsel and professionals, and KPMG LLP, the company's current outside auditors.

Consistent with the Court's initial directive, my professionals and I have also coordinated extensively with the Department of Justice, the SEC and other agencies that are investigating matters related to WorldCom. We have refrained from publishing certain findings or results of our investigation in deference to those ongoing prosecutorial and regulatory inquiries, because those agencies have represented to us that such disclosures may adversely affect the process of determining possible criminal or other wrongdoing by persons involved in these matters.

Mr. Chairman, I respectfully request that you and other members of the Committee respect my inability to discuss these matters at today's hearing because of the related law enforcement and regulatory concerns. Similarly, I feel it would be inappropriate for me to discuss our ongoing fact-gathering efforts because any such comments may have a detrimental impact on our investigation. Accordingly, I will confine my remarks this afternoon to matters that have been addressed in my first and second interim reports of examination which are a part of the public record.

As I stated earlier, the Court initially directed that I file a report of examination within 90 days of my appointment. Pursuant to that directive, I filed my first interim report in a timely manner on November 4, 2002. The initial 90-day period obviously did not permit me the time necessary to explore all matters related to the conduct of WorldCom management. In addition, as I stated a moment ago, we omitted from the first interim report certain details, particularly items related to the specifics of the company's accounting fraud in deference to ongoing prosecutorial and regulatory interests. Therefore, the observations set forth in my first interim report were preliminary in nature. Nonetheless, as described in that report, a picture had already begun to emerge regarding the deeply problematic culture and lack of corporate controls at WorldCom.

After I filed my first interim report, my professionals and I continued our investigative efforts to advance the preliminary observations contained in that first interim report. My second interim report filed July 9, 2003, summarized my observations based upon this additional investigation. As stated in that report, the WorldCom story is not limited to the massive accounting fraud that has been publicly reported. We uncovered additional deceit, deficiencies and a disregard for the most basic principles of corporate governance. My observations in that report reflect a broad breakdown of the system of internal controls, corporate governance and individual responsibility, all of which worked together to create a culture which all too few individuals took responsibility until it was too late.

Our investigation reflects that WorldCom was dominated by Bernard Ebbers and Scott Sullivan, the former chief executive officer and chief financial officer of the company, respectively, with virtually no checks or restraints placed on their actions by the Board of Directors or other management. Significantly, although many present or former officers and directors of WorldCom told us that they had misgivings regarding decisions or actions by Mr. Ebbers or Mr. Sullivan during the relevant period, there is no evidence that these officers and directors made any attempt to curb, to stop or to challenge the conduct by Mr. Ebbers or Mr. Sullivan that they deemed questionable or inappropriate. Instead, as described in our reports, it appears that the company's officers and directors went along with Mr. Ebbers and Mr. Sullivan, even under circumstances that suggested corporate actions were at best imprudent and at worst inappropriate and fraudulent.

There are many specific corporate governance failings identified in my first and second interim reports. I will highlight only a few examples for you this afternoon. First, we observed no meaningful deliberative processes related to the company's acquisitions. As stated in my reports, WorldCom's dramatic rise in stock value throughout the 15 years preceding its bankruptcy fueled numerous acquisitions that caused the company to grow tremendously in both size and complexity in a relatively short period of time. The company's approach to such acquisitions was ad hoc and opportunistic. Acquisitions were completed with little meaningful or coherent strategic planning. WorldCom management routinely provided the company's directors with extremely limited information regarding many of these acquisitions. In fact, several multibillion dollar acquisitions were approved by the Board of Directors following discussions that lasted for 30 minutes or less and without the directors receiving a single piece of paper regarding the terms or implications of the transactions. Significantly, although persons involved with the Board's consideration of some of these matters informed us that they were disturbed at the time, no director or anyone else voiced any objection to cursory considerations by the Board.

Second, the company's lack of internal controls infected its debt offerings and use of credit facilities. Indeed, there is no evidence that WorldCom management or the Board of Directors reasonably monitored the company's debt level or its ability to satisfy its outstanding obligations. Messrs. Ebbers and Sullivan had virtually unfettered discretion to commit the company to billions of dollars in debt obligations with virtually no meaningful oversight. WorldCom issued more than $25 billion in debt securities in the 4 years preceding its bankruptcy. With respect to such offerings, Messrs. Ebbers and Sullivan comprised the entirety of the company's price committee. The Board passively "rubber-stamped" proposals from Messrs. Ebbers or Sullivan regarding additional borrowing, most often via unanimous consent resolutions that were adopted after little or no discussion.

It seems clear that WorldCom's ability to borrow monies was facilitated by its massive accounting fraud, which allowed the company to falsely present itself as credit-worthy and "investment grade." It also seems clear that the company's ability to borrow vast sums allowed it to perpetuate the illusion of financial health created by its accounting fraud. As late as a few weeks before it disclosed its massive accounting irregularities, WorldCom used false financial statements to access all of a $2.65 billion line of credit, the proceeds of which it used to pay down another credit facility. As the company's treasurer candidly told us in an interview, WorldCom merely "robbed Peter to pay Paul."

Third, our investigation raises significant concerns regarding the circumstances surrounding the company's loans of more than $400 million to Mr. Ebbers. As detailed in my reports, the Compensation and Stock Option Committee of the Board of Directors agreed to provide enormous loans and a separate guaranty for Mr. Ebbers without initially informing the full Board or taking appropriate steps to protect the company. Further, as the loans and guaranty increased, the Committee failed to perform appropriate due diligence that would have demonstrated that the collateral offered by Mr. Ebbers was grossly inadequate to support the company's extensions of credit to him, in light of his substantial other loans and obligations. Our investigation reflects that the Board was similarly at fault for not raising any questions about the loans and merely adopting the actions of the Compensation Committee.

I believe the loans to Mr. Ebbers are troubling for another additional reason. These extraordinary loans highlighted the extent of Mr. Ebbers' business activities that were not related to WorldCom. In my view, the Board should have questioned whether these non–WorldCom business activities were consistent with the need for Mr. Ebbers to devote his time and attention to managing the business of such a large and complex company as WorldCom. However, it appears that the Board did nothing to attempt to persuade Mr. Ebbers to divest himself of his other businesses or otherwise limit his non–WorldCom business activities. To the contrary, the Compensation Committee and the Board provided the massive funding that facilitated Mr. Ebbers' personal business activities.

Finally, the fact that WorldCom's accounting irregularities went undetected for so long provides further testament to the inadequacy of the company's systems of internal controls. The Audit Committee of the Board of Directors and the Internal Audit Department appear to have acted in good faith. To their considerable credit, they took significant and responsible steps once accounting irregularities were discovered in the spring of 2002. Nonetheless, it seems abundantly clear that the Audit Committee over the years barely scratched the surface of any potential accounting or financial reporting issues. Moreover, the Internal Audit Department adopted an operational audit function: that is, it focused its efforts on efficiency and cost savings concerns, rather than acting as WorldCom's "internal control police." Finally, it appears that the Audit Committee, the Internal Audit Department, and Arthur Andersen, the company's former outside auditors, allowed their missions to be limited and shaped by Mr. Sullivan in ways that served to conceal and perpetuate the company's accounting fraud.

All told, I believe that WorldCom's conferral of practically unlimited discretion upon Messrs. Ebbers and Sullivan, combined with passive acceptance of management's proposals by the Board of Directors, and a culture that diminished the importance of internal checks, forward-looking planning and meaningful debate or analysis formed the basis for the company's descent into bankruptcy. In many significant respects, WorldCom appears to have represented the polar opposite of model corporate governance practices during the relevant period. Its culture was dominated by a strong chief executive officer who was given virtually unfettered discretion to commit vast amounts of shareholder resources and determine corporate direction with only minimal scrutiny or meaningful deliberation or analysis by senior management or by the Board of Directors. The Board of Directors appears to have embraced suggestions by Mr. Ebbers without question or dissent, even under circumstances where its members now readily acknowledge they had significant misgivings regarding his recommended course of action.

Although the absence of internal controls and the lack of transparency between senior management and the Board of Directors at WorldCom does not directly translate to the massive accounting fraud committed by the company, I believe that these corporate governance failings fostered an environment and culture that permitted the fraud to grow dramatically. A culture and internal processes that discourage or implicitly forbid scrutiny and detailed questioning can be a breeding ground for fraudulent misdeeds. They also can beget ill-considered and wasteful acquisitions, improperly managed and unchecked debt and poor credit management, a lack of due diligence regarding personal loans made by the company to its chief executive officer, and an effective neutering of other gatekeepers, such as the lawyers, the Internal Audit Department and the company's outside auditors. In tandem with the accounting irregularities, these developments fostered the illusion that WorldCom was far more healthy and far more successful than it actually was during the relevant period. Ultimately, they also produced the largest bankruptcy in the history of this country.

With that, Mr. Chairman, I will conclude my introductory remarks. I thank you for the opportunity to address the Committee this afternoon. With your permission I will offer the summary sections of my first and second interim reports, which outline more fully my observations based upon our investigation, to be entered into the record as a supplement to my statement. Thank you.

Chairman HATCH. Thank you, General Thornburgh. Let me commend you for the work you are doing as the examiner in this case. As always you have demonstrated a commitment to finding out the facts in a careful, deliberative and thorough manner. I have to say the reports are valuable to this Committee as we examine this difficult issue.

Now, your reports carefully describe WorldCom's massive fraud accounting irregularities and a complete lack of basic principles of corporate governance. Some contend that the "bad apples" responsible for these problems have left or have been forced to leave the company. Would you briefly describe your findings to date concerning—you have given us the extent of the fraud and other problems with WorldCom, but I would like to know whether personnel who are responsible for these activities, are still with the company, in your opinion.

Mr. THORNBURGH. In the course of my duties as examiner and carrying out the Court's instruction to us in carrying that job forward, we have identified in our investigation individuals who were guilty of fraudulent, dishonest, incompetent activities and of misconduct, mismanagement and irregularity in the management of the affairs of WorldCom. That was what we were charged to do by the Court. Those persons identified in the two reports that I have rendered up to now in many cases have been the subjects of criminal proceedings or proceedings by the Securities and Exchange Commission, and a number of these persons have, to my understanding, been discharged or terminated by the company.

Our investigation proceeds, as I indicated. We are constrained in identifying any other potential subjects of this kind of activity we were directed to investigate by two limitations which I am sure you will understand. One is our deference to law enforcement authorities who have requested in some cases that we not even interview individuals who are persons of interest to them in their investigation. Secondly, with respect to matters that are under way and will be spelled out in our final report, it would be premature to discuss or identify any of those persons.

All that being said, I think that the task of cleaning out the company is a business responsibility, one for the current management of WorldCom. Our job is to report the facts and to identify those practices and persons that come within the scope of the order entered by Judge Gonzalez in my appointment.

Chairman HATCH. I think that you have done some relative work in examining WorldCom's accounting and internal controls. What is your assessment of MCI's prior and current accounting and internal controls?

Mr. THORNBURGH. The examination that we undertook that resulted in our first report dwelt on a number of accounting issues. At that time we were requested by law enforcement authorities to forego any mention in our first interim report of any findings or conclusions in that respect. Since that time the Securities and Exchange Commission, the United States Attorney's Office in the Southern District of New York and the Special Committee appointed by the Board of Directors and its counsel and accountants have more or less carried the ball on the completion of those examinations, and mindful of Judge Gonzalez's admonition about duplication of effort, we have been content to monitor those ongoing efforts rather than run out to completion the initial work that we undertook last fall.

I think those accounting deficiencies have been pretty well chronicled to date with regard to the internal controls. The deficiencies that existed during the period in question on the part of the external auditors, Arthur Andersen, the Internal Audit Department and the Audit Committee of the Board of Directors have been set forth in great detail in the two reports that we have filed, and I think they provide a road map of precisely what went wrong in that regard.

Chairman HATCH. Let me just say, in your second interim report you observed that there is a great deal more to this story, and that you believe, "that the extent of the breakdowns that WorldCom will eventually be determined to extend even beyond the examiner's findings."

Without compromising your ongoing investigation, when do you anticipate that you will have a more complete picture of the problems at MCI/WorldCom?

Mr. THORNBURGH. We hope and expect to wind up our efforts by the end of September of this year. Let me develop a little bit more beyond the record and the order entered by Judge Gonzalez what our charge was from the Judge. First of all, and obviously, was to compile a history, if you will, of precisely what occurred within the company that brought it to its collapse, and that is really the prime narrative of the reports that we will file and will be completed we hope by the end of September. The second was to identify practices and persons responsible for the wrongdoing that we found, so as to ensure the bankruptcy judge that any plan of reorganization did not carry forward either those persons or those practices in any reorganized company. The third is to identify potential causes of action against third parties or against insiders that will enhance the bankrupt estate and recover any ill-gotten gains.

In each of those cases our task, I am sorry to say, is not complete to the extent that we can give you a full and complete picture today, but I anticipate with the filing of our final report and the examination of the three reports in toto will give as good a record as can be compiled in each of those three areas and provide a basis for appropriate action by Judge Gonzalez as he requested.

Chairman HATCH. I understand that your investigation is still continuing, but do you believe that your final report will be completed before the bankruptcy court confirms its reorganization plan?

Mr. THORNBURGH. That of course we do not really have any control over because that is under Judge Gonzalez's jurisdiction. I hope that we will be able to proceed with dispatch, although I must say that recent scheduling problems for interviews and recent requests for documents have been a bit frustrating, and we are in constant communication with the company in order to try to speed that up so that we can meet whatever deadlines Judge Gonzalez feels are appropriate. As I said, we have had a lot of cooperation from all the parties involved here, but in order to finish our task within the parameters that permit the proceedings to go forward and ultimately determinate, we need to have that cooperation stepped up a couple levels.

Chairman HATCH. I want to thank you for being here. I appreciate your testimony and always appreciate having you appear before the Committee.

Mr. THORNBURGH. Thank you, Senator.

Chairman HATCH. Thanks my friend.

[The prepared statement of Mr. Thornburgh appears as a submission for the record.]

Chairman HATCH. Let me to go to the second panel. William Barr will be our next witness. He is the former Attorney General of the United States. He headed the Justice Department during the first Bush administration and brings a unique perspective on the telecom industry, given his previous position as General Counsel for GTE and his current position as the Executive Vice President and General Counsel for Verizon Communications. So we are happy to have you here, Attorney General Barr, and look forward to hearing your testimony here today.

Nicholas Katzenbach, I would like to welcome you to the Committee, yet another former Attorney General, Hon. Nicholas Katzenbach, held the top position at the Justice Department during the Johnson administration, and later served as Under Secretary of State from 1966 to 1969. Attorney General Katzenbach appears today in his capacity as a Board member of MCI.

Marcia Goldstein, we are honored to have you here as well. She a partner with the New York law firm of Weil, Gotshal and Manges. Ms. Goldstein is the lead attorney in charge of WorldCom's Chapter 11 reorganization.

Morton Bahr is the President of the Communication Workers of America. We are delighted to have you here and welcome you. CWA is America's largest communications and media union, represents over 700,000 telecom workers in the private and public sectors. We are just honored to have you with us, and we look forward to hearing what you have to say.

Douglas Baird. Mr. Baird is the Vice Chair of the National Bankruptcy Conference. NBC is a well-established nonprofit organization that has routinely advised us up here in Congress on the operation of the bankruptcy laws. So we are grateful to have you here to enlighten us.

Then Mark Neporent is the Chief Operating Officer for Cerberus capital Management. He appears today on behalf of the largest creditor for MCI, and as Co–Chair of the MCI/WorldCom Official Creditors Committee.

We are happy to have all of you here, and we will turn to you first, General Barr.

STATEMENT OF WILLIAM P. BARR, GENERAL COUNSEL OF VERIZON COMMUNICATIONS, WASHINGTON, D.C.

Mr. BARR. Thank you, Mr. Chairman.

MCI committed largest fraud in American history, inflicting the greatest harm on the greatest number of American citizens ever. I believe that the Federal Government's enforcement response to this has been the most shameful episode I have witnesses in 25 years in Washington, D.C.

The problem in my view is not with the bankruptcy laws. I believe the problem is the abdication of enforcement authorities. Have the enforcement authorities taken any action to strip away the fruits of the crime? No. In fact, they have left this company with virtually all of the fruits of the crime intact to deploy against law-abiding companies in the marketplace. Have they taken any action which would have been a matter of course to suspend the company from doing further business with the Government? No. In fact, they have radically expanded MCI's business with the Government in the months since the fraud came to light. Have they obtained meaningful restitution for the victims of this crime? No. In fact, restitution has been limited to three-tenths of 1 percent of the loss.

I believe that the problem here involves the intersection of two different and distinct bodies of law that have very different objectives in which the Government plays very different roles. The first of these is the bankruptcy law. Bankruptcy law provides the general rules for handling the estate of an insolvent company. Here, under bankruptcy, creditors are given priority, and obviously there is a lot of interest in conserving the assets of the entity. But when a company engages in criminal activity, criminal fraud, deriving substantial ill-gotten gains and business advantages at the expense of a variety of victims including shareholders and other companies, than a wholly different set of rules and laws and principles come into play, and that is the criminal enforcement process.

When a crime is committed the Government's interest is not in preserving the assets of the company that committed the crime and derived those assets through fraud. It is in securing the disgorgement of the ill-gotten gains through enforcement processes, and also it is not just directed at the interest of the creditors, it is directed at the interest of vindicating the interest of all of the victims of the fraud. Title 18 makes this explicit in the criminal code where it says that these enforcement responsibilities of the Government take priority in bankruptcy. In other words if I was a massive con artist and went out and—and probate law provides a good analogy here because probate are the general rules that apply to the disposition of an estate when someone died—but if I was a massive con artist and part of my estate involved ill-gotten gains, money I had obtained through fraud, the Government does not waltz in and say, now the probate process takes over, now we are interested in conserving your assets and passing them on. No, the enforcement authorities sort out what goes into the estate and what does not, and the same is true with bankruptcy. If I was a con artist and did not die, but just declared bankruptcy, then it is no answer to say, well, gee, the bankruptcy process is now invoked. The person is in bankruptcy. Let the bankruptcy rules handle this. No. The Government's responsibility is the same. In other words, bankruptcy relates to the disposition of assets that are in the estate, but where a crime is involved, it is the responsibility of the enforcement authorities to determine what assets are fair to allow to go into the estate, and that is the threshold issue.

But what is happening here is that the Government has abdicated its responsibility and it is stumbling all over itself to meet MCI's timeline and private preferences as to how it wants to emerge from bankruptcy. It is interesting, we have a lot of bankruptcy aficionados here today, and it is always interesting to hear about bankruptcy, but it sort of misses the point which is the enforcement responsibilities of the Government. Bankruptcy does not provide the remedial scheme for crime. The enforcement authorities and the criminal laws provide the remedial scheme for crime. For people to come in today and say, well, the Government should only punish individuals. That is one proposition, the Government should punish individuals not the company; and the other proposition is: hey, under bankruptcy law creditors get everything. Therefore, you should not take any of the assets away from the company, you should leave it all for the creditors. That is clearly fallacious and I cannot imagine that any member of this Committee would embrace either of those principles. Enforcement is not just about punishment, as every of this Committee knows. Enforcement is about, in part, remediation, disgorgement of ill-gotten gains and restitution, dealing with the victims of crime. It is not a question of punishment. It is a question of the intervention of enforcement authorities to make sure that crime does not pay and ill-gotten gains are surrendered.

MCI is suggesting that we are here trying to force the liquidation of MCI, but in fact we are not. We do not care what result is ultimately reached in bankruptcy so long as the Government does a fair job with its enforcement responsibilities, and MCI is not able to use its ill-gotten gains to secure dishonest advantage in the marketplace, and it is very clear that the Government could do far more without denying MCI the opportunity to reorganize. Indeed, some of the major issues such as continuation of Government contracts and the use of net operating losses, that is, their claim that they should be able to operate tax free for the foreseeable future, these are matters which they themselves say are not integral to their reorganization plan.

So, further, the amount of penalty that has been exacted by the SEC, as I said, is three-tenths of 1 percent of the losses, and is a tiny fraction of the amount of ill-gotten gains, and it leaves the company in a position where its debt-to-sales ratio is the lowest in the sector, 22 percent, compared to the average in the sector of 85 percent. So it is being put in an extremely advantageous position in the sector. None of the companies here today who are concerned with this—and I know I am speaking here not just for Verizon but for AT&T and SBC and Bell South. None of these companies are concerned about competing with anyone on an honest playing field. But what we object to and what should offend the sense of justice of this Committee, is that MCI, far from being punished and far from being held to account, required to remedy the consequences of its wrongdoing, it is being massive advantages over competitors and law-abiding citizens. That is not good for the employees in this sector. It is not good for the consumers in this sector. It is not good for the economy.

Thank you.

[The prepared statement of Mr. Barr appears as a submission for the record.]

Chairman HATCH. Thank you, General Barr.

General Katzenbach, we will turn to you.

STATEMENT OF NICHOLAS DEB. KATZENBACH, BOARD MEMBER, MCI TELECOMMUNICATIONS, ASHBURN, VIRGINIA

Mr. KATZENBACH. Mr. Chairman, my name is Nicholas Katzenbach. I serve as an independent member of the Board of Directors of MCI. I served as Attorney General from 1964 to 1966, and since leaving public service I have practiced law, including serving for 17 years as General Counsel of IBM.

I joined the Board of MCI in July 2002, and I served as a member of the Special Investigative Committee of the Board. Prior to that time I had no connection with WorldCom or any of its affiliates. I knew none of the directors, all of whom have since resigned. I knew none of its senior management, all of whom have since either been dismissed or resigned. I was not around the company in any way when its then senior management perpetrated the largest financial fraud in American business history.

In my written statement, which has been submitted to the Committee, Mr. Chairman, I describe at some length the measures that the new management under Michael Capellas has taken to overcome the legacy of gross misconduct. I have not seen the slightest doubt that we are succeeding in that effort, and it is gratifying to know that Judge Rakoff, who presides over the SEC suit against the company, agrees. In his recent decision fining the company he said, “The Court is aware of no large company accused of fraud that has so rapidly and so completely divorced itself from the misdeeds of the immediate past and undertaken such extraordinary steps to prevent such misdeeds in the future.” That is the end of the quote. I do not think even our competitors question those efforts. I certainly hope not.

What they do seek is to inflict more pain on MCI, and if possible, I believe, to destroy the company. I think their real purpose is to reduce competition, but their ostensible reason to punish the corporation for past misdeeds. There is of course no way to punish an abstract legal concept. So the question is who? Which real people do they believe should be punished? Is it the 55,000 remaining employees of MCI who already have seen their jobs put at risk and their retirement savings driven toward oblivion? Or is it the stockholders whose investment has been totally destroyed? Or the creditors who financed this huge expansion only to see fraud destroy most of their investment? All these people are victims of the fraud, not perpetrators. The perpetrators are long gone, and they are defendants in the courts where they should be. Or is it the new management and the new board who are trying successfully both to make the company a model for ethical behavior and a successful competitor? Or is it our customers who are free today and should be free tomorrow to choose the most reliable service at the best price? Or is it, as I believe, simply a ploy to reduce competition and raise prices in troubled times at the expense of those who have already suffered far more than competitors have suffered?

I am not a bankruptcy expert by a long shot, but it seems to me that our competitors seek to amend those laws narrowly for no reason other than to enhance their competitive advantage. If they believe that those laws should be changed whenever the management of a company is guilt of fraud, they should at least be forthright and say so. Such changes would potentially affect companies in many diverse industries who are not here today to defend laws duly enacted by Congress. Such changes raise important policy questions which kicking around MCI's past management does not suffice to answer.

Mr. Chairman, I heard the eloquent statement of Mr. Barr, and all I can say is that what he describes as those ill-gotten gains are the loans that were made to MCI/WorldCom, which were made in part as a result of fraud. I do not see any pot of gold anywhere that is not before the bankruptcy court, and I think Mr. Barr would agree that all the assets are before the bankruptcy court. They are to be distributed there in accordance with law, in an effort to punish those to reward as far as it can, those who have suffered the losses from this fraud. Mr. Barr refers to the interest of justice, and quite frankly, Mr. Chairman, I cannot see how punishing innocent people who are not involved in the fraud serves the interest of justice in any way whatsoever.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Katzenbach appears as a submission for the record.]

Chairman HATCH. You are welcome. Thank you so much.

Ms. Goldstein?

STATEMENT OF MARCIA L. GOLDSTEIN, PARTNER, WEIL, GOTSHAL AND MANGES, LLP, NEW YORK, NEW YORK

Ms. GOLDSTEIN. Thank you, Mr. Chairman.

I am MCI's bankruptcy counsel, and I co-chair the Business, Finance and Restructuring Department at Weil, Gotshal and Manges, which is the largest bankruptcy and reorganization practice in the country.

This is a hearing on public policy matters arising from the WorldCom Chapter 11 case. The company's competitors have called for MCI's liquidation or have demanded other punitive actions against the company. Verizon particularly has done so in written communications to Chairman Donaldson of the SEC, and in submissions to the District Court presiding over the SEC enforcement action and presiding over the recent approval of our settlement with the SEC.

My view is that these demands represent the narrow, competitive self-interest of MCI's long-time competitors and completely ignore the structure and goals of our bankruptcy laws. Let me state emphatically that as a matter of law the liquidation or forced sale of MCI is not an option here. MCI will emerge from bankruptcy consistent with its reorganization plan and the requirements of Chapter 11. The only parties who would benefit from a liquidation or forced sale would be MCI's competitors, not creditors, not shareholders, not employees, not consumers.

The Federal bankruptcy laws balance two goals: equal treatment for creditors of equal rank and the restructuring of a business to preserve jobs and to maximize return to creditors. At the heart of these goals stands the basic premise of bankruptcy policy, that when the going concerned value of an enterprise exceeds liquidation value, reorganization of the debtor will maximize return to creditors and lead to preservation of the enterprise.

Following the announcement of the accounting fraud last June, WorldCom turned to Chapter 11 in order to preserve value for its creditors. Just as the bankruptcy laws intended, Chapter 11 enabled WorldCom to obtain otherwise unavailable financing and the much-needed breathing room to develop and implement a business plan, provide uninterrupted service to its customers, and propose a plan of reorganization that is supported by 90 percent of its creditor constituencies.

Under Verizon's theory MCI should be liquidated, subjected to a forced sale, or otherwise punished, rather than reorganized to prevent it from benefiting from its pre-petition fraud. The theory, however, not only completely ignores the fundamental principles of Chapter 11 but also the realities of who the stakeholders are in this Chapter 11 case. The legislative history of Chapter 11 is clear that the creditors, the new owners of the company, should not pay for the fraud. Indeed, in this case, if any parties were the victims of the fraud who should receive the restitution that Mr. Barr talked about, it is the creditors who made loans based upon misleading financial information. Contrary to the premise of the Verizon theory, a Chapter 7 sale or a forced sale would not yield a fair result to either the company's employees or its creditors. Creditors would recover significantly less than under MCI's reorganization plan. In the scenario of a Chapter 7, and this is what was suggested to Chairman Donaldson in the letter from verizon back in March, financing would be cut off, trade credit would dissipate, new business would be highly unlikely, customers would be unnerved and the value and stability that has been achieved in the Chapter 11 state could precipitously decline. Most significantly, creditors would have no vote as they would in Chapter 11, and as a natural result of consolidation, many MCI jobs would be eliminated. The notion that MCI would remain a going concern and employees would not suffer is just disingenuous.

Let us be clear: Verizon's proposed punishment, which as we have read would be a break up or forced sale of MCI, is only for its own benefit so that it can bid for MCI's business at a distressed value, and eliminate it as a competitor. This scenario demonstrates clearly why bankruptcy laws are not driven by the interests of competitors, but rather, by their nature, preserve competition. In addition, injured stockholders of MCI, many of whom are employees or were employees will receive compensation, including stock from reorganizes MCI through the settlement made with the SEC. However, the distributions contemplated by the SEC settlement would only be available upon completion of a successful emergency from Chapter 11. If Verizon gets its way, the shareholders would suffer as well.

Verizon and others have expressed the concern that MCI will emerge from Chapter 11 with a reduced debt load and therefore a competitive advantage. Such concerns are misplaced. Chapter 11 assists all debtors in restructuring a balance sheet when they cannot meet the debt load that they have. Over leverage was one of the problems that resulted from WorldCom's fraud, and lack of corporate governance as described by Mr. Thornburgh.

The proposed debt level for reorganized MCI, which is approximately $5.5 billion, represents about 41 percent of the post-bankruptcy value of the company. In contrast, Verizon's debt represents only 30 percent of the value of its company. We do not believe that that is necessarily a relevant measure, nor the measure of debt service to sales is a relevant measure for determining the ability to compete in a market. But if there is any competitive advantage based upon leverage, it clearly falls to Verizon. Further, in my experience, companies seek bankruptcy protection only as a very last resort, given the burdens, constraints and other negative repercussions of Chapter 11.

Mr. Chairman, I apologize, but I would just like to conclude with a final remark. The creditors of the company will be the new owners of a reorganized MCI. If Chapter 11 could not achieve this results, such creditors would be penalized twice, once by the losses resulting from WorldCom's pre-bankruptcy fraud and again by being denied recovery under the normal operation of the Bankruptcy Code. It is the protections and benefits of Chapter 11 that have enabled MCI to take the steps to emerge as a rehabilitated enterprise that has regained the confidence of its creditors, customers and employees. The context in which MCI cleaned house, settled with the SEC, developed a business plan, and negotiated a plan of reorganization with its major creditor constituents is the product of a balance Federal bankruptcy law. It should be commended. It should not be punished or otherwise denied.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Goldstein appears as a submission for the record.]

Chairman HATCH. Thank you.

Mr. Bahr, we will turn to you.

STATEMENT OF MORTON BAHR, PRESIDENT, COMMUNICATIONS WORKERS OF AMERICA, WASHINGTON, D.C.

Mr. BAHR. Thank you, Mr. Chairman, Senator Durbin.

WorldCom's bankruptcy was not the result of honest business mistakes or unforeseen economic conditions. Rather, it was the produce of persistent, pervasive and massive corporate fraud. WorldCom's Chapter 11 filing cost investors $200 billion, three times the size of Enron. WorldCom's lies and false financial reports destabilized the entire telecommunications industry.

I want to talk about the real people that General Katzenbach referred to. Tens of thousands of employees, not only at WorldCom but throughout the telecom sector lost their jobs and retirement savings, yet WorldCom is positioned to emerge from bankruptcy with perhaps the strongest balance sheet in the industry. This would cause further destabilization and job loss in the struggling telecom sector.

The victims of WorldCom's crimes are legion. Among the largest group are employee pension funds. Public pensions and Taft–Hartley funds lost at least $70 billion. Public funds in almost every State suffered staggering losses, $1.2 billion in California, $393 million in New York, $277 million in Texas, $23 million in Utah, to cite just four examples. I have attached a list of public pension funds losses by State.

State and local governments have been forced to make up for these losses by cutting vital public services. According to New York State Comptroller Alan Hevesi, and I quote, "Police officers, firefighters, teachers and other public servants have lost their jobs and public services have been diminished throughout New York State because of these financial losses."

Mr. Chairman, the damage does not stop there. More than 22,000 WorldCom employees lost their jobs, and thousands more saw their 410(k) retirement savings decimated. Initially, these laid-off workers were left with nothing, even as the new WorldCom Board agreed to pay its new CEO $20 million over 3 years. The AFL–CIO came to their aid, and won minimal severance benefits of $5,000 each.

WorldCom employees were not the only telecom workers who saw their livelihoods and careers collapse. How can an honest company compete with WorldCom's $11 billion in counterfeit earning? Imagine that you are AT&T or Sprint, bidding against WorldCom. AT&T and Sprint have to price the bid to cover costs, plus a reasonable profit, but WorldCom could low-ball the bid, get the contract and then cover the losses by cooking the books. When WorldCom's fraudulent accounting was revealed, AT&T's Vice Chairman said, and I quote, "We were constantly dissecting all of the public information about WorldCom and we would scratch our heads and try to figure out how they were doing it."

Trying to match WorldCom's cost structure, AT&T turned to cost cutting. AT&T told us it had to downsize half of the employees who took care of the network, maintained the network, to make it line up with WorldCom. During the period of WorldCom's corrupt practices, AT&T eliminated 18,000 jobs represented by our union. These job cuts devastated individual workers and their families.

Let me read from just one letter written by Laura Unger, the CWA Local president in New York City. "AT&T told us it had to downsize half of the employees that took care of AT&T's network to make it line up with WorldCom's financials. Cost cutting was accomplished in several ways: layoffs, office consolidations and so-called voluntary terminations. My local had over 800 members in 1999. By the spring of 2002 it was under 400. An office was moved from New York City and consolidated with another in White Plains to cut costs. In order to keep their jobs many members added over 2 hours to their daily commute. One member was leaving at 5:00 a.m. every morning to get to work. This winter he died suddenly of a heart attack at age 47. His wife attributed it to the extra strain of traveling so far every day." I have attached letters from CWA leaders across the country with similar stories to my testimony.

WorldCom is using the bankruptcy proceeding to shed more than $27 billion in debt and to avoid punishment for its crimes. Absent meaningful penalties, WorldCom is positioned to emerge from bankruptcy with the best balance sheet in the business. Employees at companies that played by the rules will once again be victims of aggressive cost cutting setting off another destabilizing cycle of job loss throughout the industry.

Mr. Chairman, to date WorldCom has received paltry punishment for its crimes. The $500 million SEC cash settlement plus $250 million in stock is less than the cash penalty imposed on junk bond trader Michael Milken in the 1980's.

Some argue that higher penalties would prevent WorldCom's emergence from bankruptcy, and this in turn would hurt the company's remaining employees and customers. This argument fails on at least three counts.

First, our bankruptcy laws were not designed to shield criminal companies from punishment.

Second, WorldCom could sell assets. There are buyers who would continue WorldCom's operations and provide stability to WorldCom's employees.

Third, in today's marketplace long distance customers have many choices. Wireless plans and the Bell companies' bundled offerings would be the driving force behind price competition, not WorldCom.

No company including Enron has done as much damage to the American economy. The Federal Government must send a clear message that it will not coddle the poster child of corporate crime. It is long past time for the Government to suspend WorldCom from Federal contracts and prevent its unfair use of tax loopholes.

Thank you.

[The prepared statement of Mr. Bahr appears as a submission for the record.]

Chairman HATCH. Thank you, Mr. Bahr.

Mr. Baird, we will take your testimony.

STATEMENT OF DOUGLAS G. BAIRD, VICE CHAIR, NATIONAL BANKRUPTCY CONFERENCE, CHICAGO, ILLINOIS

Mr. BAIRD. Mr. Chairman, I am grateful for the opportunity to speak on behalf of the National Bankruptcy Conference.

We should not underestimate the harm done in the name of WorldCom before it filed for bankruptcy. Fraudulent conduct disrupted the lives of thousands of workers both at WorldCom and elsewhere. Moreover, this conduct likely caused others to invest billions of dollars on telecommunications equipment that no one needs. The frauds and other crimes committed by WorldCom's former managers give rise to a large number of issues in many areas of the law.

I have been asked to focus narrowly on the bankruptcy issues raised by WorldCom. I make two points. First, we should be mindful of the central concern of bankruptcy law. When a firm's finances become hopelessly confused, we need to make sure that the assets of the firm are preserved and put to good use rather than broken up piecemeal. Second, we want to make sure that any bankruptcy reforms made because of WorldCom take account of other bankruptcy cases. These include the bankruptcies of firms that were victims of the fraud committed by WorldCom.

Let me elaborate first on the need to preserve assets. Bankruptcy law fully respects the legal rights of those who have recourse against WorldCom's assets. These include competitors to the extent they have causes of action under non-bankruptcy law. Moreover, bankruptcy law does not and should not affect the regulatory sanctions WorldCom must face for these past transgressions. The job for bankruptcy law, given all this, is to ensure that WorldCom's assets are not destroyed in the process of holding those responsible for the frauds and other crimes they committed. We use WorldCom's fiberoptic cables every day as we access the Internet and place a phone. WorldCom still employs thousands who keep this vast network up and running. It makes no sense to rip up that cable or tear out those phone lines because of what was done in the name of WorldCom in the past.

Imagine I commit a crime with a car. Now, I of course should be held accountable. I should not be able to keep the car. But we should not destroy the car. Destroying the car does nothing to help the victims of the crime. Indeed, preserving the car may be the only way we can compensate the victims for their loss. In the end we can punish only people, not assets. You can imagine Chapter 11 at that part of the law that is worried about the car as opposed to the criminal who used it. Bankruptcy law allows the assets to be used productively, while allowing the bad guys to be punished and the victims to obtain redress. Chapter 11 creates a forum in which the assets of troubled firms can be kept together rather than scrapped.

Now, there are different ways of doing this.

In many large Chapter 11's a firm can be sold as a unit. In others, there is not a formal sale of the firm. Instead, a new capital structure is put in place, and those with rights to the assets, rather than getting cash, get interest in the reorganized firm. But in the end these two routes are the same. These two routes both allow the assets to be used productively. Both allow the on-the-ground people to maintain those assets and to keep their jobs. Both allow victims to be compensated. The choice between these two routes depends on what is best for the investors, fraud victims and others with rights against the firm. In short, bankruptcy allows us to make the best of a bad situation.

WorldCom, I should say, does present some peculiar challenges. For example, in part of because of WorldCom's bad behavior but also because of technological innovation, much fiberoptic cable throughout the telecommunications industry lies unused and will remain dark forever.

Hard regulatory issues need to be sorted out by virtue of this overcapacity that is now in the system. These issues, however, are not bankruptcy issues. Chapter 11 focuses only on a particular firm and asks whether that firm going forward can succeed, notwithstanding its troubled past. What do we do with the car, assets, now that the car is in the hands of new owners? Bankruptcy judges are poorly equipped to decide how to make an entire industry work better. Bankruptcy judges are not regulators and they should not be regulators.

I focused on bankruptcy issues narrowly, but I think bankruptcy law may offer one broader lesson. After all, Chapter 11 has had to deal with fraud from the time of Charles Ponzi to the present day. Bankruptcy suggests that solutions to industry-wide problems should be forward looking. If we are to use Government regulation to solve the problem of overcapacity, we should ask what regulations make the most sense for consumers today and for consumers tomorrow. We should not focus on bad acts committed in the past. Again, we have to separate the car from the driver.

I conclude with a brief note about S. 1331 and the treatment of net operating losses on consolidated returns. We have a tax code that treats related entities as a single entity for some purposes but not for others. Sorting through what type of treatment, whether it should be treated as one or many separate firms, has proved enormously complex. S. 1331 addresses a question that is currently unsettled. This is the question when there are consolidated returns should net operating losses of one entity be reduced when another related entity has cancellation of indebtedness income? S. 1331 provides that net operating losses should be reduced in these cases. This is a reasonable position, and this indeed may be the law today.

I would urge caution however before legislating this change. This question arises all the time. It applies to many firms. It affects WorldCom but it also affects firms that are in bankruptcy that may have been the victims of WorldCom. In some cases reducing net operating losses of related entities makes intuitive sense. In others it makes no sense at all. The tax treatment of consolidated returns is an intricate web. You cannot pull out one thread and expect nothing else to change. In my written statement I identified one technical problem, but there may be others. This kind of change—and again, it would be a reasonable outcome—is a change that the experts on the Joint Committee on Taxation should vet carefully before you proceed.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Baird appears as a submission for the record.]

Chairman HATCH. Mr. Neporent, we will turn to you.

STATEMENT OF MARK A. NEPORENT, CHIEF OPERATING OFFICER, CERBERUS CAPITAL MANAGEMENT, LP, NEW YORK, NEW YORK

Mr. NEPORENT. Mr. Chairman and distinguished members of the Committee, thank you for the opportunity to express my views and the views of the Official Unsecured Creditors Committee in MCI's Chapter 11 case at this hearing.

My name is Mark Neporent and I am the Chief Operating Officer of Cerberus Capital Management, one of the largest creditors in MCI's Chapter 11 case. My firm, together with its affiliates, manages funds and accounts with committed capital exceeding $9 billion. Our investors includes insurance companies, pension funds, endowments, institutions, wealthy individuals and many fund-to-funds.

I have personally been engaged in the business of restructuring and reorganizing companies, both large like this one, and small companies, as a practicing lawyer and as a principal, and I have observed the delicate balancing of policy and law that occurs in this process. I am also the Co–Chairman of the Official Unsecured Creditors Committee in MCI's case. The committee, as the statutory representative of all unsecured creditors, represents creditors across the entire MCI corporate structure with aggregate claims exceeding $40 billion.

MCI's creditors, employees, customers and public policy are best served and protected by adherence to the process envisioned by and incorporated in the Bankruptcy Code. Ms. Goldstein has already described today the two separate and distinct policies that have long guided this process in the United States. They are, one, a fresh start for financially distressed companies, and two, the equality of treatment of creditors. These policies, while designed to protect two different albeit converging interests are equally important to the success of the Federal bankruptcy regime. Taking punitive action against MCI, as suggested by Verizon and others, will only undercut the policies underlying the Bankruptcy Code and its role in our economy. These actions will harm, not help, the very parties and interests that these policies were designed to protect, the victims here, the creditors.

Bankruptcy long ago lost its stigma and it is now widely recognized as a legitimate and sometimes necessary corporate strategy in the context of our capitalist system. As noted in a recent news article, scores of businesses, some of them icons of American industrialism, have gone through bankruptcy and emerged to become strong, vibrant concerns, employing millions, offering consumers a wide variety of desirable goods and services. Texaco, Remington Arms, Continental Airlines, Southland Corporation's 7–11 stores, these companies have all gone through this process and been restored to viable business enterprises.

MCI's bankruptcy case is an excellent example of how the policies underlying Federal bankruptcy law are being implemented effectively to take what is a truly tragic situation and salvage the maximum possible value for the true victims of this fraud, again, the creditors.

MCI was forced to seek bankruptcy protection in July 2002 due to the fraudulent activities of but a handful of its top executives.

Within a year of the filing, virtually all employees remotely connected to the fraud, and the entire Board of Directors, had been fired or replaced. A dynamic new CEO has been hired to lead MCI out of the woods, and its financial management team has been completely rebuilt. All parties have worked closely with Hon. Richard Breeden, the former Chairman of the SEC, to shape and ensure that MCI will emerge from bankruptcy as a model of good corporate governance and a good corporate citizen.

A number of MCI's competitors have asserted that it should be punished for the crimes of its former executives by being either forced to liquidate or restricting its ability to obtain and serve its Government contracts. This is the equivalent of the corporate death penalty, capital punishment for the transgressions of a few rogue executives. In doing so, those opposing MCI's reorganization ignore a fundamental policy of Federal bankruptcy law, the protection of the creditors, the real victims here, which include numerous individuals, banks, pension funds, insurance companies and endowments, who had nothing to do at all with the fraud perpetrated by these few senior executives.

MCI's reorganization plan provides creditors with a much greater chance of recovery than does liquidation. MCI's going-concern value is estimated to be approximately 12 to $15 billion, while its liquidation value is estimated to be only $4 billion. Within 9 months after this filing, representatives of virtually all of MCI's debt have quickly and efficiently resolved their differences exactly in the manner contemplated by the Bankruptcy Code, and have given their support to MCI's reorganization plan.

Mr. Chairman, this would be remarkable in any case, but it is especially so in this case, the largest bankruptcy case in history. The only parties who will benefit from MCI's liquidation are its competitors and related powerful special interest groups. These competitors have enjoyed decades of unchecked monopolistic advantage as the mega combinations of the past. Monopolies, which built their franchises in an environment protected from competition, now rather than face MCI head-to-head on the competitive landscape, they seek to eliminate the competition and destroy creditor value with misplaced and misguided attacks on innocent creditors, employees and customers.

I note that the recently enacted Sarbanes–Oxley Act of 2002 has reaffirmed the policy of allowing corporations to attain relief from claims arising from fraud, while revoking that privilege for individuals. This underscores an important distinction that has already been made here today between the individual corporate officers that commit a fraud and the corporate entity and creditors that they victimize.

I see I am virtually out of time, Mr. Chairman, so let me say that MCI's new management, the Board, and the creditors Committee have worked tirelessly for more than a year to provide the building blocks for the emergence of MCI from bankruptcy and a chance to recover some of the billions of dollars that have been lost at the hands of a few dishonest and misguided executives.

This Chapter 11 case is an exemplar of how Congress envisioned the Bankruptcy Code to work. I can tell you from two decades of personal experience, it does not often work this well. The company, its employees, its creditors, the Federal judges supervising this case, and the system are to be commended. The self-serving attempts by MCI's competitors to force liquidation find no support in the law, public policy or common sense, and should be dismissed.

Thank you again, Chairman Hatch and distinguished members of the Committee for allowing me to share my views.

Mr. Chairman, with your permission, I would like to submit my full written testimony to the record.

Chairman HATCH. Without objection we will take all the full written statements as though fully delivered.

[The prepared statement of Mr. Neporent appears as a submission for the record.]

Chairman HATCH. Mr. Barr, let me turn to you. Some have suggested that MCI/WorldCom's past frauds have had a direct impact on bursting the telecommunications bubble. As a competitor in the market, can you describe what impact the WorldCom fraud had on the actions of your company and others in the telecommunications industry? And if you care to—and I want to give the same rights to Mr. Katzenbach or Ms. Goldstein—comment on what you have heard here today from those who disagree with you.

Mr. BARR. Yes. If I could start with the latter part of the question and then work my way around to the bubble.

Chairman HATCH. Sure.

Mr. BARR. In our criminal justice system we recognize two kinds of misconduct by corporations. One is where there is in fact a rogue employee, who for self-serving reasons, to benefit themselves, commits a violation. In that situation the company is viewed as a victim. In the other situation, as where the acts are committed to benefit the company's business, in that situation the company is not the victim. They are the beneficiary of the fraud. It might do well to remember why do people commit corporate crimes other than of the latter type, that is, to benefit the corporation? Why do they do it? They do it to hurt competitors. That is the reason they commit the fraud in the first place.

So if I go out and steal $15 billion from a bank, and I set up a business, and I use that cost-free money to me to set up a business, what am I doing? I am stealing customers, I am stealing business, from competitors. So there are two sets of victims, there are the people I stole the money from, and then there are the—the reason I stole that money is to deploy it to hurt other companies and to gain advantage over those companies.

There are two sets of victims. Now, we have no problem with the creditors getting paid money for their losses, but what is wrong here is for the creditors to waltz in as if they are the only ones that have been hurt by this, and says, you know what? That looks like a good deal. This company is set up with cost-free money. We want a piece of that action.

What justice requires and what enforcement requires, and what that means in this situation is that they are getting the premium for the crime. They are the participants after the fact and the beneficiaries of the fraud, and the continuing injury is done to competitors in the marketplace. So I make no apology for being a competitor in the marketplace. We are the obvious victim of the fraud, and we, like they, are an entity. So who are the victims? It is our employees and our shareholders, and we are standing up for them, and we do not want them to continue to be victimized for the benefit of vulture funds.

Now, turning to the bubble. This is another very severe injury done to our economy by WorldCom and by the senior leadership of WorldCom, who for years put out statements that the Internet was doubling, traffic was doubling every 3 months, and that combined with their own fallacious revenue reports, led to a lot of investment in long-haul fiber, $50 billion of misinvestment, largely driven, in my view, by the false public statements of high-level WorldCom executives. This is all laid out in a very good article by Greg Sidak over at AEI, which I call to the Committee's attention. So that is even another example of the damage done to our sector and to our economy by this company.

Chairman HATCH. Mr. Katzenbach or Ms. Goldstein?

Mr. KATZENBACH. I will be very brief. I must say that I was amazed to hear that Mr. Ebbers and Mr. Sullivan were acting for the benefit of the company. That is something I had never perceived before. I think they were acting for their own benefit, for the millions of dollars which they got out of this purported success for an enormous ego trip that they were on, and I think that is why they acted.

I was also happy the Mr. Barr at least acknowledged that his purpose was liquidation. He had not said that as precisely before. He just does not want—

Mr. BARR. I did not say that.

Mr. KATZENBACH. Yes, you did. You did say that. You said that the purpose was to punish them in a way—it is all right for the creditors to get money, but they could not get back into the market.

Mr. BARR. Nick, not punishment. To surrender the ill-gotten gains. That is called justice.

Mr. KATZENBACH. The ill-gotten gains? You are talking about the money that the creditors lent because of the fraudulent representation of Mr. Ebbers. Those are the ill-gotten gains.

Ms. GOLDSTEIN. Mr. Chairman, I would like to also make a few comments on that point. Mr. Barr makes the analogy of stealing from a bank and having cost-free assets to run a company. That is not what happened here. There is no cost-free money here. The company, as a result of the acts of its prior management, poor corporate governance, ended up in a very over-levered situation. At the same time creditors were defrauded. They were the parties who lent the money to WorldCom during this frenzy of the telecom bubble. So I would like to address at both times the question of the telecom boom and WorldCom's part in it, and also who are the victims and what is the proper way to proceed to punishment.

There is no theft here that is cost free. As I said, there was a fraud, an accounting fraud. Creditors lent money. The company became over leveraged. What is the ill-gotten gain? The ill-gotten gain, as Mr. Katzenbach said, was the money taken from creditors, not from competitors. Those same creditors were also investing in the competitors. Shareholders were also investing in the competitors. WorldCom was not responsible for either the boom or the bust in the telecom industry. There were a number of economic issues that were taking their toll on the overall telecom market, and that had much more to do with just WorldCom and its particular fraud in the accounting area, and the telecom bust occurred well before WorldCom announced and discovered its fraud.

The problem here, Mr. Chairman, and other members, is that the company is in part the victim. Even as Mr. Thornburgh described, the frenzied acquisitions undertaken with insufficient corporate governance, who is the victim today of assets that this company overpaid for substantially when we look at those transactions in hindsight and look at the real value of the assets that this company has.

The fraud overinflated the company's earnings. It resulted in unnecessary and over leverage. The company is now reorganizing. It has to make restitution, but it has to make restitution to the parties who were injured in the first instance. That is the creditors. The creditors lent the money.

The other point to make here is there has long been a distinction between the bankruptcy of an individual who commits a fraud—that individual cannot obtain money by purposes of fraud and then discharge that debt in bankruptcy. But the policy that this Bankruptcy Code enacts is very different for the corporate entity that has been involved in a pre-petition fraud. The creditors of that company are not the perpetrators of the fraud. They are not, as Mr. Barr suggests, the beneficiaries who are going to run off with a premium. They are not going to recover more than 100 percent here, indeed far less. The creditors become the new owner of the company, so the company will be sold, maybe not sold to a competitor, but it will be sold to a new owner, the group of creditors, who in exchange for the indebtedness that was incurred by WorldCom from them will now become the shareholders of this company.

I would like to quote, if I may, from the legislative history of this Bankruptcy Code. "A corporation which is taken over by its creditors through a plan of reorganization will not continue to be liable for obligations arising from the corporation's pre-petition fraud, since the creditors who take over the reorganized company should not bear the burden of acts for which the creditors were not at fault."

This is the core of a number of provisions in the Bankruptcy Code, including the distinction between individuals who commit fraud and a corporation that commits fraud. It is also notable that Section 510(b) of the Bankruptcy Code requires the subordination of securities fraud claims to the claims of creditors in the same class. The defrauded security holders have other remedies that are being pursued. There are many, many class actions here, and it is not the normal creditors who extended credit, made loans to this company, who should pay for the fraud committed vis-a-vis these defrauded security holders. The individuals responsible are being sued. They are being pursued by the criminal authorities and rightly so. That should not interfere with the transfer of ownership under the plan of reorganization that has been—

Chairman HATCH. My time is up, but I want to give Mr. Barr a chance since both of you have testified, to say anything he wants to say.

Ms. GOLDSTEIN. Sorry, sir.

Mr. BARR. Yes. This notion that the creditors are the only victims here is just nonsense, and I will give just one very tangible example why the existing business, the customers and the network, are not all the assets of the creditors here. During the time of this fraud WorldCom's business in Government contracts went from $122 million to $1.2 billion, increased ten times, tenfold, its business with the executive. But for the fraud they were not qualified for that business. If their true financial picture had been presented to the Government, they could not have gotten that business. They lied to the Government and they increased their business by $1.2 billion. Now, who would have gotten that business? That is money out of the pocket primarily of AT&T. That is business stolen from AT&T shareholders by this fraudulent company, and those customers, the Federal Government, exists today. That business exists.

So to say that, gee, we want an interest in this thing because we were the only ones hurt, is simply wrong.

Chairman HATCH. Senator Durbin?

STATEMENT OF HON. RICHARD J. DURBIN, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator DURBIN. Thank you, Mr. Chairman. I am listening to this and it sounds like a very high-level seminar involving a law school and a business school. Perhaps I can bring this discussion to a little bit different level for a moment. I think we all can see the obvious, the commission of the largest corporate fraud in history, $11 billion. I guess what we are trying to determine is whether or not MCI/WorldCom has been unjustly enriched because of that situation, because of that fraud. I think that is an important question. We certainly know the victims. They include not only creditors, they include people in my home State who had pension funds invested in MCI/WorldCom. Illinois looks like they had State pension fund losses due to their fraud, $65 million; State bankruptcy claims in Illinois filed in the case, $145 million; in overall State residents' 401(k) funds lost due to the corporate fraud, $8.6 billion. So there is a human side to this story.

But I guess I will go over to your point, Mr. Barr, this concept of justice, and what does the Government owe its citizens in terms of the enforcement of justice, and the best we can do is to take a look at illustrations. After the Enron scandal, clearly something had been done which was egregious and demanded a response, and before the first Enron officer was indicted, this administration, this Department of Justice, brought criminal action against Arthur Andersen. The net result of it, corporation based in my home city of Chicago, my home State of Illinois I should say, was that some 18 to 20,000 people lost their jobs. No one ever suggested they were all guilty of wrongdoing. Only a small number may have been. The net result of it is they were all out of business, they were all out of work, before the first Enron official was even indicted.

Now let us look at the other side of the ledger at MCI/WorldCom. $11 billion in accounting fraud with the creation of the trillion dollar bubble that the Chairman mentioned, the loss of 500,000 jobs or more in the industry. And what was the net result for MCI/WorldCom? It appears that they have done quite well. It appears that their approach is, everybody has a bad day. And now they have even reached the point where they are not only not subject to criminal action to this point, but are being rewarded by this administration with sole source contracts in Iraq.

I would like to ask Mr. Katzenbach or Ms. Goldstein, can you explain to me why we should set an example where a corporation on one hand is guilty of the worst corporate fraud in the history of the world, and then is rewarded with a $45 million sole source contract by the Government that is supposed to police that kind of activity?

Mr. KATZENBACH. Yes, I will certainly try to, Senator. Let me be absolutely clear, I agree with you in every respect about the nature of the fraud, about the way the company was run, about the horrors that took place, about the losses that people made in it. All of that you and I are totally in agreement with.

And the question is, as you put it, what do you do about that? Now, the thing that I think you do not do about that is what you just suggested with Arthur Andersen, you do not punish people further. You do not punish the employees who were not involved in this by putting this company out of business. You do not punish the creditors who were the ones that were defrauded, in my view. There is not much point in talking about the stockholders. They have not got much left, although they might have a little bit out of this if in fact it was successful. You are sort of saying that there is some big bonanza that somebody got here? Who? Who got it? I do not know anybody that got it. The creditors are the only ones that could even be conceived as getting it, because they are not the stockholders.

Senator DURBIN. Mr. Katzenbach, let me ask you this. In terms of Government doing business with the private sector, do you feel any price should be paid by MCI/WorldCom for the largest corporate fraud in the history of the world, or it is just business as usual? They should be allowed to not only bid on contracts, to be favored with sole source contracts in Iraq and the like. Is that not sending a message that corporate misconduct of historic proportion is not even a factor in terms of how you will be treated by our Government?

Mr. KATZENBACH. Let me see if I cannot answer that, because the way in which you put it is that somehow or other you can punish MCI/WorldCom without punishing all these other people. I think that is what you are saying, I can do that in some way which does not punish the employees, does not punish the stockholders, does not punish the creditors, does not punish the new management, does not punish the customers of this.

Now, let us turn to the Government contracts issue which is the other issue. I think it is still a punishment if you take that away and give it to competitors, although I can see that competitors would like it. But who is that a punishment of? It is the same people we were just talking about. May I just say parenthetically, that was not a sole source contract in Iraq.

Senator DURBIN. It is my understanding that it was, but I will stand corrected.

Mr. KATZENBACH. It was not.

Senator DURBIN. Who else bid on that contract?

Mr. KATZENBACH. It was an Australian company that bid on it. AT&T bid on a contract in conjunction with the other company.

Senator DURBIN. I stand corrected on that. I thought that it was.

Mr. KATZENBACH. That is my understanding.

Senator DURBIN. It is my understanding that—

Mr. KATZENBACH. It is a classified contract, and I cannot get into it any deeper, even if I knew, which I do not.

Senator DURBIN. I just say that it is my understanding that then Eriksson, the foreign corporation, was turned to by your company to perform under that contract. So, obviously, a lot remains—

Mr. KATZENBACH. As I understand it, they have performed a number of these kinds of contracts.

Senator DURBIN. Mr. Chairman, I will just conclude.

And thank you very much for your response, and say try to rationalize the treatment of Enron, Arthur Andersen and MCI/ WorldCom. Try to rationalize the Government response to these three corporations, and tell me that we have established any meaningful standard of conduct, any meaningful punishment for misconduct. I just cannot find any linkage within this administration which gives me comfort that justice is being served.

Ms. GOLDSTEIN. Senator Durbin, I would like to take a shot at trying to rationalize the treatment of those three entities if the Chairman would permit.

Chairman HATCH. That would be fine, but let us give Mr. Barr equal time.

Mr. BARR. Well, let me just say that I think—

Chairman HATCH. Well, let her do it, and then you can sum up. I mean I just want to make sure this is balanced, and I think so far that seems to be.

Ms. GOLDSTEIN. Thank you very much, Mr. Chairman.

Arthur Andersen was indicted criminally for obstruction of justice. That is a very, very different scenario from what we have with respect to WorldCom. This company has fully cooperated with all of the authorities conducting investigations. When it learned of the accounting improprieties, the company immediately came forward to the SEC, and ever since then it has cooperated with the SEC, it has cooperated with the examiner, it has cooperated with the United States Attorney's Office for the Southern District of New York, it has cooperated with the Justice Department.

I would just like to refer to Judge Rakoff's opinion in which he approved our recently-announced settlement with the SEC. The SEC should not be blasted, as Mr. Barr has done, for not taking enough action. The monetary penalty is not everything here. In fact, the SEC is very clear that this is the largest monetary penalty in corporate history. It will actually get some money to the company's stockholders by virtue of the cash and stock, $750 million, that will be set aside for that purpose.

And just as an aside, with respect to the pension funds, Senator, the pension funds are among the creditors that I referred to who have been injured here. If MCI is not allowed to reorganize, they will be hurt twice, just like every other creditor, once by the fraud, and then by virtue of the fact that the company is not allowed to reorganize in the best way it can for creditors, and as the pension funds of Illinois, and the pension funds of New York, and many other pension funds, are very large creditors who would be hurt if we cannot reorganize in the way proposed.

But the SEC, as Judge Rakoff commented, said that the way the SEC has proceeded here is not just to clean house but to put the company on a new and positive footing, not just a monetary fine, he points out. They are not just enjoining future and violations, but trying to take WorldCom and create a model of corporate governance and internal compliance for this and other companies to follow.

Pursuant to the consent order, Senator, WorldCom has to adhere to and establish the highest ethical standards on an ongoing basis. It has established an Office of Ethics. It has established a mandatory training program, educational program for its officers with respect to, and to assure that these ethical standards are maintained. This company and this bankruptcy—the company's fraud and the bankruptcy are unprecedented in many ways, the largest corporate fraud in history, the largest bankruptcy in history, but also, as Judge Rakoff points off, few if any companies have ever been subject to such wide-ranging internal oversight imposed from without, but to the company's credit it has fully supported to corporate monitor's efforts and the strict discipline thereby imposed. Even the appointment of a corporate monitor is unprecedented in a situation like this.

This company has done everything possible to cooperate with all the law enforcement authorities to totally clean house and go beyond just firing the culpable, but to establish itself as a good corporate citizen.

Chairman HATCH. Mr. Barr?

Mr. BARR. I will just focus on what Senator Durbin was talking about which was the Government contracts. In my view, the administration is flouting the requirements of law in Government contracts and it is a disgrace. Congress has clearly provided in law that to do business with the Government is a privilege, and the burden is on the company of establishing that it has a satisfactory record of business ethics, and that is the language in the statute, and the burden is on the company. If there is any doubt, the call goes against the company. There is no way that MCI could establish a satisfactory record of business ethics. Even if you just put aside their past misconduct, this is a company that cannot even file a public financial statement because they do not have sufficient confidence in the integrity of their data. This is a company whose own auditors just came forward, KPMG, and said they still do not have sufficient controls in place. So under statutory standards they should not be doing business with the Government, and yet the Government continues to throw contract after contract on them. Contrast that to Enron. Within a split second almost of them being put under investigation, they were suspended by the GSA. Andersen, suspended by the GSA. To say there is a double standard here is an understatement.

Chairman HATCH. Senator Kennedy.

Senator KENNEDY. Thank you very much, Mr. Chairman.

I thank all of the witnesses. As the Committee looks at this issue, we are obviously concerned about bankruptcy laws. We have jurisdiction on those issues. We are concerned about competition.

We have important responsibilities on those issues, tax law, what the implications are going to be.

It seems to me you have a remarkable combination of a variety of different forces that are taking place here, just in following these arguments.

I would like to come back to questions for Mr. Katzenbach. We have not had the completion of the report ordered by the bankruptcy judge, but as we understand from Attorney General Thornburgh's presentation earlier that is going to be wrapped up in the fall. Mr. Katzenboch, How can you be so sure in terms of the representations that you are giving to the Committee that all of the challenges which the MCI was faced with during this area in terms of fraud, that all of the circumstances which might have gotten contracts based on fraudulent information, all of these elements, how can you give the assurances to the Committee that all of these issues have been resolved to your own kind of satisfaction? How much weight can we give to that?

Mr. KATZENBACH. I think you should give considerable weight not to what I say, but to what has been done. I think that will be up to the two judges are sitting in bankruptcy, to determine whether that has been done.

In terms of the employees that have gone, let me speak to that because I was on the Special Investigative Committee. I should say that because of the difficulty of getting law firms that did not have conflict, the investigation is being done by more than one law firm. For the special committee, we used Wilmer, Cutler, Pickering and Bill McLucas, head of the group, to investigate all of the fraud connected with the finances of the company. When Mr. Capellas came in he said he wanted zero tolerance as far as people were concerned. Anybody who was connected with this, he wanted out. We did that with Wilmer Cutler, and I and two Board colleagues, plus the monitor, Mr. Breeden, spent two full days going through the history of everybody who was identified as even a possible person involved in this fraud. I think we were very tough because if any one of us thought somebody should be discharged, that person was discharged without argument. So at least in terms of a pretty thorough investigation, I feel pretty confident about that.

As far as other areas are concerned, we were not involved. Mr. Thornburgh was responsible for looking at other areas and any misconduct there. Mr. Capellas went to him and said, if you come across anybody whom you think has been engaged in any bad conduct, I want their names, and you tell me what they have done and they are out. Mr. Thornburgh—this is not a criticism—Mr. Thornburgh, I think he felt his responsibilities were primarily to the court and not to MCI/WorldCom, so he declined to do that.

But when anybody was mentioned, as they were, in his report, they left, rightly or wrongly. I am concerned because I think we may have been tougher on some people than fairness and justice would have required. But because of the past of the company we felt, and Mr. Capellas felt, there could be no doubt about what we did. That is a long answer, I know, but that is one that worries me. It is awfully hard to look at a company so dominated by a couple of people without any way of getting out the truth except to go to the Board of Directors, perhaps, who was also dominated by the company.

As far as processes are concerned, we worked very hard on that with KPMG. I think by the time we come out of bankruptcy we will have controls in the financial area that are as good as or better than any other company that now exists. If we do not, we should not be allowed out of bankruptcy, and that will be for the judges to look at and to evaluate.

Senator KENNEDY. I gather from what you have told us, you are satisfied from your own personal knowledge that all of the fraud was discovered, and you are satisfied that all of the employees that were involved in the fraud have left the company, and you are telling us that all of those who might have known about the fraud have left the company.

Mr. KATZENBACH. I think so. Certainly as far as the financial fraud I am talking about. There are areas that Mr. Thornburgh is investigating which could conceivably above fraud, and as to those I cannot make representations because I do not know.

Senator KENNEDY. What about a point that is made that at least some of the contracts that they are getting or that they might have received in the recent time may have been based upon conditions that are in place now that are based upon some illicit activity, and therefore given them some kind of unfair advantage over their competition?

Mr. KATZENBACH. I do not think they had any unfair advantage over the competition. The Government is free, in these cases, if they do not want the contracts, do not like the contracts, and do not believe that they are being well served by the company, they can avoid the contracts, as can private concerns. The fact that big users, private and public, have considered—have stayed with MCI, I believe, is because not only do they have well-performed at a good price, but in fact, and I think this is generally known, Senator, but in fact, in terms of outages which are of great concern to an intelligence agency, for example, MCI is very significantly lower than anybody else in this industry. It is technologically good.

Senator KENNEDY. Is there anything you want to add to that, Mr. Bahr?

Mr. BAHR. I would just comment on the last statement by General Katzenbach. As I said in my testimony, because of its corporate fraud, MCI/WorldCom was able to low-ball the bid. When you had AT&T and Sprint bidding, they had to come in with a bid that was competitive, that had a reasonable profit, and here we had WorldCom able to come in and low-ball the bid because later they cooked the books.

What we have now in the Federal Government are contracts that WorldCom still has that were gained during the time of this fraud, and now the argument is, well, if you discontinue MCI/WorldCom, there will be an enormous expense to put a new carrier in. But I would just like to make one other comment. We heard Mr. Barr refer as to how quickly the Government moved to debar or suspend from Federal contracts, Enron and Arthur Andersen. Somehow we are being told that this bankruptcy is different.

We heard Mr. Baird here say that the guy that was driving that automobile should be responsible for the accident, but do not destroy the automobile. I do not see the analogy. First of all, that automobile never disadvantaged other automobile drivers, nor letting it still operate would further disadvantage. The testimony by Mr. Neporent, giving us other bankruptcies, or when Continental Airlines went into bankruptcy, prior to that bankruptcy they did not cook the books to the point that it caused other airlines to stress, caused layoffs in other airlines, or when they came out of bankruptcy, which they did not get in because of massive corporate fraud, were they at a much greater advantage than the other competitors and airlines. So I think that the case is not made to treat WorldCom differently than other bankruptcies.

Senator KENNEDY. Chairman, my time is up. Can I put a statement of Senator Leahy in the record, be placed in the record? Thank you.

Chairman HATCH. Without objection, we will do that.

Ms. GOLDSTEIN. Mr. Chairman, may I respond to the comments made by Mr. Bahr to my left?

Chairman HATCH. Sure. Let me just make a point. Senator Schumer has indicated he wants to come through. I will give him 5 minutes. We are going to recess unless he gets here, because I do not know whether he is coming or not. I just want to make that clear, so please get Senator Schumer here if he wants to question.

Go ahead.

Ms. GOLDSTEIN. Yes. I just want to get back to the issue of Government contracts and compare the situation of WorldCom to Enron and Arthur Andersen. Arthur Andersen was suspended from Government contracts because it was indicted. Enron, immediately upon commencing its Chapter 11 case, rejected its Government contracts and then was suspended. WorldCom, on the other hand, has been working with the GSA, cooperating with its inquiry, and has been performing and performing well under its Government contract, so it does stand in a different situation than both Enron and Arthur Andersen.

Also I just wanted to clarify a point raised earlier with respect to the bidding on the Iraq contract, and I would like to add to the record an article dated June 9th from the Bloomberg Press, which indicates that a company called Telstra, which is Australia's largest phone company, bid together with AT&T Corporation to build that mobile phone network in Iraq, so it was bid on by a coalition between Telstra and AT&T, and I just wanted to clarify the record on those two points.

I thank you very much, Mr. Chairman.

Chairman HATCH. Thank you. We have just a few more minutes we will give Senator Schumer to get here.

But, Mr. Bahr—

Senator SCHUMER. I am here, Mr. Chairman.

Chairman HATCH. I am glad to see you got here.

You know, I appreciate your observations about the impact of WorldCom fraud on employees of the telecommunications industry. As you know, District Judge Rakoff recently approved the civil fine and settlement between WorldCom and the SEC, and in his ruling Judge Rakoff, as I understand it, noted that a harsher penalty would unfairly punish WorldCom's employees. Now, could you help us to know what your feelings are with regard to how you reconcile

CWA's advocacy of stiffer penalties against WorldCom with the findings of Judge Rakoff? I think that is important for the record, and I want to give you that chance.

Mr. BAHR. I appreciate that, Senator. I think if our assessments are correct, and assessments largely outside of the WorldCom family, that MCI coming out of bankruptcy, largely free of debt, creates more instability in the telecom sector that really cannot stand it, that there will be employees laid off, that they will be employees of the companies that played by the rules.

We certainly do not advocate any worker getting laid off anywhere, but if there had to be a choice of who has a job, it should be those workers who work for companies that are law-abiding and that play by the rules.

On the other hand, there are companies that are willing to buy the assets and would guarantee the stability of employment of MCI's employees. So there are alternatives. I admit no easy answers, but alternatives.

Chairman HATCH. Senator Schumer, we will turn to you.

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate you waiting for me. Most of the questions I was going to ask were asked already, but I have a few that I would like to ask. I thank this distinguished panel for being here.

The first question I have is the settlement. As most of you know, I was very worried about the SEC sort of giving WorldCom a slap on the wrist situation. At the end of the day they did more than many people had feared, maybe not enough for some. Can I get a general view of what people thought of the settlement in terms of how fair it was? You do not want to be punitive. At the same time you want to make sure wrongdoing is punished. If people regard this kind of massive fraud as a cost of doing business, we have not done much good in this country. So I will just go right down the line.

Mr. BARR. Senator, I think it was grossly deficient. It was not just a question of punishment, because as you know, enforcement is not just about punishment but making sure that people do not enjoy the benefits of the crime, disgorgement, restitution for victims. Here they did not go nearly far enough, and in fact, explained themselves by saying, well, even if we should have gone further, we really cannot, because we are worried if we push it too far, this is a civil proceeding and we may drive them into liquidation.

But the law specifically provides that if the SEC does not believe that it has the civil tools, then it should refer it to the Department of Justice who has the criminal tools, and notwithstanding the misstatement of law earlier by Marcia Goldstein. Criminal forfeiture, disgorgement, penalties are not dischargeable; they take priority, which is clear recognition in the law that enforcement comes first, decides what is fair to leave in the estate, and then bankruptcy comes second, which determines how that state is split up.

Senator SCHUMER. Mr. Katzenbach?

Mr. KATZENBACH. I have already spoken on that, so many times, Senator, all I will say to you on this is we could live with that because it did not put us out of business. I think anything more would have been punitive. That was also the opinion of Judge

Rakoff. Got it as 250 million, and then said anything more than that is punitive and will put them out of business. That is the wrong—

Senator SCHUMER. Do you think it compared fairly, given the amount of fraud, to other settlements?

Mr. KATZENBACH. Yes. But that amount of fraud is so great, you know, you could boil the ocean and then not satisfy people on that amount of fraud, I agree. But who was involved in that, they are gone.

Senator SCHUMER. Ms. Goldstein.

Ms. GOLDSTEIN. Than you, Senator Schumer. First, I would like to address what Mr. Barr said was a misstatement on my part, which was not. I was referring to the provisions earlier, Senator, in the Bankruptcy Code, that distinguish individual bankruptcy under which a indebtedness incurred by reason of fraud would not be dischargeable.

Mr. BARR. That is only civil.

Ms. GOLDSTEIN. It is not clear, frankly, because I have done a lot of work in this area, that even a criminal penalty would be non-dischargeable in the corporate case. There is a complete discharge, and there is no case and no statute that is clear, and I would admit, Mr. Barr, that there is some open issue as to the status of a criminal penalty in a corporate bankruptcy. But clearly, penalties associated with the commission of a fraud, indebtedness associated with the commission of a fraud, are clearly dischargeable in bankruptcy.

And I would like to turn now more directly to Senator Schumer's question about the SEC settlement. That settlement itself is very controversial because it demonstrates to some extent the conflict between securities law enforcement and the Bankruptcy Code, and I think that the settlement is fair. It is still subject to approval in the bankruptcy court, and I believe that the bankruptcy court will approve this settlement because it balances the enforcement power of the SEC versus the goal of bankruptcy, which is to pay creditors in the order of their priority and rehabilitate the company.

Senator Schumer, earlier I mentioned that it is the creditors who will become the new owners of WorldCom, so I think we have to bear in mind that this large penalty, as $750 million recovery against a $2.25 billion fine will be paid and it will be a reduction in the potential recovery of the innocent creditors who did not commit the fraud. Now—

Senator SCHUMER. But if you had a sort of classic law school rascal case, the creditors are probably more to blame, although admittedly—

Ms. GOLDSTEIN. If the creditors were a party to the fraud, we might have a different instance here, but I think here—

Senator SCHUMER. Do they not have some kind of watch dog responsibility?

Ms. GOLDSTEIN. I do not think that a lender has ever been held responsible for the accounting fraud of the party who effectively obtained loans based on fraudulent financials from the particular lender or investor.

Chairman HATCH. Senator, would you yield on that?

Senator SCHUMER. I yield to my good friend, Orrin.

Chairman HATCH. Let me just ask you this. Is there not some responsibility on the creditors' part to investigate why they rose the debt so much, and loaned so much money?

Ms. GOLDSTEIN. I think that—

Chairman HATCH. Let me ask you further. In that regard—and I am sorry to interrupt you, Senator, but this is something that has bothered me. In that regard, how much of the total debt of WorldCom will be discharged in bankruptcy, and then how much will remain after? I have heard various figures. I would just like to know for myself, but those two questions I would like you to answer. It seems to me some of the creditors, to give that kind of money, if it is as high as I have heard it is.

Ms. GOLDSTEIN. Let me explain a little bit about the plan of reorganization that was negotiated with the creditors.

Chairman HATCH. Would you answer that other question too?

Ms. GOLDSTEIN. The indebtedness owed to WorldCom's creditors at the commencement of the case is approximately $40 billion.

Chairman HATCH. Do you not think that is awfully high, and do you not think the creditors have some responsibility to be sure that the money they are lending is—

Ms. GOLDSTEIN. The creditors, I would say 30 billion of that or I would say 27 billion of that is institutional debt, bond holders, bank debt, and I would say, Senators, that those institutions do due diligence and make a credit assessment. I know for certain that banks take their loans up through a credit Committee and do a credit analysis of the company that they are making loans to, and there is information when bond debt is issued in the high yield market, through a prospectus that describes the financial condition of the company. The fact is that at the time some of this debt was issued, not all, for example, you have a $2.6 billion issue of debt at MCI, MCIC, which is one of the subsidiaries, that is issued before 1996. So I would say that with respect to that debt, there were no fraudulent financials. That is outside the parameter.

So we are looking at the more recently issued debt of the WorldCom entities.

Senator SCHUMER. Which is how much of the total?

Ms. GOLDSTEIN. Which is at least $11 billion out of the $27 billion total that was issued during the period of fraud. It may be more. It may be $18 billion.

Senator SCHUMER. It is a lot.

Ms. GOLDSTEIN. It is a lot. But those creditors, Senators, did not have the information that would enable them to understand that these books were cooked.

Senator SCHUMER. Ms. Goldstein, what Orrin is saying and what I am saying here, or just asking, frankly, is that nobody is saying the creditors committed the fraud, encouraged the fraud, participated in the fraud. But these are all these bankruptcy proceedings, and all of these are very difficult balancing acts, and in the law we often hold that somebody who is not fully to blame, but might have been more in a position to do something to stop it, not being fully culpable, but not being fully removed, should suffer more than somebody who is totally removed, let us say one of Mr. Bahr's union members who is in another company that is competing, or I guess a stockholder would be more directly involved, per se, even if it is a small little stockholder, than a debtor, but a worker. I mean we do not have any—what about all the workers who lose their jobs and things like that, their pensions, et cetera?

Ms. GOLDSTEIN. Let me make a few comments on that. Most of the creditors in this case will receive a recovery which we estimate to be 36 cents on the dollar. So it is not as if they are running off with a lot of money here. They are being punished. They have suffered dramatic losses, and that includes the pension funds who hold bonds in this company. So to take further punishment against the company, which would reduce recoveries even more, would be very hurtful to those parties, including pension funds.

Senator SCHUMER. Okay, I have it. So you are saying the market punishment suffices.

Ms. GOLDSTEIN. There is tremendous market punishment.

Senator SCHUMER. Do you agree with that, Mr. Bahr?

Mr. BAHR. Senator, WorldCom acquired $17–1/2 billion of assets through the use of its inflated earnings, so taking away a half a billion still leaves 17 billion.

But as I stated in my testimony, the cash penalty was larger against Mr. Milken than against this company.

Chairman HATCH. Would the Senator yield?

Senator SCHUMER. I will be happy to yield.

Chairman HATCH. Of the $40 billion how much of that would be dischargeable in this bankruptcy? At least approximate it.

Ms. GOLDSTEIN. Okay. All of the 40 billion will be dealt with in the bankruptcy. The company will emerge with 5.5 billion in new debt that will be issued to these creditors, and the creditors will receive the balance of their recovery in stock. Some trade creditors will also receive a cash payment.

Chairman HATCH. But virtually all of the $40 billion except for the 5.5—

Ms. GOLDSTEIN. Will be exchanged for stock and notes, that is correct.

Senator SCHUMER. So they did not lose as much as you were first saying if the company comes back and does great?

Ms. GOLDSTEIN. The valuation of the company that is projected on its emergence is only $12 billion.

Senator SCHUMER. Yes, but they have equity and—

Ms. GOLDSTEIN. They have equity, and if the company can perform, and compete in an environment vis-a-vis their much larger and better positioned competitors. I pointed out earlier, Senator, that on emergence MCI will come out with $5.5 billion in debt vis-a-vis a value of $12 billion. It is about 41 percent. If you look at Verizon's debt, for example, that represents about 30 percent of the company's value. So from who is more leveraged, frankly, even on emergence from bankruptcy, MCI will be.

Chairman HATCH. Senator, would you yield again?

Senator SCHUMER. You are the Chairman.

[Laughter.]

Chairman HATCH. I am grateful you would yield, but these are problems that bother me.

You indicated that there would be a competitive disadvantage in your testimony, General Barr. And you have indicated that

Verizon, for instance, would have an advantage from a debt-to-capital ratio, I guess. I am not sure. But who is right here?

Mr. BARR. How do people pay off debt? They pay it off with money coming in the door, and money coming in the door, your revenue, your sales, that is a hard and fast thing that you can count and see. The proper way of measuring your leverage is the ratio of your debt to the money coming in the door, your sales, and that is a figure that, as I say, the average in our industry is 85 percent, and they are coming out with 22 percent.

The problem with a debt-to-equity ratio is how do measure equity for WorldCom? They do not have financial statements out in the public. They can pick any number out of the air.

Chairman HATCH. They have all these assets that they have developed, right, minus the debt?

Mr. BARR. Right.

Chairman HATCH. Does assets—

Mr. BARR. What is the value of the equity? I do not how to value the equity except sell—

Chairman HATCH. Some would say $40 billion. I do not think that is accurate. I guess I am asking what would be accurate.

Ms. GOLDSTEIN. I would like to address that. First of all, by saying what is our equity, we do not have financial statements, we have an approved disclosure statement in the case with financial information and a valuation done by the company's financial adviser, Lazard Freres and Company.

The historical financials do not bear on the valuation of the company's assets today, and so that valuation, which is approximately $12 billion, is based upon information that has been available to creditors, indeed to Verizon as well, and has been approved as adequate information for creditors to make a decision.

Chairman HATCH. So assuming that you have about 5.5 billion in debt and the assets are worth about 12 billion, to use your figures, how does that compare to other companies in the industry who claim that they are going to be disadvantaged by the reduction of $35 billion approximately in—

Mr. BARR. Their equity value is based on a series of their own projections, which they have been changing almost on a weekly basis. They do not have accurate financial statements. The equity number is a number you can game, but cash in the door is not.

Chairman HATCH. But, General, are you not saying that because of the huge discharge in bankruptcy, whatever that number may be, but starting with 40 billion, whatever it is below that, that all the other companies are stuck with their high debt for putting in infrastructure and so forth, and that WorldCom will only have 5.5 billion and yet will have all the infrastructure that at least some of the $40 billion built?

Mr. BARR. What I am saying is, especially when you have stolen assets—

Chairman HATCH. I mean am I right in that?

Mr. BARR. The only way you can get fairness here is to make sure there is a real cost basis to the property that is being used by MCI going forward, a real cost basis that puts real constraints on their business. And when companies like Verizon and AT&T build network, we spend real money, and we have to recover that in our prices. They are coming in here with made-up numbers as to their equity and what their costs are, and huge debt relief. So the only way to put the stolen assets, particularly, here, because—I am not complaining about the operation of bankruptcy law. What I am complaining about is its operation in tandem with forgiving their continued possession of tainted assets. The only way is to put a real cost basis on those assets. I have no problem if they want to borrow the money and pay the creditors cash.

Mr. NEPORENT. Mr. Chairman, maybe I could address that for a moment. I guess I am a little bit confused by Attorney General Barr's analogies. I mean nobody disputes that $40 billion has gone into this company and been lost. Nobody disputes, and in fact the creditors agreed, that 35 of that $40 billion is going to be converted to equity. The valuation of that equity can be determined on very standard market metrics, multiples of earnings before interest and taxes, many other metrics, which incidentally is also the way that Verizon's equity is valued including the way that the public markets value the equity, so there is really no confusion here. The value of the equity can be measured coming out based on metrics that financial professionals can agree upon. The cost basis is fairly obvious. We know how much money has gone into the company; creditors' claims have been reconciled.

So it is really quite simple. The dollars that purchased those assets were the dollars that were invested by the real creditors, by the victims of this fraud.

Mr. BARR. Look, either your equity is based on the market, and you can look at our stock and what it trades for and see what it is, or what he is saying is it is based on historical numbers. But then their historical numbers are garbage.

Mr. NEPORENT. No, Senator, that is not what I am saying. I am saying that our numbers are based probably—I think on the last year's worth of revenues, the last year of earnings before interest and taxes. There is a track record of this company post-fraud. There is a projection. There is a core business operation that can be measured, and those are the numbers that are being used to measure this equity value, not the completely different business that existed before the company was reorganized, simply not the case.

Ms. GOLDSTEIN. Senator, I would like to make one other point here. Verizon has suggested that the proper measure is to look at the debt of the company as compared to its sales, but that really is meaningless. If you ran a company for sale and did not factor into it other parts of the picture such as costs, such as EBITDA, you could run a company to the ground based on the amount of sales. In fact, I was confused earlier by Mr. Morton Bahr when he said that the company had ill-gotten gains because we could underbid on a contract. The company probably found itself, as we did when we reviewed these as bankruptcy counsel, with many, many contracts that they had to reject because they were just not profitable.

Let me get back to debt and compared to sales. Sales is not a meaningful figure here. If you look at MCI's revenue, half of that revenue gets paid to local exchange carriers, so you really cannot look at it that way. The other point to make here—

Mr. BARR. Wait a minute. Excuse me. That is a ludicrous argument. Everyone has expenses, and we collect a lot of revenue that we have to pay out to expenses including companies like MCI.

Ms. GOLDSTEIN. But that is my point, Mr. Barr.

Mr. BARR. So it is ludicrous to say that if your revenue includes expenses, it is not a legitimate—

Ms. GOLDSTEIN. That is my point, Mr. Barr. Let us look at Verizon's margin and let us look at MCI's margin. That would be a little different. What I am saying is, is that sales cannot be looked at in a vacuum, and you could argue that yours is a better way to look at it, and I could argue that debt-to-equity ratio is a better look at it, but the fact is, that if you actually look at the debt service as a debt service number, how much does Verizon pay in interest as compared to its revenues, or how much does any of these other—of the other RBOCs such as SBC pay in interest as compared to its revenues, you would see that this is a very small fraction. We are dealing with numbers of 5 percent and under. So whether we are having a competitive advantage really is not going to be determine on the level of debt here.

Mr. BARR. This is academic. There have been repeated statements by all manner of MCI officials about how lean, mean, fighting machine they are going to be when they come out, and how they will have competitive advantages, and they make them every day up to Wall Street in order to pump up.

Senator SCHUMER. Let me ask you this, Ms. Goldstein, and then I have one final question of Morty, of Mr. Bahr. We have two Barrs, only one is a member of the bar. Right? I think I am right about that.

Do you think that WorldCom should emerge from this with the same competitive—let us not say a greater competitive advantage? But there is the argument, do you think that WorldCom should emerge with the same competitive advantage, on equal footing with the other companies or not?

Ms. GOLDSTEIN. I am not convinced that based upon the plan of reorganization that WorldCom has filed that we are going to emerge with any kind of unprecedented and improper competitive advantage.

Senator SCHUMER. That is not the question I asked you.

Ms. GOLDSTEIN. Then I am not sure what the question is.

Senator SCHUMER. My question is not whether you should have an advantage, but is there not an argument that can be made that maybe you ought to have a disadvantage?

Ms. GOLDSTEIN. I think we already do have a disadvantage. WorldCom went into Chapter 11. Chapter 11 is not a desirable route for any company. I have been practicing in this area for 28 years. No company wants to be in Chapter 11. It carries with it, no matter what we say about the fact that there is not a stigma, it carries with it a number of negatives. Customers are concerned, particularly in a company which has to enter into long-term contracts. Trade creditors are reticent to extend credit. The company is totally disabled. WorldCom has been fortunate that it has been able to achieve stability—

Senator SCHUMER. The markets, if you have to go issue new debt, will the markets pay any attention to the fact that you have come out of Chapter 11?

Ms. GOLDSTEIN. I think the fact that we have just been in Chapter 11, the markets will scrutinize us very heavily in terms of—

Senator SCHUMER. Well, they will scrutinize everybody hopefully.

Ms. GOLDSTEIN. And the fact is that the success rate of companies coming out of Chapter 11 is not very good. I think only about 20 to 30 percent succeed, and there is a high level of return to Chapter 11. You are weakened by Chapter 11. We hope that WorldCom can pursue—and when Mr. Capellas says we are going to come out as a lean, mean competitive machine, what he is trying to say is, we are going to try and be competitive and succeed.

The fact is we have not changed our projections every week. The company put out a set of projections back in March that was associated with its April 15th disclosure statement. We did a supplement, and the company amended its projections. The amendment to the projection reflected a few things: the increase in the SEC settlement from 500 million to 750 million; but it also reflected a decrease in its EBITDA projections because of the competitive pricing that they have been experiencing recently with respect to bundled services. So MCI, in bankruptcy, where it pays no debt service, had to relook at how successful it could be because it is going to have to match the competitive pricing engaged in by competitors.

Senator SCHUMER. But that is true of any new company in the world.

Ms. GOLDSTEIN. I am not criticizing that. I am saying that is a fact.

Senator SCHUMER. One final question to my friend, Mr. Bahr, and this is a general question. We have lost 172,000 jobs in the telecom sector in the last 2 years. That is pretty huge. So my question to you is, in relevance to this, how do we grow those jobs again? How do we have telecom return to be the vibrant sector that it was in the 1990's, growing and creating new jobs and all of that?

Mr. BAHR. I think a good deal of the problem is a result of bad public policy by the FCC, starting in the previous administration and continuing into this administration. The order that we are expecting for the last two or 3 months from the FCC, which still has not come down, is going to prolong a good part of it. You cannot ask any company to invest in its business and then in the name of competition give it away below cost, and then still have the responsibility of maintaining the network.

So I think we are driven by public policy as well as a bad economy at this time, and the lack of investment.

Senator SCHUMER. You see it turning around in the near term?

Mr. BAHR. We always hope. I always have confidence in all these folks sitting here. We know that it is the companies that create the jobs, and our role is to try and work as best we can in the most cooperative way to help grow the business so that we have good jobs and good customer service, and thus impact positively on the economy.

Senator SCHUMER. I think you have done that. You have really tried to help whichever companies your members are part of. I have seen that.

Mr. BAHR. Thank you.

Chairman HATCH. I just want you to know you are my kind of union leader. I think you have done very, very well.

I appreciate all of you coming today. We hope this has been a balanced and fair hearing, and it has been very interesting to me, and we will all have to reassess and reevaluate, and we appreciate the information that you have given us today.

With that, we will recess until further notice.

[Whereupon, at 4:41 p.m., the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

[Additional material is being retained in the Committee files.]

QUESTIONS AND ANSWERS

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August 20, 2003

VIA E-MAIL AND MAIL

Senate Judiciary Committee
Att: Barr Huefner
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Huefner:

Attached are answers to the questions submitted by Chairman Hatch to William Barr in connection with his testimony before the Committee on July 22, 2003.

If you have any questions, please let me know.

Yours truly,

John M. Goodman

Responses to Questions from Members of the Committee

Out-of-market competition

Q. Why hasn't Verizon entered and competed in the home market of another RBOC?

A. Verizon is actively competing in the home markets of other Bell companies, and has, for many years, been competing across the country against other incumbent local carriers in both the traditional local telephone market and in the wireless market.

In just the three years since the merger of Bell Atlantic and GTE that formed Verizon, the company has spent hundreds of millions of dollars to allow it to compete in providing both narrowband and broadband services in out-of-region areas. Pursuant to the terms of the FCC order approving that merger, the Commission has already has reviewed and confirmed more than $400 million of Verizon's out-of-region investment, and it is currently reviewing submissions documenting more than $150 million in additional out-of-region investment. And these sums do not reflect out-of-home-market activities by GTE and Bell Atlantic before their merger in 2000.

Verizon also competes with (and faces competition from) other incumbents in the wireless market. Verizon currently has over 35 million wireless customers nationwide, many of whom live in the home markets of other Bell companies. In growing numbers, wireless services compete directly with landline phones, diverting billions of minutes and millions of lines from incumbents' traditional local business. The wireless sector also has affected the pricing of landline services. For example, the bundled and flat rate packages that have become so prominent in the landline sector were influenced by and in many ways reactions to the marketing of wireless services. Verizon and the other incumbents thus compete against each other, other wireless carriers, as well as other non-traditional alternatives to voice service, such as e-mail and instant messaging.

Increased FCC enforcement powers

Q. Would you agree[that FCC enforcement powers should be increased to maintain healthy competition envisioned by the 1996 Telecom Act]?

A. No. The FCC has ample enforcement authority, and uses it.

Q. Please comment on the following proposals to strengthen FCC enforcement power:

1) An increase of the penalty for violations of the Communications Act committed by common carrier.

Verizon does not support changing the existing statutory forfeiture caps. Actual FCC enforcement actions against carriers clearly demonstrate that these caps do not operate as a ceiling or otherwise limit the FCC's broad discretion under section 503(b) to impose significant fines and forfeitures.

Under section 503(b) of the Act, and the inflationary adjustments provided for under the Debt Collection Improvement Act of 1996, the FCC currently can fine a common carrier up to $120,000 per violation or per day of a continuing violation, up to a total of $1.2 million. The FCC has repeatedly demonstrated its ability under existing authority to impose fines or reach settlements with common carriers for amounts far in excess of $1.2 million; as high as $6.5M in a single enforcement action.

If any change is made, it should not be limited to "common carriers," as the question suggests, and should apply equally to all firms subject to the FCC's jurisdiction. This is especially important in light of the convergence underway in the telecommunications sector, whereby companies that started in different lines of business are providing a broad range of services in competition with one another.

2) An extension of the statute of limitations for a violation.

There is no need to extend the statute of limitations. As noted above, the FCC has demonstrated its ability to take swift and significant action against carriers under the existing limitations period. While extending this period would not necessarily change the outcome of any FCC action, it would certainly add further delay, uncertainty and regulatory uncertainty in a market that already has too much.

3) Additional penalties for any violations of the "market-opening" provisions of the 1996 Telecommunications Act (sec. 251, 252, 271, 272).

The Bell companies' conduct in the marketplace is actively overseen by the FCC and state commissions. It is also subject to significant performance monitoring and remedy plans imposed by both the states and the FCC. In addition, the FCC can revoke or suspend a Bell company's long distance authorization for a violation of these provisions. There is no need for additional penalties for violations of the market opening provisions of the Act.

In addition, Congress should not single out these provisions of the Act for special penalties. Other violations by carriers can endanger public safety (*e.g.*, the E911 rules), disrupt the operation of competitive markets (*e.g.*, slamming) and invade consumer privacy (*e.g.*, CPNI, junk fax, do-not-call). Congress should not signal that these violations are less important by authorizing additional penalties only for the Act's market opening provisions.

Weil, Gotshal & Manges Responses to Questions from Senator Feingold

1. **Your law firm represents both WorldCom and MCI, even though both companies are separate legal entities that filed for bankruptcy as separate legal entities. How can a single law firm address – in a neutral and fair way without conflicts of interest – all of the legal issues relating to claims against MCI asserted by WorldCom? Isn't it a conflict of interest to represent both MCI and WorldCom as to matters which are adverse between them?**

It is standard practice in chapter 11 cases for one law firm to represent affiliated debtor entities in jointly administered cases. Well known examples, in addition to WorldCom, are Enron, Bethlehem Steel, Global Crossing, Kmart, and United Airlines. In fact, the Supreme Court recognized congressional intent to allow affiliated debtors to be reorganized in joint proceedings. *See Duggan v. Sansberry*, 327 U.S. 499, 511 (1946) (*citing Mar-Tex Realization Corp. v. Wolfson*, 145 F.2d 360, 363 (2d Cir. 1944)). The unified administration of affiliated debtors is eminently practical because it conserves both judicial and estate resources. *See Grubbs v. Pettit*, 282 F.2d 557, 563 (2d Cir. 1960). In the WorldCom cases, 222 individual legal entities filed chapter 11 petitions. It would have been impractical for each legal entity to retain separate bankruptcy counsel to represent its estate.

The requirements for a law firm (or other professional) to be retained by a debtor are set forth in section 327 of the Bankruptcy Code. Section 327(a) permits the retention of a professional as long as the professional does not (i) hold or represent an interest adverse to the estate and (ii) is disinterested. 11 U.S.C. § 327(a). The term "disinterested" is defined in section 101(14) of the Bankruptcy Code and essentially requires that the professional not have an interest materially adverse to the estate. 11 U.S.C. § 101(14). The "twin requirements of disinterestedness and lack of adversity telescope into what amounts to a single hallmark." *In re Martin*, 817 F.2d 175, 180 (1st Cir.1987). Therefore, professionals seeking to be retained under section 327(a) of the Bankruptcy Code must demonstrate that they hold no interest adverse to the estate. *In re Mercury*, 280 B.R. 35, 54 (Bankr. S.D.N.Y. 2002).

The fact that intercompany claims may exist between and among affiliated debtors does not automatically disqualify a law firm from representing all of the affiliated debtors. *See Hassett v. McColley* (*In re O.P.M. Leasing Servs., Inc.*), 16 B.R. 932, 939-40 (Bankr. S.D.N.Y. 1982) (despite the existence of an intercompany claim, where parent and subsidiary debtor share a "common goal" and "unity of interests," one attorney may represent both estates); *In re Iorizzo*, 35 B.R. 465, 468-69 (Bankr. E.D.N.Y. 1983) (attorney could represent five affiliated debtors as long as the attorney was not involved in pursing intercompany claims). Therefore, without a showing of an actual, present conflict, courts will permit one law firm to represent affiliated debtors. *See O.P.M. Servs.*, 16 B.R. at 940; *In re Rundlett*, 137 B.R. 144, 146 (Bankr. S.D.N.Y. 1992) ("In this district, it has been held that inter-company claims do not constitute an impermissible conflict of interest for representation.").

While significant intercompany claims exist between and among nearly all of the 222 debtor entities in the WorldCom chapter 11 cases (collectively, the "Debtors"), none of those claims are being prosecuted by any Debtor against any other Debtor. The Debtors share a "unity of interest" and a "common goal" of being reorganized as a single, integrated business. Moreover, the Debtors believe that the prosecution of those intercompany claims would severely prejudice the Debtors in terms of cost and delay and would negatively impact the distributions to all creditors. In fact, for these and other reasons, the Debtors have worked closely with all of the major creditor constituencies to formulate a plan of reorganization that takes into consideration the relative strengths and weaknesses of the intercompany claims and eliminates the need to prosecute the intercompany claims through substantive consolidation.

2. Why didn't you seek separate legal counsel for MCI to provide neutral advice regarding the claims asserted by WorldCom?

As discussed above, WorldCom is not asserting claims against MCI. The relative strengths and weaknesses of intercompany claims manifest themselves in disputes between creditors of the different estates. Accordingly, while the Debtors serve as fiduciaries for all creditors, the separate interests of creditors of MCI Communications Corp. and its subsidiaries (collectively, the "MCI Companies") are fully represented in these chapter 11 cases by several constituencies. On July 29, 2002, the United States Trustee for the Southern District of New York (the "U.S. Trustee") appointed the statutory committee of unsecured creditors (the "Committee"). The Committee and each of its members serve as fiduciaries for all unsecured creditors, regardless of which Debtor such creditors' claims are asserted against. Of the 14 members of the Committee, six are creditors of the MCI Companies. Moreover, no less than eight law firms have been retained by various constituencies to represent the specific interests of the creditors of the MCI Companies. Specifically, creditors of the MCI Companies are represented by (i) an ad hoc committee of MCI senior bondholders, (ii) the indenture trustee for the MCI senior bond, (iii) an ad hoc committee of MCI subordinated bondholders, (iv) the indenture trustee for the MCI subordinated bonds, (v) an ad hoc committee of MCI trade creditors, and (vii) AOL and EDS, which are members of the Committee and trade creditors of the MCI Companies. Each of these parties or groups is represented by one or two law firms.

The adequate representation of the creditors of the MCI Companies has been confirmed by the United States Bankruptcy Court for the Southern District of New York. On April 30, 2003, HSBC Bank USA, the indenture trustee under the MCI subordinated bonds, filed a motion (the "HSBC Motion") to appoint an official committee of creditors of the MCI Companies on the grounds that the creditors of the MCI Companies' estates were not properly represented in the plan of reorganization negotiation process. By order, dated May 30, 2003 (the "HSBC Order"), the Bankruptcy Court denied the HSBC Motion on the basis that "the representation of the creditors of MCI by the [Committee] is adequate as required by section 1102 of [the Bankruptcy Code] and that the appointment of an additional committee pursuant to section 1102 of the Bankruptcy Code is not necessary to assure adequate representation of creditors of MCI." *See* HSBC Order at 2, a copy of which is annexed hereto.

3. Who is your primary client in this matter – MCI or WorldCom?

WG&M represents all of the Debtors in these jointly administered cases, including WorldCom and MCI.

4. I assume you sought permission from the Department of Justice or the Court to represent both MCI and WorldCom as to claims between the companies. Is that correct? If so, please provide details of that request and the response you receive.

On July 21, 2002, WG&M filed an application, pursuant to section 327(a) of the Bankruptcy Code (the "WG&M Application"), seeking to be retained as counsel to the Debtors. By order, dated September 4, 2002, the Bankruptcy Court granted the WG&M Application. The U.S. Trustee did not object to the WG&M Application.

5. Did your law firm specifically and separately disclose to the Bankruptcy Court or the Department of Justice that you would represent both MCI and WorldCom as to claims between them? If so, please provide copies to the Committee.

In the WG&M Application, WG&M discloses that it will represent all of the Debtor entities. WG&M does not specifically and separately disclose that it will represent any Debtor entity in its prosecution of claims against any other Debtor entity, and in fact, WG&M has not and will not represent any Debtor entity in its prosecution of claims against any other Debtor entity. The WG&M Application makes clear that the Debtors are retaining "conflicts counsel" and, to the extent it would be inappropriate for WG&M to represent the Debtors in a certain matter, conflicts counsel (or another appropriate firm) will be retained to represent the Debtors in such matter.

6. In the WorldCom/MCI bankruptcy, MCI has only one director. This sole director is also the CEO of WorldCom. Because WorldCom is asserting numerous claims against MCI, do MCI's creditors have reason to be concerned that this director has divided loyalties when it comes to protecting the bankruptcy estate of MCI for the benefit of MCI's creditors?

As CEO of WorldCom, Inc., and as a director of each of the 222 Debtor entities, Michael Capellas has a fiduciary duty to all creditors. The estates of all 222 Debtors share a "unity of interest" and a "common goal" of being reorganized as a single, integrated business. Thus, there is no divided loyalty.

This too has been confirmed by the Bankruptcy Court. On April 17 and 21, 2003, the ad hoc committee of MCI trade claims and ad hoc committee of MCI bondholders, respectively, filed motions seeking the appointment of a trustee (the "Trustee Motions") for the MCI Companies on the basis that, among other things, the MCI Companies do not have a fiduciary acting on their behalf. Following an evidentiary hearing, the Bankruptcy Court denied the Trustee Motions based upon, among other things, the fact that the Debtors had appropriately discharged their fiduciary duties in evaluating and analyzing the issues surrounding the formulation of the plan of reorganization. *See Memorandum*

Decision and Order Denying Motions for Appointment of a Chapter 11 Trustee and Examiner, dated May 16, 2003 at 15, a copy of which is annexed hereto.

7. Given the potential conflicts of interest associated with representing both WorldCom and MCI when WorldCom is asserting claims against MCI, why did you oppose motions to set up a trustee or a committee of MCI creditors to safeguard MCI's interest? Are you opposed to separate representation for MCI's creditors?

Neither WG&M nor the Debtors are opposed to the creditors of the MCI Companies receiving proper representation. In fact, as noted above in response to question 2 and as recognized by the Bankruptcy Court, the creditors of the MCI Companies are adequately represented in these chapter 11 cases.

At the outset of these cases, the U.S. Trustee found no legal or factual basis to support the appointment of a chapter 11 trustee or separate committee for creditors of the MCI Companies. In addition, the U.S. Trustee did not support the Trustee Motions. Simply put, in light of the more than adequate representation of the creditors of the MCI Companies, the relief requested in the HSBC Motion and the Trustee Motions was not in the best interests of the Debtors, their estates, or creditors (a conclusion that the Bankruptcy Court agreed with). Accordingly, consistent with their fiduciary duties, the Debtors, through WG&M, opposed the motions.

8. Examiner Thornburgh's report indicated that many of the claims against MCI by WorldCom were suspicious. Did you advise MCI regarding possible defenses it could raise against WorldCom claims?

In analyzing the issues concerning substantive consolidation, we examined and advised the Debtors of various issues concerning the enforceability of, and defenses to, intercompany claims.

9. Should Examiner Thornburgh's work be completed before there is a confirmation hearing on the proposed re-organization plan?

Mr. Thornburgh's appointment as examiner is focused on the facts and circumstances surrounding the prepetition fraud and related issues. Mr. Thornburgh's examination does not concern whether the Debtors can satisfy the requirements for confirming a plan of reorganization under section 1129 of the Bankruptcy Code. The confirmation requirements will be the subject of an evidentiary hearing and will be decided upon by the Bankruptcy Court.

10. Did KPMG serve as an advisor in any capacity for WorldCom or MCI prior to the bankruptcy filings? If so, how can KPMG independently evaluate the validity and enforceability of intercompany claims that may have arisen, in part, because of advice it gave?

Prior to the commencement of the chapter 11 cases, KPMG provided tax advice to the Debtors. KPMG has now been retained as the Debtors' auditor.

11. Is KPMG also a client of your law firm, in addition to being the auditor for WorldCom and MCI? If so, how can your law firm assess the usefulness of KPMG's service to the bankruptcy estate in a disinterested fashion? Wouldn't you have an obligation to protect your client KPMG if it turns out that KPMG provided pre-bankruptcy advice that could be the subject of litigation?

KPMG is a client. This fact was prominently disclosed in WG&M's disclosure affidavit, which was annexed as an exhibit to the WG&M Application. WG&M would not represent either KPMG or the Debtors in any dispute or litigation between them.

12. Will you or your law firm receive a bonus or other form of special compensation if the proposed re-organization plan is confirmed?

No.

13. Has anything occurred since you and your firm decided to represent both WorldCom and MCI in this proceeding to make you doubt whether this dual representation is appropriate in these circumstances?

No.

Weil, Gotshal & Manges Responses to Questions from Senator Kohl

1. **Can you please explain how your joint representation is not a conflict of interest and how the representation would not adversely affect either company when their interests diverge?**

It is standard practice in chapter 11 cases for one law firm to represent affiliated debtor entities in jointly administered cases. Well known examples, in addition to WorldCom, are Enron, Bethlehem Steel, Global Crossing, Kmart, and United Airlines. In fact, the Supreme Court recognized congressional intent to allow affiliated debtors to be reorganized in joint proceedings. *See Duggan v. Sansberry*, 327 U.S. 499, 511 (1946) (*citing Mar-Tex Realization Corp. v. Wolfson*, 145 F.2d 360, 363 (2d Cir. 1944)). The unified administration of affiliated debtors is eminently practical because it conserves both judicial and estate resources. *See Grubbs v. Pettit*, 282 F.2d 557, 563 (2d Cir. 1960). In the WorldCom cases, 222 individual legal entities filed chapter 11 petitions. It would have been impractical for each legal entity to retain separate bankruptcy counsel to represent its estate.

The requirements for a law firm (or other professional) to be retained by a debtor are set forth in section 327 of the Bankruptcy Code. Section 327(a) permits the retention of a professional as long as the professional does not (i) hold or represent an interest adverse to the estate and (ii) is disinterested. 11 U.S.C. § 327(a). The term "disinterested" is defined in section 101(14) of the Bankruptcy Code and essentially requires that the professional not have an interest materially adverse to the estate. 11 U.S.C. § 101(14). The "twin requirements of disinterestedness and lack of adversity telescope into what amounts to a single hallmark." *In re Martin*, 817 F.2d 175, 180 (1st Cir.1987). Therefore, professionals seeking to be retained under section 327(a) of the Bankruptcy Code must demonstrate that they hold no interest adverse to the estate. *In re Mercury*, 280 B.R. 35, 54 (Bankr. S.D.N.Y. 2002).

The fact that intercompany claims may exist between and among affiliated debtors does not automatically disqualify a law firm from representing all of the affiliated debtors. *See Hassett v. McColley (In re O.P.M. Leasing Servs., Inc.)*, 16 B.R. 932, 939-40 (Bankr. S.D.N.Y. 1982) (despite the existence of an intercompany claim, where parent and subsidiary debtor share a "common goal" and "unity of interests," one attorney may represent both estates); *In re Iorizzo*, 35 B.R. 465, 468-69 (Bankr. E.D.N.Y. 1983) (attorney could represent five affiliated debtors as long as the attorney was not involved in pursing intercompany claims). Therefore, without a showing of an actual, present conflict, courts will permit one law firm to represent affiliated debtors. *See O.P.M. Servs.*, 16 B.R. at 940; *In re Rundlett*, 137 B.R. 144, 146 (Bankr. S.D.N.Y. 1992) ("In this district, it has been held that inter-company claims do not constitute an impermissible conflict of interest for representation.").

While significant intercompany claims exist between and among nearly all of the 222 debtor entities in the WorldCom chapter 11 cases (collectively, the "Debtors"), none of those claims are being prosecuted by any Debtor against any other Debtor. The Debtors share a "unity of interest" and a "common goal" of being reorganized as a single, integrated business. Thus, there are no divergent interests between and among the Debtors. Moreover, the Debtors believe that the prosecution of those intercompany claims would severely prejudice the Debtors in terms of cost and delay and would negatively impact the distributions to all creditors. In fact, for these and other reasons, the Debtors have worked closely with all of the major creditor constituencies to formulate a plan of reorganization that takes into consideration the relative strengths and weaknesses of the intercompany claims and eliminates the need to prosecute the intercompany claims through substantive consolidation.

On July 21, 2002, Weil, Gotshal & Manges ("WG&M") filed an application, pursuant to section 327(a) of the Bankruptcy Code (the "WG&M Application"), seeking to be retained as counsel to the Debtors. By order, dated September 4, 2002, the Bankruptcy Court granted the WG&M Application. There were no objections to the WG&M Application. In the WG&M Application, WG&M discloses that it will represent all of the Debtor entities. WG&M has not and will not represent any Debtor entity in its prosecution of claims against any other Debtor entity. The WG&M Application makes clear that the Debtors are retaining "conflicts counsel" and, to the extent it would be inappropriate for WG&M to represent the Debtors in a certain matter, conflicts counsel (or another appropriate firm) will be retained to represent the Debtors in such matter.

2. Can you also explain how creditors to the different legal entities may be affected by your joint representation?

The separate interests of creditors are fully represented in these chapter 11 cases by several constituencies. First, Debtors serve as fiduciaries for all creditors. Second, as CEO of WorldCom, Inc., and as a director of each of the 222 Debtor entities, Michael Capellas has a fiduciary duty to all creditors. Third, on July 29, 2002, the United States Trustee for the Southern District of New York (the "U.S. Trustee") appointed the statutory committee of unsecured creditors (the "Committee"). The Committee and each of its members serve as fiduciaries for all unsecured creditors, regardless of which Debtor such creditors' claims are asserted against. The 14 members of the Committee are representative of the entire creditor body, including creditors holding WorldCom, Inc. bonds, MCI Communications Corp. bonds, Intermedia Communications Inc. bonds, bank claims, and general unsecured trade claims. Finally, there are numerous ad hoc committees that have been formed to represent the various interest of creditors. For example, no less than eight law firms have been retained by various constituencies to represent the specific interests of the creditors of the MCI Communications Corp. and its subsidiaries (the "MCI Companies"). Specifically, creditors of the MCI Companies are represented by (i) an ad hoc committee of MCI senior bondholders, (ii) the indenture trustee for the MCI senior bond, (iii) an ad hoc committee of MCI subordinated bondholders, (iv) the indenture trustee for the MCI subordinated bonds, (v) an ad hoc committee of MCI trade creditors, and (vii) AOL and EDS, which are members of the Committee and trade creditors of the MCI Companies. Each of these parties or groups is represented by one or two law firms. In addition, ad hoc committees of WorldCom, Inc.

bondholders, bank claim holders, and Intermedia Communications Inc. bondholders have been formed.

In fact, the adequate representation of the creditors of the MCI Companies has been confirmed by the United States Bankruptcy Court for the Southern District of New York. On April 30, 2003, HSBC Bank USA, the indenture trustee under the MCI subordinated bonds, filed a motion (the "HSBC Motion") to appoint an official committee of creditors of the MCI Companies on the grounds that the creditors of the MCI Companies' estates were not properly represented in the plan of reorganization negotiation process. By order, dated May 30, 2003 (the "HSBC Order"), the Bankruptcy Court denied the HSBC Motion on the basis that "the representation of the creditors of MCI by the [Committee] is adequate as required by section 1102 of [the Bankruptcy Code] and that the appointment of an additional committee pursuant to section 1102 of the Bankruptcy Code is not necessary to assure adequate representation of creditors of MCI." *See* HSBC Order at 2, a copy of which is annexed hereto.

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September 2, 2003

BY FACSIMILE AND FIRST CLASS MAIL

Honorable Orrin G. Hatch, Chairman
United States Senate
Committee on the Judiciary
Washington, D.C. 20510-6275

Re: The WorldCom Case: Looking at Bankruptcy and Competition Issues

Dear Chairman Hatch:

Thank you for the opportunity to appear at the referenced hearing of the United States Senate Committee on the Judiciary conducted on July 22, 2003.

I write in response to your July 29, 2003 letter enclosing certain written questions from Committee Members. My responses to those written questions are as follows:

Question No. 1: In your Second Interim Report, you criticize claims by WorldCom against MCI as biased. You also said you were investigating these claims further. The existence of claims asserted by WorldCom against MCI is being used as the legal basis to consolidate the two companies for purposes of paying creditors, to the detriment of MCI's other creditors. If, upon further investigation, it turns out that these WorldCom claims are fraudulent or invalid, would it be proper to reduce payments to MCI's other creditors based on the legal theory that assumes these claims are valid?

Answer: As I testified at the hearing on July 22, I respectfully state that I believe it would be inappropriate for me to comment regarding matters that go beyond the findings or observations contained in my First Interim Report and Second Interim Report. As the Bankruptcy Court Examiner, I am committed to discharging responsibly and objectively the broad mandate prescribed by Judge Arthur J. Gonzalez of the United States Bankruptcy Court for the Southern District of New York. Consistent with the Court's directives, I am also committed to coordinating closely with the prosecutorial and regulatory bodies addressing matters related to WorldCom. Our investigation of several matters is active and ongoing. Under these circumstances, I do not feel it would be appropriate for me to comment or speculate regarding matters that are not addressed in my prior reports to the Court or that may be the subject, in whole or in part, of our ongoing investigative efforts.

Question No. 2: What is the status of your investigation of WorldCom's claims against MCI?

Answer: As stated above, I respectfully assert that I do not believe it is appropriate for me to comment regarding the status or scope of our ongoing investigative efforts. I make this general assertion both because I do not wish to compromise our continuing investigation and because I do not want to address matters prematurely and prior to the discovery of all relevant facts or before I report my findings to Judge Gonzalez.

Question No. 3: Are you aware of the large royalty claim that WorldCom is asserting against MCI? Are you investigating that claim?

Answer: I have some familiarity with the royalty claim. However, for the reasons stated above, I do not believe it would be appropriate for me to comment regarding matters that may touch upon subjects of our active and ongoing investigation.

Question No. 4: Do you believe that your work as Examiner should be completed before the reorganization plan is completed?

Answer: As I stated above, my charge is to report to the Bankruptcy Court in the manner and according to the timetable dictated or approved by Judge Gonzalez. Accordingly, I believe that questions regarding the relationship between the end of my work as Examiner and the Court's assessment of the reorganization plan are committed to the sound discretion of the Court.

* * * *

Thank you again for your courtesies and attention.

Respectfully submitted,

Dick Thornburgh

SUBMISSIONS FOR THE RECORD

Statement of

Morton Bahr
President
Communications Workers of America

Before
U.S. Senate Committee on the Judiciary

"The WorldCom Case:
Looking at Bankruptcy and Competition Issues"
July 22, 2003

Good afternoon, Mr. Chairman and members of the Senate Judiciary Committee. I appreciate the opportunity to testify before you.

WorldCom's bankruptcy was not the result of honest business mistakes or unforeseen economic conditions. Rather, it was the product of persistent, pervasive, and massive corporate fraud, the largest in U.S. history, estimated at $11 billion and counting. WorldCom's chapter 11 filing cost investors $200 billion, three times the size of Enron.

WorldCom's lies and false financial reports destabilized the entire telecommunications industry. Tens of thousands of employees – not only at WorldCom but throughout the telecom sector -- lost their jobs and retirement savings.

Yet, WorldCom is positioned to emerge from bankruptcy with the strongest balance sheet in the telecommunications industry. This will cause further destabilization and job loss in the struggling telecom sector, and send a message to corporate America that crime pays.

The victims of WorldCom's crimes are legion. Among the largest group of victims are employee pension funds. Public pension funds and jointly-administered Taft-Hartley funds lost at least $70 billion from WorldCom's bankruptcy. Public funds in almost every state suffered staggering losses -- $1.2 billion in California, $393 million in New York, $277 million in Texas, and $23 million in Utah, to cite just four examples. I have attached to my testimony a list of public pension fund losses by state.

State and local governments have been forced to make up for these losses by cutting vital public services. According to the New York state comptroller Alan Hevesi: "Police officers, firefighters, teachers, and other public servants have lost their jobs and public services have been diminished throughout New York State because of these financial losses."

Mr. Chairman, the damage does not stop there. More than 22,000 WorldCom employees lost their jobs and thousands more saw their 401(k) retirement savings decimated. Initially, these laid-off WorldCom employees were left with nothing, even as the new WorldCom Board agreed to pay its new CEO $20 million over three years. The AFL-CIO came to the aid of these non-union laid-off WorldCom employees, and won minimal severance benefits of $5,000 each.

WorldCom employees were not the only telecom workers who saw their livelihoods and careers collapse as a result of WorldCom's illegal behavior.

How could an honest company compete with WorldCom's $11 billion in counterfeit earnings? Imagine you are AT&T, or Sprint, bidding against WorldCom. AT&T and Sprint have to price the bid to cover costs, plus a reasonable profit. But WorldCom could lowball the bid, get the contract, and then cover the losses by cooking the books.

When news of WorldCom's fraudulent accounting came out, AT&T's vice chairman was quoted as saying: "We were constantly dissecting all of the public information about WorldCom and we would scratch our heads and try to figure out how they were doing it."

Trying to match WorldCom's cost structure, companies such as AT&T turned to cost cutting. AT&T told us it had to downsize half of the employees who took care of the network to make it line up with WorldCom. During the period of WorldCom's corrupt practices, AT&T eliminated 18,000 non-management jobs represented by CWA.

I have attached letters from CWA leaders across the country who describe the devastating impact of these job cuts on their lives and their families. Let me paraphrase a few of the stories:

From San Antonio, Texas, where AT&T closed a 500 – person bilingual call center of largely female Hispanic employees in 2001. Clarissa Davila, a 32 year-old mother of three, was one who lost her job. She was a cancer patient in remission, who could ill afford the loss of income and especially her health coverage. Another laid-off San Antonio employee lost her health benefits while her husband was awaiting a heart transplant.

From New York City, where AT&T cut 400 frontline jobs during the period of WorldCom's fraud: One employee who was able to save his job by commuting four hours every day died suddenly this winter of a heart attack. His wife attributed it to the strain of traveling so far.

I could go on and on.

Mr. Chairman, as WorldCom's fraud-induced bankruptcy sent the entire telecommunications industry into a tailspin, other CWA-represented telecom companies eliminated an additional 55,000 frontline jobs. Altogether, more than 172,000 jobs have been cut in the telecom sector in the past two years.

WorldCom is using the bankruptcy proceeding to shed more than $27 billion in debt and to avoid punishment for its crimes. Absent meaningful penalties, WorldCom is positioned to emerge from bankruptcy with the best balance sheet in the business. Employees at companies that played by the rules will once again be victims of aggressive cost-cutting, setting off another destabilizing cycle of job loss throughout the industry.

Mr. Chairman, to date WorldCom has received paltry punishment for its crimes. The $500 million SEC cash settlement, plus $250 million in stock, is smaller than the cash penalty imposed on junk bond trader Michael Milken in the 1980s.

Some argue that higher penalties would prevent WorldCom's emergence from bankruptcy, and this in turn would hurt WorldCom's remaining employees and telephone consumers. This argument fails on at least three counts.

First, our bankruptcy laws were not designed to shield criminal companies from punishment.

Second, WorldCom could sell assets to pay higher penalties. There are eager buyers who would continue WorldCom's operations and provide stability to WorldCom's valued employees.

Third, in today's converging telecom marketplace, long-distance consumers have many choices. Wireless plans and the Bell companies' bundled offerings are the driving force behind price competition, not WorldCom.

No company, including Enron, has done as much damage to the American economy through corrupt practices as WorldCom. The federal government must send a clear message that it will not coddle corporate crime. It is long past time for the Department of Justice to initiate a criminal case against WorldCom, for the federal government to debar WorldCom from contracts, and prevent its unfair use of tax loopholes.

Testimony Presented By

Prof. Douglas G. Baird, Vice Chair

National Bankruptcy Conference

Senate Judiciary Committee Hearing

Tuesday, July 22, 2003

SD-226, Dirksen Senate Office Building

"The WorldCom Case: Looking at Bankruptcy and Competition Issues"

Testimony of Douglas G. Baird

July 22, 2003

Introduction

I am the Harry A. Bigelow Distinguished Service Professor at the University of Chicago Law School. Since 1980, I have taught commercial law and bankruptcy at the University of Chicago, as well as at Harvard, Stanford, and Yale. I also serve as the Vice Chair of the National Bankruptcy Conference, and it is in that capacity that I appear today.

The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of 61 bankruptcy judges, law professors, and lawyers. Its members are recognized experts in bankruptcy law and procedure, and they are committed to the improvement and integrity of the bankruptcy system. The organization came into being when members of Congress urged the country's leading bankruptcy experts to come together and help draft the Chandler Act of 1938, the first comprehensive revision of the Bankruptcy Act of 1898. For over 70 years, the NBC has assisted Congress in crafting this country's bankruptcy laws.

Today, I address the role that Chapter 11 plays when a firm in a troubled industry cannot pay its debts in large part because of the fraud and other crimes committed by its former managers. I make two observations.

- Chapter 11 promotes robust competition in a market economy. It allows assets to be used productively in compliance with all applicable nonbankruptcy laws and regulations even when those assets were previously managed by those engaged in harmful and criminal conduct.
- The proposal embodied in S.1331 on the tax treatment of NOLs on consolidated returns raises a long-standing issue of tax policy. Reforms in this complex environment ought to be undertaken with great care. While I take no issue on the ultimate merits, I believe that the issue deserves much more serious study than it has received to date.

Chapter 11 Promotes Competition

Chapter 11 ensures that firms that can demonstrate their future viability can sort out their financial affairs while remaining effective competitors in the market. Chapter 11 is especially valuable when a firm's managers have engaged in fraud. Indeed, managers who engage in financial fraud injure most immediately workers, suppliers, unsecured creditors, and public investors. By allowing a viable firm to survive under new management, Chapter 11 minimizes the harm these innocent people suffer.

A firm's assets should not be sold for scrap as punishment for the misdeeds of its former managers. The person who commits a crime with a car must be punished. The car itself should not be. Destroying the car does nothing to help the victims of the crime.[1] The same is true for a firm brought to financial ruin by dishonest managers. We must recognize the rights of the victims, but we do this by putting the assets to productive use and recognizing whatever rights they have as a result of the injuries they have suffered.

None of this, however, is to suggest any leniency towards those involved in wrong-doing. Individuals cannot receive a discharge in bankruptcy for liability for fraud or defalcation in a fiduciary capacity, embezzlement, larceny, or indeed any form of willful and malicious injury. *See* 11 U.S.C. §523(a)(4), (6). The Sarbanes-Oxley Act of 2002 precludes individuals from obtaining a discharge from debts related to violations of securities law. *See* Sarbarnes-Oxley Act of 2002, § 803(a), Pub. L. 107-204, 116 Stat. 745, 801 (2002)(adding Section 523(a)(19) to the Bankruptcy Code, precluding the dischargeability of debts arising from the violation of any federal or state securities laws).

Chapter 11 debtors do not get a dispensation from governmental rules and regulations. In fact, they are required to operate in compliance with all regulatory and other laws. *See, e.g.*, 28 U.S.C. §959(b)("a . . . debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in

[1] Holding a piece of property liable for a crime is known as a "deodand." Deodands are rarely found in modern legal systems. They were, however, features of some ancient legal regimes. *See, e.g.*, Exodus 21:28 ("If a bull gores a man or a woman to death, the bull must be stoned to death, and its meat must not be eaten. But the owner of the bull will not be held responsible.").

possession thereof"). Therefore, Chapter 11 does not give firms a competitive advantage over others in their industry. Firms in bankruptcy are still subject to the same rules and regulations as everyone else. Antitrust laws and indeed all other regulatory regimes that exist outside of bankruptcy apply with full force inside of bankruptcy. A firm in bankruptcy can no more violate laws against unfair competition than pollute the atmosphere. Chapter 11 merely provides firms with an additional forum in which they can sort out their financial. Firms cannot and do not file for Chapter 11 to profit unfairly at their rivals' expense.

When viable firms can sort out their financial problems while they continue to operate, jobs are saved and markets work more effectively. The world would be a worse and less competitive place if Greyhound Bus or Dow Corning no longer existed. Bloomingdale's and Macy's survived notwithstanding ill-conceived LBOs when they were able to use Chapter 11 to deleverage their capital structures. In general, competitors have little interest in encouraging competition, while the public as a whole does. Hence, we do not give competitors a voice when firms are restructured, whether outside of bankruptcy or in. Chapter 11 does allow firms to reduce debt, but the financial restructurings that take place in bankruptcy are no different in kind from the restructurings that take place outside when a firm is sold or debt is converted into equity. If such de-leveraging makes operational sense, the legal system should facilitate it.

Firms that enter bankruptcy should not be discriminated against on that account alone. Section 525 of the Bankruptcy Code sensibly prohibits discrimination against entities because they are, or have been, a debtor in bankruptcy. *See Federal Communications Comm'n v. NextWave Personal Communications, Inc.*, 537 U.S. 293 (2003) (FCC could not discriminate against a Chapter 11 debtor simply because it had filed a case under Chapter 11). Workers, suppliers, and public investors should not be put at a special disadvantage merely because their firm is in Chapter 11.

Chapter 11 focuses only on a particular firm and asks whether that firm going forward can succeed, notwithstanding its past financial difficulties. Bankruptcy judges are poorly equipped to implement a regulatory process designed to ensure that an entire industry works better. Chapter 11 does not—and should not—weed out firms merely because of perceived overcapacity in an industry. In our legal and economic system no judge or agency determines who wins and who loses—even when the problem is overcapacity. The natural forces of competition provide the best means of identifying winners and losers in the economy. Chapter 11 is part of that process.

Even if we were to use government regulation to solve problem of overcapacity, the solution should be forward-looking. It should not weed out firms by looking at the bad acts of former managers.

Comments on S.1331

I also comment briefly on S. 1331 entitled "To clarify the treatment of tax attributes under section 108 of the Internal Revenue Code of 1986 for taxpayers which file consolidated returns." As we understand it, S. 1331 is intended to clarify the tax consequences of the following fact pattern:

> **Example 1.** Acme and its wholly owned subsidiary file consolidated returns. Acme borrows $20 million from a bank and contributes the proceeds to its subsidiary. The subsidiary spends the $20 million in a deductible fashion, generating a $20 million net operating loss ("NOL") at the subsidiary level, while Acme itself breaks even. Acme then files itself and its subsidiary for bankruptcy, and upon emergence issues new Acme stock worth $5 million in exchange for the $20 million bank debt. Does Acme's $15 million in cancellation of debt ("COD") income reduce the loss generated by the consolidated group as a whole (here, the $20 million loss generated by the subsidiary)? Or does Acme's COD income reduce only Acme's own attributes (here, its basis in assets, including its stock in its subsidiary)?

If S. 1331 became law, this issue would be resolved in the government's favor by requiring Acme's COD income to be used to reduce the $20 million loss generated by its subsidiary.

I take no position on the merits of S. 1331. I do think, however, that it would be unwise for the Senate Judiciary Committee to take action on S. 1331 in this context and at this time for several reasons.

First, the issue is far more complex than it would appear to be from the simple hypothetical posed above. (The current edition of the standard treatise on consolidated tax returns devotes 11 single-spaced pages (and 19 detailed, substantive footnotes) to the topic. *See* Dubroff *et al.*, *Federal Income Taxation of Corporations Filing Consolidated Returns* § 33.06[1] (2002).) This complexity reflects not only the inherent tension that the tax law faces in dealing with consolidated groups that are treated as a single entity for some purposes and as a collection of individual corporations for others, but also the highly interactive nature of the tax attribute system applicable in bankruptcy. We think it unwise to attempt to make rifle-shot changes to this complex tapestry of tax law without a much more broad-based, in-depth review by those with the greatest understanding of the extremely complicated issues raised by discharge of indebtedness in the consolidated return context.

One example of the sorts of dangers that may be in store if an opposite course is followed can perhaps be found in S. 1331 itself. While apparently intending to clarify the state of existing law with respect to how COD income offsets NOLs and other consolidated attributes listed in section 108(b)(2) of the Internal Revenue Code, the bill erroneously references section 108(b)(1) (rather than 108(b)(2)), and then appears to require that all items listed in section 108(b)(2) be treated on an aggregate, group-wide basis, even though it could hardly be thought that extending this treatment to asset basis (*see* section 108(b)(2)(E)) could be thought to "clarify" existing law, since under no reading of that law could asset basis be thought to be subject to group-wide reduction when a member incurs COD income.

Second, I am not convinced that a policy consensus in favor of the result championed by S. 1331 has developed, even though the basic question that it addresses has been understood and debated for many years. For example, in 1990-91, the Section of Taxation of the American Bar Association formed a task force to study the problems involving cancellation of indebtedness in the consolidated return context. After months of work, the task force was unable to reach agreement on the very question addressed by S. 1331, and eventually prepared and submitted to the IRS separate reports favoring and opposing the result currently embodied in S. 1331. Indeed, even the IRS has had difficulty making up its mind on the issue. For a number of years, the IRS seemed to oppose the result suggested by S. 1331. *See* PLR 9121017 (Feb. 21, 1991). While it is true that more recently the IRS has shown some evidence of having changed its mind, *see* FSA 19991207 (Dec. 14, 1998); Chief Counsel Advice 200149008 (Aug. 10, 2001), it would appear that the IRS considers this issue to be part of a much broader policy dilemma dealing with consolidated returns that remains unresolved and under study.

This lack of consensus may well reflect the fact that, whatever the strength of the policy arguments in favor of the S. 1331 in circumstances like those in Example 1, those arguments are less compelling, if not unpersuasive, when the circumstances are somewhat different:

> **Example 2.** Acme has two wholly owned subsidiaries, SubA and SubB, and includes both of them in its consolidated return. Acme contributes $20 million of its retained earnings to SubA, which spends the $20 million in a deductible fashion, generating a $20 million NOL at the SubA level.

> Meanwhile, SubB borrows $10 million from Bank and breaks even. If SubB were to file for bankruptcy and realize $3 million in COD income in the process of restructuring its debt to Bank, S. 1331 would appear to cause the $20 million loss incurred by SubA to be reduced by $3 million as a result of SubB's realization of COD income, even though SubA's loss had nothing do with SubB's debt. Is that an appropriate result?

Finally, the statute that S. 1331 would amend has been on the books for more than twenty years and reflects the many policy compromises—pro-debtor and pro-government—that led to the enactment of the Bankruptcy Tax Act of 1980. As Senator Grassley put it in a colloquy with Senator Santorum on May 15, 2003, "we are talking about tax legislation that has been on the books for an awfully long time." It seems to us that, whatever the merits of S. 1331 may be, it addresses an issue that should not be considered in isolation, apart from its historical context, but only as part of a global effort to revisit the entire framework of bankruptcy taxation. I and other members of the National Bankruptcy Conference would, of course, be delighted to participate actively in such an effort, if Congress were to choose to follow that course.

Conclusion

Congress should not overlook the role of Chapter 11 in fostering a competitive economy. As Thomas Friedman of the *New York Times* recently noted, a person designing the best economy to compete in the new global era:

> would have designed a country with a system of bankruptcy laws and courts that actually encourages people who fail in a business venture to declare bankruptcy and then try again, perhaps fail again, declare bankruptcy again, and then try again, before succeeding and starting the next Amazon.com—without having to carry the stigma of their initial bankruptcies for the rest of their lives . . . . In Silicon Valley, bankruptcy is viewed as a necessary and inevitable cost of innovation, and this attitude encourages people to take chances. If you can't fail, you won't start . . . .

THOMAS L. FRIEDMAN, THE LEXUS AND THE OLIVE TREE 369-70 (2000) (Updated and expanded Anchor Books edition).

TESTIMONY OF WILLIAM P. BARR, GENERAL COUNSEL OF VERIZON AND FORMER UNITED STATES ATTORNEY GENERAL, BEFORE THE SENATE JUDICIARY COMMITTEE
July 22, 2003

Thank you for inviting me to appear at this hearing. My message today is a simple one: The federal government's response to date to the massive fraud committed by MCI is one of the most shameful episodes I have witnessed in Washington since starting my career in public service more than 25 years ago. MCI committed the largest securities fraud in American history, falsely manufacturing more than $11 billion in income. Investors lost roughly $180 billion—more than three times the losses in Enron—and MCI's brazen scheme dramatically deepened the crisis of confidence in corporate America, imposing incalculable costs across the whole economy. In response, the federal government has taken several affirmative steps—not to punish MCI, or to strip away the gains from its fraud, or to ensure that full restitution is paid to the tens of thousands of pensioners and companies victimized by the fraud—but to resuscitate the company from its self-inflicted wounds by giving it a series of artificial advantages over law-abiding competitors.

None of these giveaways is mandated by the bankruptcy code, through which MCI is seeking to effectuate its resurrection, or by any other law. Rather, these bail-outs are contrary to the letter and spirit of numerous federal statutes, including the securities laws, the tax code, and the laws governing the expenditure of public funds on government contracts. Companies that compete with MCI—such as Verizon, AT&T, SBC, BellSouth, and many smaller companies—have already paid a high price as victims of MCI's fraud. Going forward, we are all ready to compete for customers with anyone on an honest playing field. What we object to—and what should offend this Committee's most basic sense of justice—is that MCI is being rewarded, given massive advantages over competing firms, for bilking pensioners and employees out of their life savings, and being allowed to continue exploiting its fraud at the expense of the employees and shareholders of law-abiding companies. This action can only have dire effects for the economy—which depends on the telecommunications sector as an engine of growth—for public confidence in American financial markets, and for the rule of law.

The Precedence of Law Enforcement Over Bankruptcy

MCI and its apologists within the government completely misrepresent this matter as one governed by MCI's rights in bankruptcy. They seem to believe that the public-policy priority is conserving the company's assets and ensuring its rapid emergence from bankruptcy, and that any actions that do not support these objectives somehow violate MCI's rights in bankruptcy. The government is thus stumbling all over itself to tailor its enforcement response to *further* the particular bankruptcy result preferred by MCI.

This is a perversion of the law and the government's role. In cases where no crime has been committed, bankruptcy gives priority to creditors. But when a crime has been committed, the interests of law enforcement take precedence over the commercial default rules of bankruptcy. The government's interest is not in preserving the assets accumulated by a criminal enterprise, but in securing the disgorgement of all ill-gotten gains. The government's actions must be directed not only toward vindicating the interests of creditors, but toward securing restitution for all victims, including shareholders and other actors in the marketplace. Otherwise, bankruptcy becomes a money-laundering machine, giving criminal corporations a blank check to keep stolen property merely because they invoke its protection.

It is the government's obligation to use its law enforcement powers—including disgorgement, restitution, and punitive fines—to bring justice to all of MCI's victims. Its policy of avoiding any conflict with MCI's goals in bankruptcy is a transparent subversion of the public interest to the private interests of MCI. We are not here today because an economic downturn caused a deterioration in MCI's business. Nor are we here because MCI failed to execute its business plan. We are here because MCI committed the largest white collar crime in American history—defrauding more hard-working people out of more money than any company before it. The government has no basis to abdicate its law-enforcement authority merely because the enormity of MCI's fraud caused the company to crumble.

The SEC Allows MCI to Keep the Fruits of its Fraud

MCI's fraud was massive, whether measured by its scope, duration, or brazenness. The SEC's former economist, Robert Comment, estimated that MCI secured roughly $18.4 billion in "ill-gotten gains from its accounting fraud." As former Attorney General Thornburgh explained in two interim reports on the fraud, MCI reaped these gains by engaging in a "concerted program of manipulation" over a period of years, extending even beyond "the massive accounting fraud that has been publicly reported." The investigation into MCI's wrongdoing is ongoing, and no one has yet heard "the entire or final story" of malfeasance at MCI.

Nonetheless, the SEC has closed the books on MCI's fraud, bringing its enforcement action against the company to a close with a fine totaling $750 million. This paltry disposition imposes no punishment whatsoever on MCI, and, more importantly, allows the company to keep as much as 95 percent of the ill-gotten gains it secured through fraud.

That this result gives MCI an artificial advantage over its honest competitors—who were already the company's victims—is obvious. MCI's fraud was so massive that a significant part of its business today—its assets, customers, and market position—are the fruit of its unlawful conduct. MCI used its fraudulently inflated stock to gain strategic advantages through acquisitions, and its reporting of false results undermined the ability of competitors to raise capital and make investments. The SEC's disposition, which allows MCI to keep virtually all of the gains it obtained through fraud, blesses MCI's continuing operation with the balance sheet of a criminal enterprise—putting MCI in the same position as if it had robbed a bank, plowed the proceeds into its business, and gotten away scot-free.

A simple analogy sharpens the point. Imagine two competing trucking firms. One is an honest business, leasing trucks and making payments on time. The other is a criminal enterprise, which acquires its trucks through theft and uses this illicit advantage to steal business from the honest firm. There are two classes of victims—those whose property is directly stolen, and those whose businesses are injured by the criminal enterprise's illicit advantages.

What must the government do to right this wrong? Obviously, the individuals who stole the trucks should be punished, but just as obviously this alone does not remedy the offense. If new management is simply allowed to take over the corrupt company, keeping and using stolen trucks, the law-abiding competitor will still be a victim. It will lose customers and profits, not because it was beaten in the marketplace, but because it must compete against an enterprise built on criminal activity.

So too with MCI. Under the SEC's settlement, MCI is allowed to profit from its fraud, and competing firms will continue to be the victims of a massive crime. The fact that the new owners will be MCI's creditors—themselves victims of the fraud—does not justify allowing those new owners to exploit MCI's ill-gotten gains. It is patently unjust to reward one set of victims by offering them the opportunity to "cash in" on the crime at the expense of another set of victims.

The SEC has tried to defend its settlement by claiming that the fine imposed on MCI is the largest it has ever imposed. This is a sound bite, not a rationale. Every other case the SEC has handled before this one pales in comparison. It's obvious that MCI deserves the largest fine ever, because MCI perpetrated the largest fraud ever investigated by the SEC.

The question is, how large should the fine have been? Michael Milken paid $600 million—roughly equal to MCI's fine in today's dollars—for an offense that pales in comparison to the fraud committed by MCI. In MCI's case, the irreducible minimum of the SEC's enforcement obligation was to remediate the effects of the company's fraud by compelling disgorgement of all ill-gotten gains and preventing any continuing injury to victims. The SEC's settlement with MCI does not live up to the most basic obligation of our justice system—to ensure that "crime does not pay."

MCI's Tax-Avoidance Scheme

Compounding the SEC's failure to deny MCI the fruits of its fraud, the government has failed to block MCI's effort to avoid the payment of taxes on any profits it earns once it emerges from bankruptcy. Even though MCI is using its bankruptcy to shed more than $20 billion in debt, it is using a shell game to retain approximately $10-15 billion in net operating losses incurred while the company *claimed* it was profitable. As a result, MCI will potentially be able to escape the payment of billions of dollars in taxes.

This is a gross injustice. When MCI's honest competitors earn profits, they have to pay taxes. If MCI earns profits after it emerges from bankruptcy, they will for years be tax-free. American taxpayers will be forced to subsidize the worst corporate criminal in history, and MCI will perpetuate the harms caused by its fraud at the expense of every telecommunications company that plays by the rules. This is a brazen attempt to circumvent the *existing* tax code. And although Senators Santorum and Conrad have introduced legislation to ensure that MCI does not succeed in pulling off this scheme, no enforcement agency has moved to forestall

MCI's gratuitous and despicable effort to cheat the Treasury—and its competitors—out of billions of dollars.

MCI's Avalanche of Government Contracts

Finally, the government has moved to subsidize MCI by granting the company a growing stream of lucrative contracts. In 2000, during the height of MCI's fraud, the company only did $122 million in business with the government. Today, that figure has grown to more than $1.2 billion—meaning that MCI has multiplied its government business by *ten times* since committing its fraud. MCI is now one of the ten largest government contractors, and has won almost every telecommunications contract awarded in the past year. MCI even secured a no-bid contract to build a wireless telephone network in Iraq, notwithstanding the fact that MCI does not sell wireless service and has no expertise in building wireless networks.

By directing these tax dollars to MCI, the government—in particular the General Services Administration—has flouted the clear-cut mandate of the law, which provides that a firm cannot do business with the government unless it can affirmatively demonstrate a "satisfactory record of integrity and business ethics." That MCI does not meet this standard is obvious to everyone but the GSA, given the magnitude of MCI's unprecedented fraud and what former Attorney General Thornburgh described as a pervasive "culture that permitted . . . fraud . . . and ultimately propelled the Company's descent into bankruptcy."

Almost 30,000 firms and individuals have been suspended or debarred from government contracts, confirming the fact that doing business with the government is not a right, but a privilege. Enron was suspended promptly after its fraud was announced, and others have been debarred for improprieties relating to amounts as little as a few hundred dollars. Under pressure from Senator Collins, the GSA has only just begun to inquire into MCI's fitness to contract with the government, but has not, and apparently is not, undertaking any examination into the nexus between MCI's fraud and its ability to underbid competitors. Thus, the company that General Thornburgh described as "the poster child for corporate governance failures," and which the SEC itself called "one of the ultimate symbols of corporate corruption," continues to be kept afloat with hundreds of millions of tax dollars sent to Washington by the very same people defrauded by MCI.

As bad as MCI's fraud was, it would be a greater injustice if the government were to participate as an accessory after the fact. What the government seems to be saying is that it is willing to ignore MCI's massive fraud and prop up the company as long as MCI continues to give the government a good price. Instead of serving as the protector of society, the government has become a "fence" for stolen goods.

The Claims of MCI's Apologists

MCI's apologists in the government—particularly the SEC—have offered four justifications for their abject capitulation to the largest corporate criminal in American history.

First, the SEC claims that, because MCI is now in bankruptcy, its paltry recovery is the best it can do using its civil enforcement authority. The SEC argues that if it sought a larger recovery for MCI's defrauded shareholders, it might push MCI into liquidation. In the event of liquidation, the SEC asserts, it might not recover anything because *civil* claims—even the government's—are assigned a low priority. No matter how unfair, the SEC reasons, it is better to accept the scraps from MCI's table then be stiffed altogether.

This is sophistry. For one thing, it is clear that MCI can afford to pay a much larger penalty before facing any risk of liquidation. The average ratio of debt to sales in the telecommunications industry is 85 percent. But based on the numbers it released with its reorganization plan, MCI will emerge from bankruptcy with a ratio of just 22 percent—the lowest in the industry by far. MCI also has roughly enough cash on hand to make the states whole for all of the pension-fund losses they suffered as a result of the fraud. In other words, MCI has the financial wherewithal to pay a fine that begins to approach the magnitude of its ill-gotten gains and pays meaningful restitution to its victims. The SEC's disposition not only leaves MCI with the fruits of its fraud, but in the best competitive position in the entire sector.

The SEC's argument is also wrong as a matter of law. The gravamen of the SEC's position is that its civil enforcement powers are inadequate to secure a just disposition. But Congress has specifically provided that, where civil remedies are inadequate, the SEC is authorized to refer a securities fraud case to the Justice Department for all "necessary criminal proceedings." This is not just a question of punitive action, but of using the remedial tools available to the Justice Department, which is expressly empowered to force full disgorgement of *all* ill-gotten gains and set up a fund to compensate victims for their losses. These remedies *cannot* be avoided in bankruptcy.

The SEC has thus abdicated its most basic responsibility. Rather than affirmatively referring the case to the Justice Department for a fair disposition, it has acted as a cheerleader for MCI's efforts to blow past any enforcement, touting its slap-on-the-wrist settlement as "sufficiently tough to deter future violations of the federal securities laws." This doesn't pass the red-face test.

Second, MCI's apologists assert that the company deserves credit for cleaning up its act—that those involved in the fraud are gone and that MCI is "on its way to transforming itself" into "a good corporate citizen." Even if true, this line of argument is totally irrelevant to the issue at hand. Enforcement has *two* goals—not just punishment, but also remedying the effects of wrongdoing. The extent of rehabilitation is only relevant to what *punitive* enforcement action should be taken; it has no bearing at all on what *remedial* enforcement action is necessary. No level of cooperation or rehabilitation can justify allowing a perpetrator of fraud to keep its ill-gotten gains.

Even as to punitive action, the claim that cooperation or rehabilitation is sufficient to spare a corporation from punishment is fundamentally pernicious to the administration of justice. It is always the case that individuals commit corporate crimes. If firms could evade punishment merely by sacking the perpetrators and aiding the government in their prosecution, corporations would never be indicted. The law provides for the punishment of corporations precisely because they can do disproportionate injury to the public if they commit a crime. No individual could have pulled off a fraud of the magnitude committed by MCI. Corporations are therefore required to police themselves, and if those efforts fail in as spectacular a fashion as they did at MCI, the corporation must be punished. Any other result eliminates the possibility of deterrence. Cooperation and rehabilitation may therefore be relevant to the *degree* of penalty imposed on MCI, but they do not speak to the necessity of corporate punishment.

In any event, while the SEC has been mouthing the mantra of MCI's rehabilitation for eight months, events continue to demolish the claim. MCI's outside auditor recently concluded that the company's much ballyhooed reforms were insufficient and that fraud may still "occur and not be detected." Likewise, the Thornburgh report documented a "culture" of corruption not confined to "a limited number of individuals," and identified "a growing number of problematic issues" matching MCI's known fraud "in their egregiousness, arrogance, and brazenness." MCI itself has revised the estimates of its fraud three separate times, and the company still cannot produce audited financial statements. And the day after MCI's new CEO assured the public that "[n]o one even arguably associated with the past wrongdoing continues to work at the company," MCI's general counsel and treasurer were forced to resign. The spectacle of the SEC falling all over itself to vouch for the integrity of this company is appalling.

Moreover, MCI's cooperation results from necessity, not probity. The fraud here was so egregious that the company had no choice but to cooperate. If this kind of "desperation cooperation" were rewarded with a slap on the wrist, the most brazen violators of the law would escape scot-free, while those with the temerity to raise a legitimate defense would suffer the harshest punishment. This result cannot be squared with any rational concept of justice.

Finally, MCI's apologists claim that appropriate enforcement action would "unfairly damage the company's creditors" and would put "the 55,000 employees of WorldCom . . . out of work." While this argument seems to have persuaded Judge Rakoff to approve the SEC's settlement, it's a bugaboo. Telecommunications is a volatile and risky industry in which no one's job is guaranteed. MCI itself has already laid off more than 25,000 workers since its fraud was announced. What presents a *massive* risk to jobs is the government's campaign to subsidize MCI at the expense of honest competitors. More than 650,000 people are employed by other firms in the telecommunications sector. Giving MCI a host of artificial advantages is not required to sustain its operations and puts the jobs of honest competitors at risk.

* * *

Fortunately, the Department of Justice has not yet completed its investigation into the fraud at MCI. The Department has the tools at its disposal to ensure the complete disgorgement of MCI's ill-gotten gains, and to set up a fund to compensate MCI's victims. Moreover, the Department's guidelines make clear that this is the quintessential case for corporate prosecution, given the magnitude of the crime, the number of high-level executives involved, the pervasive culture of fraud, and the total breakdown of internal controls. Left to its own devices, it is hard to imagine that the Department will not take appropriate enforcement action. If corporate prosecution is not called for in this case, it hard to imagine a case where it would be.

The danger is that the capitulation to MCI by other offices of government, including the SEC and GSA, will create a climate of accommodation—a climate perhaps fostered by a political decision to prop up MCI regardless of the costs. This hearing is therefore quite timely, because it affords the Committee an opportunity to support the Justice Department's effort to make a decision in this case based *only* on a fair and reasoned application of the law.

The enforcement of our criminal and securities laws always takes precedence over bankruptcy. Bankruptcy is a refuge for honest companies that failed in business, not for a criminal enterprise that collapsed under the weight of its own deceptions. What MCI's competitors want—and what the American public wants—is justice. Honest competition is good for shareholders, for employees, and for consumers. Dishonest competition—competition where the government places its thumb on the scale by giving affirmative advantages to corporate criminals—kills investment, kills jobs, and kills economic growth. More importantly, it undermines the rule of law, which is the cornerstone of our freedom and prosperity.

RICHARD J. DURBIN
ILLINOIS

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July 28, 2003

The Honorable Nicholas deB. Katzenbach
Board Member
MCI Telecommunications
22001 Loudoun County Parkway
Ashburn, Virginia 20147

Dear Mr. Katzenbach:

It was a pleasure to see you at the July 22, 2003 Senate Judiciary Committee hearing on the WorldCom bankruptcy. At the hearing, I raised my concerns about the propriety of the federal government's decision to continue doing business with WorldCom/MCI, and discussed as an example, a recent government contract awarded to WorldCom/MCI to construct a wireless system in post-war Iraq. In response, you pointed out that the Iraq award was not a sole source contract because AT&T had bid on the same contract.

Following the hearing, I received the enclosed letter and attachments from AT&T which dispute your characterization of AT&T's involvement in the contract in question. In order to ensure the most accurate record of the hearing, would you please provide to me and to the Senate Judiciary Committee your response to the enclosed materials.

Sincerely,

Dick Durbin

Richard J. Durbin

Attachment

cc: The Honorable Orin G. Hatch, Chairman, Judiciary Committee
The Honorable Patrick J. Leahy, Ranking Member, Judiciary Committee
Peter Jacoby, Vice-President & Director Congressional Relations, AT&T

AT&T

Peter G. Jacoby
Vice President and Director
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July 23, 2003

The Honorable Richard Durbin
332 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Durbin:

I am writing to provide the Judiciary Committee information to clarify its record in connection with its July 22nd hearing titled, "The WorldCom Case: Looking at Bankruptcy and Competition Issues." At that hearing, you asked former Attorney General Nicholas Katzenbach, a member of the MCI/WorldCom Board of Directors, about a contract recently awarded to MCI/WorldCom to build a wireless system in Iraq. You described the award as a single source contract and Mr. Katzenbach disagreed, saying that AT&T and Telstra had bid on that contract. Because Mr. Katzenbach alleged facts concerning AT&T, I write this letter to specify the facts as AT&T understands them.

AT&T has been, and remains, very interested in opportunities to restore and enhance telecommunications services in Iraq. To our knowledge, a Request for Proposal has never been issued for this work, and no bidding procedures were established or followed concerning the award of this work. However, pursuant to our interest in helping to restore telecommunications services in Iraq, this past spring we began discussing with people in the United States government the telecommunications needs in Iraq and the various approaches to best meet those needs. We also devoted significant internal resources to explore ways to quickly restore and enhance telecommunications services to meet the needs of the United States, humanitarian efforts in Iraq and the Iraqi people. In addition, in order to provide an integrated "turn-key" solution, we reached out to partners, including Telstra, the incumbent provider of wireline and wireless telecommunications services in Australia.

The Honorable Richard Durbin
July 23, 2003
Page Two

On May 7, 2003, we submitted to the Office of Reconstruction and Humanitarian Aid an unsolicited proposal to provide various telecommunications services within Iraq. We also continued our discussions with persons in the United States government both here and in Iraq concerning opportunities for providing and enhancing telecommunications in Iraq. During the course of these discussions, on May 15, 2003, we were surprised to learn through press reports that MCI/WorldCom had already been awarded a contract to provide telecommunications services in Iraq. *(See attachments)* Given that there had been no formal bidding process and a lack of transparency in the bid process, we do not know when the work was actually awarded to MCI/WorldCom or pursuant to what contractual vehicle it is being performed. We do believe, as you indicated, that this was a no-bid award of work to MCI/WorldCom.

I hope this information proves helpful to the Committee as it seeks to gain a more complete understanding of the issues it explored at its hearing on July 22. I also would like to close this letter by thanking the Committee for taking the time to explore these issues, and by reaffirming AT&T's commitment to provide services to the United States government wherever and whenever needed. Whether it be reconstruction efforts in Iraq or telecommunications needs here at home, AT&T stands ready to serve with the same quality, reliability, and value that people have come to rightfully expect from us. Please do not hesitate to contact me if I can be of further assistance on this or any other matter.

Sincerely,

Attachments

MCI to Begin Rebuilding of Iraqi Phones
U.S. Awards Contract For Small Network

Christopher Stern Washington Post Staff Writer
May 15, 2003; Page E1

American telephone giant MCI has been awarded a contract to build a small mobile phone network in Baghdad as the United States takes an initial step to rebuild basic communications in a city ravaged by two wars and 11 years of severe economic sanctions.

A working phone system is largely absent in much of the Iraqi capital, apart from limited grids of wired networks. Many Westerners, including military personnel, aid workers and journalists, have had to rely on satellite phones, which typically do not work indoors. Even before the most recent U.S. bombing, Iraq's telecommunications resources were scarce and unreliable. Analysts estimate that the prewar telephone network was capable of serving only three out of every 1,000 people.

Given the rudimentary state of telecommunications, there is growing impatience in Iraq with the pace of the work to install a new system. Sources at the Office of Reconstruction and Humanitarian Assistance have begun complaining that MCI has fallen behind schedule in getting even a relatively small system of 5,000 to 10,000 phones up and running.

Sources said the Defense Department, which awarded the contract, never specified a completion date but the company had informed the government that it should be able to finish by next month.

MCI spokeswoman Natasha Haubold said the company has been waiting in line to ship the necessary equipment to Iraq but given the priority of other humanitarian aid, such as food and clothing, the first delivery of its gear was not completed until last week.

"We are on schedule for implementation in June," Haubold said.

MCIis a division of WorldCom Inc., which filed for bankruptcy protection last year after disclosing a massive accounting scandal. WorldCom expects to emerge from bankruptcy later this year and operate under the name MCI.

The U.S. government has continued to be the Ashburn-based telecommunications company's biggest customer throughout the current scandal and bankruptcy process. Although it no longer operates a wireless network in the United States, MCI played a role in getting a similar mobile phone network into operation in Afghanistan.

Sources declined to comment on the value of the Baghdad wireless contract.

Initially, telecommunications companies such as Lucent Technologies Inc., Motorola Inc. and Qualcomm Inc. had hoped that the U.S. government would award a far larger contract to rebuild most of Iraq's telecommunications infrastructure. But Bush administration officials earlier this month decided to leave that decision to the incoming Iraqi government. Analysts have estimated that it may cost at least $900 million to put a state-of-the-art telecommunications network in place.

Speculation about a major telecommunications contract began to build in March when Rep. Darrell Issa (R-Calif.) attacked the Defense Department's plans even before they were disclosed.

Issa called on the Pentagon to award the contract to a company that would use a wireless standard developed by Qualcomm, a telecommunications firm based near his Southern California district. Issa then introduced a bill that would have effectively required any company that won the contract to use Qualcomm's Code Division Multiple Access (CDMA) standard.

But sources confirmed yesterday that MCI's network would use the Global System for Mobile Communication (GSM) standard that is more widely used around the world, particularly in countries that neighbor Iraq.

Issa had been particularly critical of GSM because it was developed in Europe by a consortium of countries including some nations, such as France, that had opposed the U.S. invasion of Iraq.

"Obviously, we are disappointed that they didn't use a predominantly U.S. technology," said Issa's chief of staff, Dale Neugebauer.

Neugebauer questioned the wisdom of awarding the contract at the expense of U.S. taxpayers.

"There is tremendous commercial interest in building a cell-phone system in Iraq and very little need for investment by the U.S. government," said Neugebauer.

Staff writer Peter Slevin contributed to this report.

MCI Will Build Cellphone Network In Iraq by June Under U.S. Contract

By JESSE DRUCKER and MICHAEL M. PHILLIPS, THE WALL STREET JOURNAL

May 15, 2003

The Bush administration has tapped MCI -- the former WorldCom Inc. -- to build a small cellular-telephone network in Iraq to help speed the much-criticized reconstruction effort there.

The system is expected to be in place by June, according to the company, which is reorganizing under federal bankruptcy-court protection. Cellular communications would allow U.S. officials, American troops and international aid workers to coordinate better among themselves, removing one of the major obstacles to the U.S.-led rebuilding campaign.

It is unclear when the contract was awarded or how much MCI is earning for the deal. Equipment for the network already has started arriving in the country and eventually will be able to accommodate between 5,000 and 10,000 users, according to a person familiar with the pact.

A Pentagon official said the contract is worth about $45 million, but gave no details.

Business Week and CNN previously disclosed the contract.

The deal gives MCI a beachhead in a market that many telecom companies and investors have an eye on enviously. The Bush administration plans to leave decisions about major phone projects to an interim Iraqi government.

"The reason why it's not to be assumed that MCI will ... cash in on bigger contracts is there's still an international political process that needs to play out before big telecom and oil contracts are awarded," said Joseph Braude, the senior Middle East analyst at Pyramid Research, a telecommunications consulting firm in Cambridge, Mass.

Numerous Iraqi and American consortia are mustering resources to invest in the sector. But they are holding back on actual investments, in part because there is no Iraqi authority to give them an operator's license or concession, and they don't want to risk expropriation by a new government. In addition, they are nervous about remaining U.S. and United Nations sanctions.

"We're ready to go into Baghdad the day it's legal," said William T. Carlin, chief operating officer of interWAVE Communications Inc. of Mountain View, Calif. His company, which was working with an MCI competitor, supplies compact cellular networks for operators in developing countries.

MCI spokeswoman Natasha Haubold declined extensive comment on the deal, but said MCI "is looking forward to continuing to support its customers as their needs continue to change and evolve."

MCI doesn't currently have a wireless network in the U.S., and exited from its wireless-reselling business last year. The company also disclosed the largest case of accounting fraud in U.S. history last summer, but the federal government has continued to award it large contracts in part because of the perceived need for competition in telecom services.

The Iraqi network will use GSM technology, the wireless standard in most of the world, according to the person familiar with the matter. A dispute over the future of Iraq's telecom infrastructure erupted in March when Rep. Darrell Issa (R., Calif.) demanded that the U.S. fund a network using a technology known as CDMA, which was developed commercially by Qualcomm Inc., one of Mr. Issa's largest campaign contributors.

WRITTEN STATEMENT OF

MARCIA GOLDSTEIN
PARTNER
WEIL, GOTSHAL & MANGES LLP

HEARING ON

"THE WORLDCOM CASE:
LOOKING AT BANKRUPTCY AND COMPETITION ISSUES"

BEFORE THE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

JULY 22, 2003

Biographical Background

My name is Marcia L. Goldstein. I currently serve as bankruptcy counsel for MCI in its chapter 11 case. I am a partner and co-head of the Business Finance and Restructuring Department of Weil, Gotshal & Manges LLP, which is the largest bankruptcy and reorganization practice in the country. During my nearly 28 years at Weil, Gotshal & Manges, I and others in my group have represented numerous debtors in chapter 11 cases, as well as financial institutions with significant claims in such cases.

I am on the Advisory Board of Colliers Bankruptcy, 15th Ed., have been a Visiting Lecturer in Bankruptcy at Yale Law School, am a member of the National Bankruptcy Conference and the American College of Bankruptcy. I have served as the Chair of the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York.

Issues Under Consideration

Two questions which have been raised by certain competitors of MCI, particularly Verizon, are the subject of this hearing:

> First, whether a chapter 11 debtor, such as MCI, which has engaged in pre-filing fraud or misconduct, should be denied an opportunity to reorganize under chapter 11 of the United States Bankruptcy Code; and
>
> Second, whether a reorganization of MCI under chapter 11 would confer on it an unfair competitive advantage.

The answer to both of those questions is: No. To answer otherwise would be in direct conflict with the underlying policies and premises of the federal bankruptcy laws and long standing judicial precedent and practice.

The Purpose of Chapter 11: Rehabilitation of the Debtor

The federal bankruptcy laws foster the balancing of two goals: the equitable distribution of a troubled company's assets through the equal sharing of losses by creditors of equal rank, and the restructuring or rehabilitation of a business to preserve jobs and to maximize the return to creditors and, if possible, other stakeholders of the debtor. Thus, the federal bankruptcy laws prevent creditors from dismembering the assets of a debtor, while providing the opportunity for a fresh start. At the heart of these goals stands the basic premise of bankruptcy policy that when the "going-concern value" of an enterprise exceeds the "liquidation value" of the enterprise, reorganization of the debtor will maximize return to creditors and lead to the preservation of the enterprise for the greater good. Congress has recognized this fundamental premise. As Senator Hatch has observed,

> Chapter 11's overriding purpose is to take whatever steps are expedient to preserve the failing business for the benefit of all if possible.

130 Cong. Rec. S 8892 (daily ed. June 29, 1984) (remarks of Sen. Hatch). And the Supreme Court has confirmed that

> [b]y permitting reorganization, Congress anticipated that the business could continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. H.R. Rep. No. 95-595, p.220 (1977).

United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1982). Accordingly, one of the criteria for confirmation of a plan of reorganization under chapter 11 of the Bankruptcy Code (11 U.S.C. § 101 et seq.) is that the plan satisfy the so-called "best interests test," which requires that each holder of an impaired claim or equity interest either accepts the plan, or will receive or retain under the plan property of a value that is not less than the value such party would receive or retain if the debtor were to be liquidated under chapter 7 of the Bankruptcy Code. *See* 11 U.S.C. § 1129(a)(7).

Thus, in its effort to enable a debtor to rehabilitate its business and continue to operate post-chapter 11, Congress designed the Bankruptcy Code expressly to afford the debtor a "fresh start." And while we currently operate under the Bankruptcy Code of 1978, this basic premise has been part of the fabric of this country's bankruptcy laws, and our national economy, for almost two centuries. As the Second Circuit Court of Appeals has stated, "Congress made it a central purpose of the bankruptcy code to give debtors a fresh start in life and a clear field for future effort unburdened by the existence of old debts." *In re Bogdanovich*, 292 F.3d 104, 107 (2d Cir. 2002).

To this end, chapter 11 of the Bankruptcy Code provides a financially troubled business with an opportunity to restructure its balance sheet and its business affairs, and includes an array of provisions designed to promote this result:

- First and foremost, upon the filing of a petition for relief, the automatic stay instantly and automatically stops all actions and proceedings against the debtor to enforce or collect on a pre-chapter 11 obligation. The automatic stay affords the debtor breathing room from creditors and creates an opportunity for negotiation with parties in interest. 11 U.S.C. § 362.

- Section 364 of the Bankruptcy Code provides the parameters whereby the debtor may obtain liquidity in the form of "new" money through debtor-in-possession financing. 11 U.S.C. § 364.

- The debtor may relieve itself of burdensome contracts through the rejection process. Conversely, if the debtor has contracts it deems valuable but is unable to utilize, the debtor may often assign such contracts to third parties willing pay the debtor for them, even if the contract prohibits assignment. 11 U.S.C. § 365.

- Under the Bankruptcy Code pre-chapter 11 fraudulent and preferential transfers may be "avoided" and the proceeds thereof recovered for distribution to creditors. 11 U.S.C. §§ 547, 548, 550.

The comprehensive scheme embodied in chapter 11 balances the rehabilitative policies with creditors protections:

- Through the claims reconciliation process, creditors of the debtor are afforded a forum for their claims to be asserted, contested, and resolved. 11 U.S.C. § 502, Fed. R. Bankr. P. 3007.
- Non-ordinary course transactions must be on notice to creditors, who may object and be heard by the bankruptcy court. 11 U.S.C. § 363.
- The Bankruptcy Code sets forth certain mandatory provisions for a plan of reorganization. 11 U.S.C. § 1123(a).
- Holders of claims and interests are provided with a disclosure statement which contains adequate information of a kind and in sufficient detail to enable hypothetical, reasonable investors typical of a debtor's creditors to make an informed judgment whether to accept or reject a proposed chapter 11 plan. 11 U.S.C. § 1125.
- Holders whose claims or interests are impaired by distributions under the proposed chapter 11 plan are entitled to vote whether to accept or reject it. 11 U.S.C. § 1126.

In this manner, the Bankruptcy Code seeks "to avert the evils of liquidation," provide a fresh start for the debtor, and promote for the prompt and efficient administration and settlement of the chapter 11 estate that maximizes the return to creditors.

Conversely, punishing a debtor for its failure to pay debts or for its prepetition actions – even fraud or other misconduct – by mandating liquidation – is antithetical to the chapter 11 construct. The bankruptcy laws promote rehabilitative, not punitive goals. And, even in the case of criminal conduct, the statutory scheme developed by Congress relies on traditional arms of the state and federal governments to exact the appropriate punishment of culpable parties. Indeed, with the enactment of the

Bankruptcy Code in 1978, the Securities and Exchange Commission's role in bankruptcy was dramatically reduced in recognition that the SEC's policing of fraud and other securities violations pursuant to its enforcement powers diminished the need for the SEC's involvement in the chapter 11 process. Clearly, Congress believed that anti-fraud policies are best addressed by the securities laws and enforced by the SEC rather than the bankruptcy courts.

MCI's Chapter 11 Filing

How do these premises apply to MCI? The announcement of accounting improprieties last June created an immediate liquidity crisis for MCI as all sources of financing and capital were cut off. MCI turned to chapter 11 in order preserve value for its creditors. Chapter 11 was the only alternative which enabled MCI to obtain financing and the much needed breathing room to develop and implement its business plan, revive its operations, cooperate with the Securities and Exchange Commission with respect to the rectification of and punishment for its prepetition securities law violations, and propose a plan of reorganization that is supported by creditors holding 90% of the company's indebtedness. In this manner, MCI is a classic example of a company moving toward a consensual reorganization and the rehabilitation that the bankruptcy laws were designed to foster.

Concurrently, the traditional arms of the federal government have continued to investigate and indict the culpable individuals responsible for the pre-chapter 11 accounting fraud at MCI. MCI has and will continue to cooperate with these investigations. In addition, the Securities and Exchange Commission commenced an enforcement action immediately upon MCI's disclosure of accounting irregularities and in the context of that action, MCI consented to the entry of a permanent injunction regarding the company's future conduct and compliance with securities laws. MCI has also consented to a $2.25 billion penalty judgment as a resolution of the SEC action. When its reorganization plan becomes effective, MCI will pay $500 million in cash and $250 million in stock in satisfaction of the penalty judgment. It is the largest fine in corporate history and it has been approved by the United States District Court for the Southern District of New York, the court presiding over the SEC action against MCI.

MCI has not only sought to restructure its balance sheet and reshape its business, but it has also sought to re-invent itself in many ways.

- MCI consented to the appointment of a corporate monitor to oversee certain aspects of the company's business practices, including the review and reformulation of the company's corporate governance procedures;

- MCI has "cleaned house" of the culpable individuals, fired or accepted the resignation of every employee accused of participation in the fraud by the board's special investigative committee or the bankruptcy examiner, and even those employees who, while not accused of personal misconduct, are alleged to have been insufficiently attentive in preventing fraud. All of these actions have been designed to put the company on a new a positive footing – led by a new board of directors, new chief executive officer, and new senior managers;

- MCI has not only cooperated with the corporate monitor, the Examiner appointed in the chapter 11 case, the SEC, the Department of Justice, the United States Attorneys' office for the Southern District of New York, and other investigative bodies, but has sought to become a model of corporate governance and internal compliance. In furtherance thereof, MCI created an ethics office that has revamped corporate ethics standards and a mandatory educational program to reinforce such standards.

The Verizon Theory

The view that MCI should not be permitted to reorganize under the Bankruptcy Code but should be subject to a forced sale under chapter 7 is espoused primarily by MCI's competitors, notably Verizon. Under the "Verizon Theory," MCI should be liquidated to prevent it from benefiting from its prepetition fraud. The Verizon Theory, however, not only completely ignores the fundamental principles of chapter 11, but also the realities of who the stakeholders are in the MCI chapter 11 case.

Relief Under Chapter 11 is Not Denied to Debtors Based Upon Prepetition Fraudulent Conduct

Nothing in the Bankruptcy Code prohibits an entity that engaged in prepetition fraudulent conduct from seeking rehabilitation under chapter 11 or requires the liquidation of such companies. There are a number of examples of companies which engaged in prepetition misconduct or fraud, or violations of the security laws, that have successfully reorganized under the Bankruptcy Code, including Sunbeam, Inc. and Leslie Faye, Inc. Other recent chapter 11 cases demonstrate how market regulators, law enforcement agencies, and bankruptcy courts can respond in harmony when culpable individuals engage in fraudulent misconduct at the expense of creditors and public security holders. The facts and circumstances of MCI's chapter 11 case are no different. If the Verizon point of view is accepted, no such entity would be or would have been permitted to reorganize under chapter 11.

Rather, in cases in which debtors have engaged in prepetition misconduct, the initial stages of a reorganization case provide the context for the removal of culpable individuals and/or other remediation. Since the filing of its chapter 11 cases, MCI has totally revamped its management, board of directors and corporate governance practices. In fact, had MCI not "cleaned house" or remediated its prepetition improper conduct, liquidation would still not be the appropriate remedy. Rather, pursuant to section 1104 of the Bankruptcy Code, the Bankruptcy Court could direct the appointment of a trustee to replace management and conduct appropriate investigations. Given the company's voluntary replacement of its senior management and board of directors, and its consent, at the outset of its chapter 11 case, to the appointment of an examiner to investigate areas of prepetition misconduct, the drastic remedy of a trustee was not necessary. For these reasons, among others, when certain creditors of MCI filed a motion seeking the appointment of a trustee, the Bankruptcy Court denied such request. *See In re WorldCom, Inc.*, No. 02-13533 (AJG) (Bankr. S.D.N.Y. May 16, 2003) (Memorandum Decision and Order Denying Motions for Appointment of a Chapter 11 Trustee and Examiner).

District Judge Jed Rakoff of the Southern District of New York, who presides over the SEC enforcement action against MCI, responded to competitors' suggestions that denying access to reorganization under chapter 11 and requiring a forced sale under chapter 7 should be additional punishment for MCI. In approving the proposed $750 million SEC settlement, Judge Rakoff observed that liquidation

> would undercut the basic tenets of bankruptcy reorganization, a unique innovation of United States bankruptcy law that has contributed materially to the conservation of economic resources and the stability of the U.S. economy.

Securities and Exchange Commission v. WorldCom, Inc., No. 02 Civ. 4963 (JSR), slip op. at 8 (S.D.N.Y. June 7, 2003). Recognizing the inherent conflict between the rehabilitative purposes of chapter 11 and the liquidation of the company, Judge Rakoff commented that:

> To kill the company . . . would unfairly penalize its 50,000 innocent employees, remove a major competitor from a market that involved significant barriers to entry, and set at naught the company's extraordinary efforts to become a model corporate citizen. It would also unfairly impact creditors, over 90 percent of whom have stated their support for the company's plan of reorganization in recognition that it affords them far more value than liquidation.

Id. In these circumstances, and particularly in view of the policy aims of the Bankruptcy Code, the liquidation or a forced sale of MCI, an enterprise on the cusp of completing its reorganization, can serve no legitimate purpose.

The Verizon Theory: Of Trucks and Truck Drivers

On several occasions, the proponents of the Verizon Theory have expressed their view that when a business expands operations through the use of inappropriate means and acquires new customers or additional assets, that business, with its allegedly fraudulently acquired assets, should be removed from the marketplace and sold for the benefit of its competitors.

The Verizon Theory neglects the very heart of the policy goals of equitable distribution underlying the Bankruptcy Code. The expansion of MCI's operations was funded by its creditors, not its competitors. It was these creditors who financed the acquisition of the assets that enabled MCI's growth. These creditors are among the victims of the prepetition accounting fraud and are entitled to recover on account of their losses to the maximum extent possible. Although a sale of MCI's assets could occur in chapter 11 under circumstances where creditors elect this alternative in lieu of a stand-alone reorganization, MCI has received no proposal from its creditors along these lines, and, to the contrary, has received overwhelming creditor support for its proposed plan of reorganization. Where the going-concern value of the enterprise exceeds the liquidation value, as is true in MCI's case, the liquidation of the enterprise is not an appropriate remedy.

Although the proponents of the Verizon Theory assert that liquidation of the assets acquired through fraudulent means is the only way to afford the so-called injured competitor with recourse, an "injured" party is only entitled to damages where it has demonstrated a sustainable cause of action for its alleged injury and has established that the injury was in fact caused by the party charged. Competitors have put forth no sustainable causes of action along these lines.

Contrary to the premise of the Verizon Theory, a chapter 7 sale would not yield a fair result to either MCI's employees or its creditors. A mandatory chapter 7 liquidation of MCI would result in a forced sale of assets at a depressed price. Only a handful of MCI's competitors would have the wherewithal to bid and such competitors, including Verizon, would be the only beneficiaries of such a forced sale. Nonetheless, these competitors suggest that creditors would receive a fair price in such a "going concern liquidation" of MCI. This ignores the realities of chapter 7. In fact, creditors would recover significantly less than the recoveries provided for in the reorganization plan that has been filed in the Bankruptcy Court. Conversion to chapter 7 would result in a default in MCI's available DIP financing with the result that existing trade credit would dissipate, new business opportunities would disappear, customers would be unnerved and the business stability achieved by MCI since its chapter 11 filing would be immediately undermined, with a resulting deterioration in value. A forced sale in such conditions –

where creditors would have no vote – as they would in chapter 11 – would benefit only MCI's competitors, who would bid for MCI's business at a distressed value and eliminate it as an additional competitor. This is antithetical to the fundamental premise of US bankruptcy law.

The proponents of the Verizon Theory also espouse the view that MCI's employees would not be affected by a "going-concern liquidation" of the company. Again the Verizon Theory ignores reality. Many MCI jobs would be eliminated if the company were sold to a competitor in a forced sale. This is a natural result of consolidation. It is generally accepted that the reorganization of a debtor is the best way to preserve the employment of the debtor's employees. Indeed, the employees are best served by enabling them to have the opportunity to realize the benefits of the successful reorganization of the debtor. In addition, injured stockholders of MCI – many of whom are or were employees – will receive compensation, including stock, from reorganized MCI through the SEC Settlement and the Sarbanes-Oxley compensation fund. The liquidation of MCI in chapter 7 would result in the subordination of the SEC penalty and no opportunity for recovery to injured stockholders.

Our federal bankruptcy laws favor rehabilitation of the enterprise and the maximization of creditor value. These laws are not driven by the interests of a debtor's competitors, such as Verizon. Chapter 11 reorganization would have little purpose if competitor "interests" were a consideration. This consideration is neither a part of the formula, nor should it be. As the Supreme Court has observed,

> The Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization.

N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 527 (1984).

Competitive Balance Concerns

Verizon and others have expressed concern that MCI will emerge from chapter 11 with a reduced debt load and therefore a competitive advantage. They assert that reorganized MCI will be positioned to engage in predatory pricing practices and, thus, destabilize the telecommunications industry. Such concerns are misplaced. The proposed debt level for reorganized MCI, approximately $5.5 billion, which will represent about 41% of the post-bankruptcy value of the company. In contrast, Verizon's debt represents only 30% of the value of its company. We don't believe that this is a relevant measure for determining the ability to compete in a market but, if there is any competitive advantage to be had, it clearly falls to Verizon. .

Moreover, as Judge Rakoff observed, these arguments of unfair advantage should be disregarded. The Verizon Theory ignores that, while corporate reorganization under chapter 11 may confer upon the debtor an advantage in the terms of reducing pre-chapter 11 debt, companies seek bankruptcy protection as a last resort because chapter 11 involves significant competitive disadvantages due to negative publicity and customer hesitation. It is common for a debtor's competitors to try to eliminate an entity while in chapter 11 and when it emerges. The repeat filings of certain chapter 11 debtors is testimony to the difficult competitive marketplace a debtor will face following emergence from chapter 11 protection. In fact, during MCI's chapter 11 case – while it has had no pre-chapter 11 debt service requirements at all – it has been MCI's competitors (not MCI) that have engaged in competitive pricing strategies, and in that environment, MCI was forced to lower its prices and reduce its future EBITDA projections.

Despite Verizon's characterization, competitors of MCI are not the victims of the accounting irregularities. Rather, the victims in this matter are the creditors and shareholders who lost billions of dollars. Having suffered such losses, creditors of MCI have relied upon the provisions of the Bankruptcy Code to enforce their claims to obtain the maximum value possible. The creditors of MCI will be the new owners of a reorganized MCI. If chapter 11 could not be utilized to implement this result, it is not the culpable individuals who would be punished; neither is it MCI that would be punished. Rather, it is the creditors of MCI who would be punished. In fact, creditors would be penalized twice: once by losses resulting from MCI's pre-chapter 11 improprieties and financial distress and again by denying the normal operation of the Bankruptcy Code. While the credit markets have already adjusted expectations in light of the former, the latter could prove more destabilizing – not just for MCI creditors, but for the chapter 11 process in general. The impact on financial markets and the availability of credit could be significantly impaired. As Congress noted in the legislative history of the Bankruptcy Code:

> A corporation which is taken over by its creditors through a plan of reorganization will not continue to be liable for [obligations] arising from the corporation's prepetition fraud . . . since the creditors who take over the reorganized company should not bear the burden of acts for which the creditors were not at fault.

S. Rep. 95-989, at 130 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5915. This is the basis for section 510 of the Bankruptcy Code, which requires subordination of securities fraud claims to the claims of other creditors and explains why claims arising from fraud are discharged in corporate bankruptcies.

The hearing before the bankruptcy court to consider MCI's plan of reorganization is scheduled to commence on August 25th. MCI will have to establish, to the satisfaction of the Bankruptcy Court, that its plan has met all statutory requirements. It is the protections and the benefits of chapter 11 that have enabled MCI to take the steps to emerge as a rehabilitated enterprise that has regained the confidence of its creditors, customers, and employees. The context in which MCI "cleaned house," settled with the SEC, developed a business plan and negotiated a plan of reorganization with its major creditor constituents is the product of balanced federal bankruptcy law. It should be commended, not punished or otherwise denied.

Thank you for the opportunity to be heard on the matters before this Committee today.

News Release
JUDICIARY COMMITTEE

United States Senate • Senator Orrin Hatch, Chairman

July 22, 2003 Contact: Margarita Tapia, 202/224-5225

Statement of Chairman Orrin G. Hatch
Before the United States Senate Committee on the Judiciary
Hearing on

"THE WORLDCOM CASE: LOOKING AT BANKRUPTCY AND COMPETITION ISSUES"

Good afternoon and welcome to today's hearing entitled "The WorldCom Case: Looking at Bankruptcy and Competition Issues."

I first would like to thank all of our witnesses today for their time and cooperation. I hope that this hearing will help us better understand the WorldCom situation and its potential public policy implications.

Along with many Americans, I am deeply concerned about the devastation caused by WorldCom's massive corporate fraud, which has caused immeasurable harm to so many. While we can't go back in time and undo what has already occurred, we are presented today with an opportunity. We have an opportunity to examine the WorldCom case and determine whether there are lessons to be learned with respect to our public policy going forward.

The focus of today's hearing will be two-pronged. First, we will examine the WorldCom bankruptcy case and consider, in light of the facts, whether any changes in our current bankruptcy laws may be in order. Second, we will assess the implications of a reorganized MCI emerging from bankruptcy on competition in the telecommunications market. Here again, we will evaluate what impact, if any, this anticipated competitive landscape should have on public policy.

Some have raised fairness concerns that WorldCom will be able to emerge from bankruptcy with much of the fruits of its widespread fraudulent conduct intact. They argue that it will emerge from Chapter 11 with an enhanced market position relative to its competitors, giving it not only a fresh start but a head start. They believe that, in view of the WorldCom case, our bankruptcy system is set up to make crime pay.

Others contend that the MCI which will emerge from bankruptcy is a new entity with new leadership. They point to the extraordinary measures it has taken to prevent the recurrence of past misdeeds. They further argue that MCI will *not* have a meaningful competitive advantage from its Chapter 11 reorganization. And, they argue that our bankruptcy laws appropriately are not designed to punish, but rather to permit a company to reorganize and emerge from bankruptcy as a viable entity.

As we move forward, I believe we need to have a full understanding of the WorldCom case to help us determine whether our bankruptcy laws are functioning fairly and effectively. We also need to understand the WorldCom case in order to conclude whether our policies are sufficient to enable the telecom industry to enjoy robust competition under fair terms that benefits consumers. No doubt, this is a complex case containing important issues deserving of examination.

We are fortunate to have highly respected individuals here today to testify on these important matters.

We will first hear from former Attorney General Richard Thornburgh, who is the Bankruptcy Examiner in the case. We are fortunate to have you with us and look forward to your testimony.

On our second panel, we are honored to hear from: former Attorney General William Barr, the Executive Vice President and General Counsel of Verizon Communications; former Attorney General Nicholas Katzenbach, who serves on the Board of directors of MCI Telecommunications; Marcia Goldstein of the law firm Weil Gotshal; Douglas Baird, Vice Chair of the National Bankruptcy Conference; and Mark Neporent, the Chief Operating Officer of Cerberus Capital Management.

I appreciate all of you appearing today, and look forward to your testimony.

# # #

WRITTEN STATEMENT OF

NICHOLAS DEB. KATZENBACH

INDEPENDENT MEMBER OF THE MCI BOARD OF DIRECTORS,

HEARING ON

"THE WORLDCOM CASE: LOOKING AT BANKRUPTCY AND COMPETITION ISSUES"

BEFORE THE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

JULY 22, 2003

Chairman Hatch, Senator Leahy, and members of the Committee:

My name is Nicholas Katzenbach, and I serve as an independent member of MCI's Board of Directors. I served as the Attorney General of the United States from 1964 to 1966. Since leaving public service, I have been practicing law – including serving for 17 years as Senior Vice President and General Counsel of IBM.

I joined the Board of MCI on July 21, 2002, almost exactly a year ago, to serve as an independent watchdog who could represent the interests of investors and who could provide a fresh perspective on the operations and management of the company. Dennis Beresford, former chairman of the Financial Standards Accounting Board, joined me on the Board at that time and C.B. Rogers, who has wide experience as a corporate director, later joined us. Together, the three of us comprised the Special Investigative Committee of the Board that was charged with overseeing an independent investigation of the financial irregularities that occurred at WorldCom.

None of us was affiliated with the company in any way during the late 1990s, when MCI was taken over and was being operated by the former management of WorldCom. Nor were any of us affiliated with the firm when those WorldCom executives – all of whom have now been dismissed from the firm – perpetrated the largest financial fraud in American history.

As someone who has been involved in cleaning up the damage inflicted on MCI during the WorldCom era, I believe I can offer this Committee a perspective on MCI that is quite different from the viewpoints of some other witnesses from whom you'll be hearing today.

I'd like to begin by asking those who would inflict further pain on MCI: Who is it, exactly, whom you intend to punish? Is it the 55,000 employees of MCI, who have already seen their jobs put at risk and their retirement savings driven toward oblivion? Or is it the creditors of the company, who have already seen the value of their investment plummet? Or is it the victims of WorldCom's fraud who – because of our settlement with the SEC – now have a stake in the future success of MCI? Or is it the nation's long-distance telephone customers, who would surely see their phone bills rise and see their service suffer if MCI were to be driven out of business? Nothing that MCI's opponents suggest would hurt the already-departed and already-disgraced senior management of WorldCom, who were ousted and replaced after the fraud was discovered. The draconian punishment advocated by MCI's opponents would, at best, be a futile gesture – and, at worst, would inflict further pain on the innocent.

Mr. Chairman, I'd like to tell you about MCI as I've come to see it – and about the clean break that the company's new management has made with the practices of the past. The company has been transformed: The old WorldCom no longer exists. In its place is a reformed, restructured, realigned company – MCI – that is focused not on the past but on the future.

Under our new Chairman, President and Chief Executive Officer, Michael Capellas, MCI is determined to return to the high standards of ethics, innovation and vigorous competition that had marked the first decades of MCI's existence – the years before WorldCom took over our company.

Let there be no misunderstanding of our position – or of our rigorous focus on corporate integrity. The behavior of the former WorldCom executives, who were responsible for the accounting fraud at the company, is indefensible. The company was right to force these executives out, and it was right to blow the whistle on itself and on its internal problems. We will continue to cooperate completely with all of the various investigations, criminal and civil, that are looking into this past misconduct.

Let me also assert, Mr. Chairman, that I take vigorous exception to some of the allegations that have been made in recent days, and are being offered to this Committee today, about the character of the newly restructured MCI. I feel compelled to call the Committee's attention to the motivation behind some of those from whom you'll be hearing testimony today. Some of MCI's critics are calling for MCI to be barred from competing for federal contracts; to be hobbled in competing in the open marketplace; and to be broken up as a corporation, allowing its assets to be auctioned off to the highest bidder.

Mr. Chairman, MCI today is being attacked by the very same telecommunications behemoths that have always resented MCI's role as a vigorous marketplace competitor. Those industry giants have always tried to impede the creation of a level playing field. MCI's history has been one of fighting against monopolies and fighting for market innovation. Throughout its 30-year history, MCI's performance has proven the virtue of open competition. We have provided lower rates to long-distance customers; we have innovated with new and higher-quality services; we have offered customers a broad range of new service options; and we have led the industry in improving standards of customer service. For 30 years, we have proven our value as a competitor in the marketplace.

Yet like any innovator that seeks to break up cozy, long-established monopolies, MCI has inspired relentless opposition from its business rivals. By their very nature, monopolies and oligopolies don't like a level playing field, because they seek to suppress competition. At every turn, AT&T and the Regional Bell Operating Companies have sought to re-establish and reinforce their comfortable positions of dominance. And they have fought bitterly to impede MCI in its effort to innovate.

We should thus have no illusions about the one-sided information being propounded today by AT&T and the Baby Bells. Let us recognize their strident demands for what they truly are: An opportunistic business tactic to enlist support for their ultimate goal – driving MCI out of business. Our detractors are not acting in the spirit of the public interest: They are arguing a case in their own self-interest. Their arguments are driven by the economic benefits that they, themselves, may gain from politicizing this battle.

Mr. Chairman, let me submit to you: Our rivals are attempting to use political and regulatory means to quash MCI, because they know that they cannot win this fight in the open marketplace.

In fact, Mr. Chairman, it is especially interesting to note that one of the Regional Bell Operating Companies – one of the most strident voices attacking us today – actually approached MCI in 2001, offering to buy our company. The offer was rejected, and the company chose to remain an independent competitor. Now, like a spurned suitor, that Bell company seeks to win by political maneuvering what it could not win directly. By seeking a breakup of MCI, that rival aims both to eliminate a competitor and to scoop up our assets at a bargain-basement price – thus solidifying its dominant position in the marketplace, and reinforcing its quasi-monopoly. Such tactics are profoundly antithetical to consumers' interests and to the public good.

Worse, those who would put MCI out of business would punish those who have surely suffered enough already: the 55,000 innocent employees of MCI. Those dedicated, highly skilled employees have already seen their career prospects damaged, simply by their association with the WorldCom fraud; they have already seen their stock options become worthless; they have already seen the value of the company stock in their 401 (k) plans wither. And now they are living under the threat of additional job losses – amid our nation's prolonged recession, when jobs are already scarce – as the rival long-distance firms and the Baby Bells contrive to undermine their company. This final indignity, inflicted by our rivals, is an injustice to our employees and to their hard work.

MCI is restructured, realigned and ready to compete. As we anticipate our emergence from bankruptcy protection this fall, let me describe, Mr. Chairman, the steps that MCI has taken to demonstrate its good will; to reform its corporate governance structure; to strengthen its internal safeguards against any wrongdoing in the future; and to enhance the quality of its operations.

First, our efforts to overcome the legacy of misconduct. When MCI discovered evidence of the WorldCom leadership's accounting fraud, the company responded immediately. The company immediately brought the fraud to the attention of governmental authorities. The Board fired the CFO, and the board accepted the resignation of the Controller and other implicated accounting personnel. MCI has cooperated with all investigations, has submitted tens of thousands of documents, and has facilitated dozens of interviews of company personnel. Immediately after the fraud was discovered, the Special Committee of our Board directed that an independent investigation be conducted and a report be developed to determine the facts and causes of the fraud. As part of these investigations, personnel involved in fraudulent activity or otherwise associated with inappropriate conduct have been separated from the company. The company has also cooperated with a separate investigation led by an examiner appointed by the United States Bankruptcy Court.

Second, our efforts to instill the highest standards of integrity in our realigned company. The new management of MCI has made business integrity, open communication, ethics and sound corporate governance the core principles of our company. The changes we have implemented are comprehensive, and they vividly demonstrate our commitment to corporate ethics and integrity. MCI has an entirely new Board of Directors. MCI is actively rebuilding its executive management team, and has installed a new CEO, a new CFO, a new Acting Controller a new Acting Treasurer, a new Executive Vice President of Human Resources, and a new Acting General Counsel. As a result of the work of the Special Investigative Committee of the Board of Directors, a panel on which I served, more than 30 executives have been replaced.

Moreover, MCI has rebuilt its finance and accounting operations. In addition to installing a new CFO and Treasurer, more than 400 new financial personnel have been hired. MCI has a new Vice President responsible for instituting sweeping changes in internal controls. The company has also retained an external consulting group to review the adequacy of the company's internal controls implementation efforts. The company's internal audit function now reports directly to the Audit Committee of the company's Board of Directors, rather than to the CFO. The company retained the accounting firm KPMG as its new external auditor in May 2002. Since then, KPMG has conducted an extensive review of the company's financial reporting and internal control procedures, and made recommendations to ensure appropriate accounting practices going forward.

Third, our cooperation in working with the court-appointed Corporate Monitor. The company consented to the appointment of a Corporate Monitor as part of the U.S. Securities and Exchange Commission's investigation of WorldCom securities and accounting issues. That Monitor is Richard C. Breeden, a former Chairman of the SEC. The company has forged a constructive working relationship with the Monitor and his staff, who have virtually unlimited access to company decision-making and information. The Monitor is invited to all Board meetings. The Monitor reviews and approves company compensation and expenditure matters, and is in the process of developing a comprehensive corporate governance report and recommendation. MCI has made a firm commitment to implement the Monitor's recommendations.

To ensure that integrity and business ethics will be at the center of all our activities, MCI has strengthened its ethics procedures, has appointed a new Chief Ethics Officer, and has published a new company-wide Code of Ethics and Conduct. Our top 80 executives have signed a binding ethics pledge, and the compensation of our CEO is directly dependent upon ethical performance. We have implemented a "zero tolerance" policy that dictates that any suspected violation of law, company policy, or the Code of Ethics and Business Conduct will be investigated and will be addressed appropriately. MCI recently conducted a two-day ethics and financial-controls training session for its top executives, and the company is in the process of developing and implementing a company-wide ethics training program.

Fourth, our commitment to transparency and openness. The company recognizes that the small group of former personnel who perpetrated the fraud was able to do so by limiting access to information and evading appropriate internal checks and balances. We have addressed and eliminated the risk that such a circumstance will ever happen again: We have made open, far-reaching communication a hallmark of the new MCI. On a quarterly basis, we conduct a thorough business review of all the company's financial data, business plans and key issues and opportunities with the company's top 80 executives. We have made extensive efforts to communicate openly and often to employees on all-important company matters, and we have fostered a company culture that encourages communication, questions and discussion among our employees.

Fifth, our settlement with the U.S. Securities and Exchange Commission – and what it says (and what the federal Courts say) about MCI's commitment to business integrity and ethical conduct. The approval, on July 7, of MCI's recent settlement of the SEC's accounting and securities-fraud complaint was a turning point for the new MCI. The United States District Court's approval of the settlement fully supports the conclusion that MCI has implemented, and is committed to sustaining, a corporate culture based on trust and integrity.

One of the most notable aspects of the settlement is that, using the provisions of Sarbanes-Oxley, \$500 million in cash plus \$250 million in stock of the new company will be distributed to shareholders and bondholders defrauded by WorldCom. In a very real sense, the victims of WorldCom's fraud now have a stake in the future success of MCI.

The decision – by Judge Jed Rakoff of the United States District Court for the Southern District of New York – included several very powerful findings that support MCI's position. In his decision, Judge Rakoff wrote: "The Court is aware of no large company accused of fraud that has so rapidly and so completely divorced itself from the misdeeds of the immediate past and undertaken such extraordinary steps to prevent such misdeeds in the future. . . . The Court is satisfied that the steps already taken have gone a very long way toward making the company a good corporate citizen." The Court added that the SEC, "with the full cooperation of the company's new management and significant encouragement from the Court-appointed Corporate Monitor, has sought something different: Not just to clean house, but to put the company on a new and positive footing; Not just to enjoin future violations, but to create models of corporate governance and internal compliance for this and other companies to follow; Not just to impose penalties, but to help stabilize and reorganize the company and thereby help preserve more than 50,000 jobs and obtain some modest, if inadequate, recompense for those shareholder victims who would otherwise recover nothing whatever from the company itself."

The Court's treatment of the same arguments put forward here today by Verizon is instructive and worth noting. The Court said that the argument by competitors, "notably Verizon and AT&T," that MCI should be liquidated, "has not commended itself to the [SEC] and does not persuade this Court. Corporate reorganization under Chapter 11 of the bankruptcy laws always confers a competitive advantage to the debtor in terms of elimination of debt; yet companies rarely seek bankruptcy except as a last resort, for it involves numerous competitive disadvantages as well. . . . "

The Court continued: "...[A]ny suggestions that companies as large and well-positioned as Verizon and AT&T will not be able to compete effectively with the new WorldCom/MCI lacks credence. Verizon, indeed, already enjoys a special competitive advantage of its own by virtue of its status under FCC rules as a de facto local monopoly."

The Court's decision is a ringing endorsement of MCI's actions and commitment. It recognizes that MCI is not – as some of our rivals contend – a company somehow built on or created by fraud. MCI has been built by employees who are driven by a competitive, pioneering spirit, and who seek to deliver the benefits of open market competition: lower prices, technologically advanced products and services, innovation, and an unwavering commitment to customer service.

The Court's decision, moreover, underscores the fact that MCI has long been at the forefront of competition in the telecommunications marketplace. Our company helped break open the long-distance monopoly that had existed well into the 1970s. We have consistently provided our customers with a greater range of choices, naturally leading to lower prices, better service and product innovation. MCI created a host of new consumer long-distance services, built the first data network, and drove Internet and e-mail innovation.

Given MCI's record of innovation, it's no wonder that our rivals are putting intense pressure on Congress, the General Services Administration and other government decision-makers in an effort to challenge our right to continue to serve the government as a federal contractor. Our rivals' self-serving attacks should have no place in the determination of whether MCI is now indeed a responsible government contractor. In the Court's recent decision, Judge Rakoff saw through the hyperbole of our rivals: "To kill the company . . . would unfairly penalize its 50,000 innocent employees, remove a major competitor from a market that involves significant barriers to entry, and set at naught the company's extraordinary efforts to become a model corporate citizen."

MCI remains a responsible federal contractor under any reasonable interpretation of the applicable standards. Companies that (like MCI) fall victim to misconduct by some executives, but who take meaningful steps to address it, should not automatically be disqualified from competition for government business. We remain able to provide our government customers with the positive benefits of competition, including more choices and lower prices. That surely benefits the taxpayers. It also helps ensure that our satisfied government customers do not face an unwarranted disruption of services.

MCI takes great pride in our many years of service to our federal, state and local government customers. We provide services to nearly every federal government agency, and operate some of the most complex, sophisticated and reliable network solutions ever deployed. Our performance as a government contractor continues to meet and exceed the most exacting standards. Our network is unmatched in scope and capability. We are especially proud of our role in supporting our national-security agencies' infrastructure, and we are gratified by the many positive comments about our service from officials at the U.S. Department of Defense and other national-security agencies. We provide a host of critical network solutions to the federal government, and believe we have demonstrated – and continue to demonstrate – a record that is unparalleled in its rapid response, flexibility and dedication in supporting national-security initiatives, both at home and abroad.

Mr. Chairman, MCI remains an innovative, responsible, cost-effective competitor in the open marketplace. Having fallen victim to a corporate fraud – perpetrated by a relative handful of senior executives, all of whom have now been dismissed – MCI has taken vigorous action to restore the integrity of its procedures and its internal standards. MCI is determined to live up to a high standard of ethical conduct that will set a positive example for all other corporations to follow. MCI is reborn, realigned and ready for competition. It is deeply regrettable that our business rivals, promoting their own business goals, would seek to restrict choice, stifle innovation and limit competition by attacking MCI – and thus would attempt to deny the nation's consumers, and our government, of the proven services MCI provides.

Mr. Chairman, thank you for the opportunity to offer this testimony to you today. I look forward to answering any questions that you and your colleagues may have, and to providing any further information that the Committee may desire.

# # #

NICHOLAS DEB. KATZENBACH

33 GREENHOUSE DRIVE
PRINCETON, N.J. 08540

TEL: (609) 924-8536
FAX: (609) 924-6610

The Honorable Richard Durbin
United States Senate
332 Dirksen Office Building
Washington, D.C. 20510

September 6, 2003

Dear Senator Durbin:

Thank you for your letter of July 28 and the opportunity to respond t AT&T's letter to you regarding the Iraq cellular network that MCI operates and maintains for the Department of Defense. Just to be clear, this is a small network fro DOD use, not an Iraq-wide commercial network. DOD has told MCI that this contract was awarded to MCI after DOD duly considered its competitive choices. Although I have no firsthand knowledge regarding other vendors that were considered, as was mentioned at the July 22nd hearing, Bloomberg News Service reported that the Australian company, Telestra, and its partner, ATT&T, lost the contract to MCI. The Bloomberg article is enclosed and was given to the Judiciary Committee staff for inclusion in the hearing record.

We believe that MCI received the contract because we offered a good price, could meet the customer's wartime planning and installation schedule and its service delivery requirements. Further, MCI had the experience of establishing and operating telecommunications networks in similar hostile environments, including Afghanistan, Bosnia, Somalia, Haiti and Desert Storm. MCI employees, working with our Armed Forces ad at great personal risk, set the Iraqi network up in less than two weeks after arrival in Baghdad and continue to maintain it.

I have also enclosed a copy of a letter that one of our employees who has been involved with the Iraqi cellular network wrote to Senator John Warner. The letter vividly describes some of the circumstances under which our employees are living and working in Iraq and the pride they take in doing their jobs. I am extremely proud of our employees who volunteered for this assignment and I am equally proud that MCI could be of service to our country.

Sincerely,

Nicholas deB. Katzenbach

Telstra Misses Out on Iraq Mobile Contract, Australian Says

2003-06-08 17:06 (New York)

June 9 (Bloomberg) -- Telstra Corp.'s failure to win a contract to help rebuild Iraq's phone network shows how hard it will be for Australian companies to compete against U.S. businesses for work there, the Australian newspaper reported.

Telstra, Australia's biggest phone company, bid with AT&T Corp., to build a $45 million mobile phone network in Iraq, the newspaper said. The contract was awarded to WorldCom Inc., which has never built a mobile network, and which fell into bankruptcy last year after perpetrating a $11 billion fraud on investors, the newspaper said.

Telstra executives, including Phil Sporton, the head of the company's network design and construction unit, visited Baghdad three weeks ago to look at building a general system for mobiles, the newspaper said, citing Telstra spokesman Stephen Morrison.

Telstra's share of the work would have been worth less than A$10 million ($6.6 million). Winning the contract could have helped Telstra win a share of a further $1 billion of phone infrastructure contracts there, the newspaper said.

(Australian, 6-9, Online)

1945 Old Gallows Road
Vienna, VA 22182-3931

MCI

July 21, 2003

Senator John Warner
225 Russell Senate Office Building
Washington, DC 20510

Dear Senator Warner:

I'm writing to inform you that MCI's cellular contract, in support of the Department of Defense and other U.S. Agencies in Iraq, continues to be in the press for the wrong reasons. It has been alleged that the contract was improperly sole-sourced to MCI and that MCI lacked the experience necessary to deploy this network. Both of these allegations are untrue.

Although I am not personally aware of the details due to the sensitive nature of the contract, a DOD official told me that it was a competitive contract. Recently, there was an article released by Bloomberg indicating that AT&T teamed with the Australian company, Telstra, to pursue this opportunity. So there was at least one other bidder for this contract.

As for our experience, MCI has supported the DOD in the past by establishing and operating telecommunications networks in similarly hostile environments, including a cellular system in Afghanistan, and other networks in Bosnia, Somalia, Haiti and Desert Storm. In the past, MCI has been the go-to company for the DOD when it needed support in these situations.

I would like to share with you our experience to-date, in providing cell phone service in Baghdad that is not being told by the media. MCI continues to work alongside the soldiers and civilians in Iraq, providing desperately needed communications across much of the city of Baghdad. It is the primary and most reliable means of communications locally and internationally as satellite phone coverage is spotty and requires the user to be outside.

MCI employees travel the road between the airport and the "green zone" (where the Coalition Provisional Authority (CPA) and V Corps HQ are located) many times daily. This is the same road mentioned in an article in the Washington Post last week as being the deadliest road in Iraq. Our mission requires we go into the heart of the city daily to install more cellular antennas, perform maintenance and refuel generators.

Our employees have been fired at (a bullet hole in one of our Suburbans attests to that), have had a narrow miss when a grenade was dropped from an overpass, have come upon Humvee's destroyed by satchel charges or land mines, witnessed our troops being MedEvac'd after being wounded or killed, have been shot at on top of buildings in downtown Baghdad while installing cell towers/antennas, and have suffered the loss of friends we've made in Iraq. Our employees have endured no water, no plumbing, no electricity, 120-degree heat day after day and long periods without a shower. They do this without complaint knowing their job is critical, aware of the sacrifice that many Americans have already made.

Everyday is a challenge operating and maintaining the 11 cell sites we have working. We drive through the street of Baghdad pulling a 1000-gallon fuel tanker behind a Ford F-350 pickup for refueling the generators. MCI employees understand the risk and know what an RPG would do to them and the tanker. But they go out day after day, into increasingly hostile streets to get the job done.

Senior government officials have acknowledged that the only thing that works well in Baghdad is the cell phone system. The current system was never designed to handle the call volume locally or internationally that it is being asked to support. Recently call blockage has been a constant and our customers have been so concerned about adverse publicity in the US press that they had been reluctant to add additional capacity even though it impacts their mission. Late last week we were given permission to expand the system and rectify, what had been a very sad state of affairs, especially considering young Americans were dying and political maneuvering, largely driven by MCI's competitors, was the principle cause for the delay.

Given the criticism that MCI has received over our involvement with the DOD, one could wonder whether we would bid on a similar contract in the future. I can tell you unequivocally that we would, because it's the right thing to do ... **because we are proud Americans**.

As Paul Harvey says, "now you know the rest of the story". Thanks for taking the time to read it.

Sincerely,

Marlin Forbes
Director,
Defense and International Markets
MCI

U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

Statement Of Senator Patrick Leahy
Senate Committee On The Judiciary
Hearing On WorldCom Bankruptcy
July 22, 2003

Like most Americans, I was outraged by the actions taken by WorldCom's top executives, by their fraud, and by their attempts to escape responsibility for their misdeeds. If reports are to be believed, the executives at WorldCom took steps that were deceptive, unethical and illegal.

I vigorously supported Sarbanes-Oxley, the most sweeping corporate reform legislation in decades, precisely because of the need to confront corporate fraud, like the debacle that has since been presented by WorldCom. Working with Senator McCain and other Senators, I sponsored many of the criminal and corporate accountability provisions in the new law, including strong new criminal penalties for securities fraud and for failure to comply with new document retention requirements. In addition, I worked on provisions for corporate whistleblowers who alert us to this kind of fraud. I was honored to serve on the House-Senate conference committee.

In terms of sheer dollar amounts, WorldCom may have perpetuated one of the largest corporate frauds in American history. WorldCom issued financial reports that grossly exaggerated its income by more than $11 billion and its balance sheet by more than $75 million. In doing this, WorldCom left its employees without a secure retirement. It also took out enormous loans that could not be repaid, and in its failure, WorldCom threw the telecommunications industry into disarray.

When WorldCom's fraud came to light, its creditors lost an estimated $200 billion in debt and equity. That is *three* times the size of the Enron losses. In addition, at least 22 States lost more than $2.6 billion in public retirement funds. In Vermont, WorldCom's fraudulent actions reduced the State pension fund by $9 million. WorldCom's fraud hit its own employees particularly hard. More than 22,000 employees lost their jobs and incomes for their families. WorldCom's actions solidified a downward spiral in the telecommunications sector, resulting in significant job losses and bankruptcies across the industry and reduction in competitive alternatives for consumers.

In addition to the private, civil remedies being sought against WorldCom, the federal government has responded on many levels. The Securities and Exchange Commission and the Department of Justice have launched investigations. WorldCom has agreed to

- more -

pay a $750 million penalty to the SEC and to comply with corporate governance and internal controls. WorldCom executives are under indictment, and some have pleaded guilty to criminal charges. The General Services Administration is reviewing WorldCom's fitness to hold government contracts, and the Internal Revenue Service is reviewing the propriety of its claims to certain tax deductions and for refunds.

By the same token, our purpose as WorldCom goes forward and emerges from bankruptcy proceedings should be the same here as it is in other bankruptcies: to divide assets fairly, and, if possible, create an entity that will be able to compete and create jobs in the future. Unless there is some reason to believe that the bankruptcy code is not sufficient to respond to the failure of WorldCom, then the bankruptcy should proceed in the ordinary course. Our bankruptcy laws are intended to attempt to achieve fairness through a structured division of a debtor's assets, and our bankruptcy laws can also allow companies to restructure and return to business. In this way, the bankruptcy code attempts to prevent the situation in which a company that is capable of holding its own is driven out of business. I would like to see competition in the telecommunications industry be both fair and spirited.

I understand that there are significant concerns about the competitive landscape as WorldCom emerges from bankruptcy. As a result of the bankruptcy proceeding, WorldCom may have less debt than some of its competitors. Lowered debt ratios are a serious concern and one that bankruptcy courts handle frequently. If, as we move forward, there is some reason to believe the bankruptcy system is breaking down, we are ready to step in and take appropriate action. Similarly, if the actions taken by the DOJ, the SEC, the IRS, and the GSA are inadequate to the challenges presented in this uniquely troubling situation, we should do whatever is necessary to help those agencies chart the right course.

# # # # #

Testimony of

Mark A. Neporent
Chief Operating Officer

Cerberus Capital Management, L.P.

on the Benefit of MCI's Reorganization to Creditors and the Economy

Committee on the Judiciary

United States Senate

July 22, 2003

My name is Mark Neporent and I am the Chief Operating Officer of Cerberus Capital Management, L.P. Cerberus, together with its affiliates, manages and has full investment discretion over funds and accounts with committed capital exceeding $9 billion. Cerberus is one of the largest participants in the U.S. distressed debt, distressed securities, and reorganization markets. Cerberus' investors include insurance companies, pension funds, endowments, institutions, wealthy individuals and many fund-of-funds. We have been managing capital in this sector for more than 15 years.

I have been engaged in the business of restructuring and reorganizing companies, both large and small, as a partner in Schulte Roth & Zabel LLP, a large New York City based law firm, and as a principal at Cerberus. Accordingly, I have first-hand experience with the utility of federal bankruptcy law and policy and the delicate balancing of the diverse interests affected by those laws and policies. I am also the co-chairman of the Official Creditors' Committee of WorldCom/MCI's ("MCI") Chapter 11 bankruptcy case. The Committee, as the statutorily mandated fiduciary representative of all unsecured creditors, represents the various classes of creditors across the MCI corporate structure, with aggregate claims exceeding $40 billion.

MCI's creditors, employees and customers will be best served and protected by adherence to the process envisioned by and incorporated in the Bankruptcy Code. Taking punitive action against MCI, at the behest of its competitors, would undercut the longstanding and successful implementation of the policies underlying the Bankruptcy Code and its role in our economy.

Even before federal bankruptcy law was substantively revised in 1978 with the passage of the United States Bankruptcy Code, two separate and distinct policies have long guided the bankruptcy process in the United States. [1] Those policies consist of a fresh start for financially distressed companies and equality of treatment of its creditors, large and small. Congress reiterated, and reinforced these policies 25 years ago when it enacted the Bankruptcy Code. [2] These policies, while designed to protect two different (albeit converging) interests, are equally important to the success of the federal bankruptcy regime. Bankruptcy long ago lost its stigma, and is widely recognized, not only in the United States, but in numerous other developed countries that have modeled their bankruptcy laws after ours (*i.e.*, Canada, Japan, Germany), as a legitimate and sometimes necessary corporate strategy in the context of a capitalist system. As noted in a recent news article, "scores of businesses, some of them icons of American industrialism, have gone through bankruptcy and emerged to become strong, vibrant concerns, employing millions and offering consumers a wide variety of desirable goods and services. Texaco, Remington Arms, Continental Airlines, Southland Corporation's 7-11 stores – all have declared bankruptcy and stayed in business." [3]

Federal bankruptcy law is designed to favor reorganization rather than liquidation and to provide debtors with a "fresh start" by affording a variety of protections to a company undergoing a reorganization, including the ability to emerge from bankruptcy with a reduced debt load if its creditors agree and certain tests are met. Just as important are the policies of absolute priority (*i.e.*, the statutory hierarchy which dictates the order of payment among creditors and shareholders) and providing creditors a fair and equal opportunity to get paid. Creditors are to be treated the same as every other similarly-situated creditor and are assured that they cannot be forced to take less in a reorganization than they would receive in a liquidation.

The reorganization provisions contained in the Bankruptcy Code take each of these policies into account by providing both debtors and creditors certain rights and protections under the law. Indeed, MCI's bankruptcy case is an excellent example of how these policies are being implemented effectively to take a tragic situation and salvage the maximum possible value for creditors, shareholders, customers, employees and vendors . It is well documented that WorldCom, Inc., MCI, and a number of their affiliates were forced to seek bankruptcy protection in July 2002, largely due to the fraudulent activities of a handful of the top executives of a company that, at the time, employed nearly 75,000 employees. Within a year of the filing of the largest bankruptcy case in U.S. history, all employees even remotely connected to the fraud, and the entire Board of Directors, were replaced. A dynamic new CEO, Michael Capellas, whose integrity is beyond question, has been hired to lead MCI out of the woods. The financial management team has been rebuilt around Robert Blakely, MCI's new CFO, and over 400 new financial personnel. MCI has worked with Richard Breeden, former chairman of the SEC, to shape MCI as a model of good corporate governance. Each of MCI's top 80 executives have signed a comprehensive ethics contract and MCI has adopted a "zero-tolerance" ethics policy firm wide. Within nine months after the filing, representatives of all major creditor constituencies agreed on a reorganization plan. This would be remarkable in any case, and is especially so in the largest bankruptcy case in history.

Since the announcement of its reorganization plan, a number of MCI's competitors have asserted that it should be punished for the crimes of its former executives by either being forced to liquidate or having its ability to service government contracts revoked. This is the functional equivalent of a corporate death penalty – capital punishment of the enterprise for the transgressions of a few rogue executives (who are now being pursued, rightfully so, by the government and the victims of these executives' fraud). In doing so, those opposing MCI's reorganization are completely ignoring the second fundamental policy of federal bankruptcy law, namely that of protecting the thousands of creditors, including numerous individuals, banks, pension funds, insurance companies, and endowments, not to mention over 55,000 innocent employees who had nothing to do with the fraud.

Overall, Chapter 11 of the Bankruptcy Code is intended to provide a debtor with the opportunity to rehabilitate its business in all respects, to preserve jobs, and to maximize the value for creditors. [4] Forcing MCI to liquidate or otherwise limit its activities or opportunities would not accomplish any of these objectives. Instead, liquidation would cause MCI's extinction, leave 55,000 employees without jobs, negatively impact millions of residential and business customers who rely on MCI for their critical telecommunications needs, dramatically reduce the return to creditors, and adversely affect the competitive balance in the telecommunications sector (which is exactly what MCI's opponents are trying to achieve under the guise of moral high ground). Similarly, limitations imposed on MCI's servicing of government contracts would seriously and unfairly constrict MCI's ongoing operations, not to mention the government's bargaining power with local monopolies and other entrenched competitors. In addition, it would put the success of MCI's plan of reorganization in jeopardy and leave tens of thousands of workers jobless and reduce the anticipated return to creditors, not to mention create certain disruption and massive cost to government operations currently serviced by MCI.

MCI provides services to nearly every federal government agency and to many states, operating some of the most complex and sophisticated network solutions ever deployed. MCI's performance as a government contractor continues to meet and exceed the most exacting standards – it was never affected by the fraud – and its network is unmatched in scope and capability. MCI's service levels are the best in the industry and are continuing to improve. [5]

It is beyond doubt that MCI's reorganization plan provides creditors with a much greater chance of recovery than does liquidation, which would literally throw away billions of dollars of value. MCI's going-concern value is estimated to be approximately $12-15 billion, while its liquidation value is only $4 billion. Not surprisingly, representatives of 90% of MCI's debt have quickly and efficiently resolved their internecine differences – exactly as contemplated by the Bankruptcy Code – and have given their support to MCI's proposed reorganization plan.

It is obvious that the only parties who would benefit from MCI's liquidation, elimination of its aggregate viability and value, or restriction of or elimination of its ability to participate in government contracts, are MCI's competitors and the powerful special interest groups that work for these competitors. Neither the provisions of the Bankruptcy Code, nor the policies promulgated thereby, are satisfied by such tactics. Essentially, these competitors and special interest groups are attempting to gain a strategic advantage by seeking MCI's liquidation. The competitors who propose the imposition of the corporate death penalty here have themselves enjoyed decades of unchecked monopolistic advantage as the mega-combinations of the past monopolies. These competitors built their franchises in an environment protected from competition. Now, rather than turn their resources to competition and face MCI head-to-head on the competitive landscape, they seek to eliminate the competition, or at least hamper it severely, with misplaced and misguided attacks on innocent creditors, employees and customers.

The liquidation of MCI or diminution in its services in no way punishes those few individuals responsible for forcing MCI into bankruptcy. These individuals have long since been removed. There has been, at the creditors' insistence and with MCI's cooperation, a full "housecleaning" both in management and of the Board of Directors. Likewise, the destruction of MCI will not benefit creditors, employees, customers, vendors or the public interest. MCI's demise at the hands of its competitors will, instead, directly punish those who are specifically entitled to be protected as a matter of public policy and law by forcing thousands of employees to lose their jobs and thousands of creditors to receive billions less than they would otherwise receive through reorganization – the exact opposite of a fundamental bankruptcy principle of value maximization.

Some have urged that creditors be brushed aside as mere "vultures" and that the old Worldcom/MCI shareholders who, for the most part, are institutions and not individuals, are the only real victims of the fraud and insolvency. To be sure, the rogue senior executives at WorldCom did mask the true financial picture and held or delayed the disclosure of the information that led to the destruction of the value of WorldCom's equity. However, the reality is that in March 2000 a variety of macroeconomic concerns began to take their toll on the overall telecom market and, ultimately, resulted in an historic three year bear market from which we are only now (maybe) beginning to emerge. These macroeconomic forces led to a decline of over 40% in the Telecom Growth Index, while WorldCom's stock declined approximately 25% over the corresponding period. [6] So, like the stock of virtually every company in the telecommunications sector, WorldCom's stock was already in the process of plummeting at the time the fraud was announced. Shareholders who did not cut their losses by selling during the bear market likely lost most, or all, of their investment.

MCI's fraud did not create the telecom bubble, nor did it pop that bubble. The SEC noted, in presentations to Judge Rakoff at the hearings on the SEC fine and settlement, that shareholders did not give their money to MCI, they gave it to other market participants. [7] MCI "gained" not a dollar from shareholders as a result of its fraud. The same is not true of MCI's creditors. Creditors (the banks and bondholders) lent their money directly to MCI because MCI defrauded them into doing so. MCI gained billions of dollars from creditors whose funds were used to build the business and acquire the assets that MCI's competitors now say should be liquidated. Common sense, not to mention the law, measures damages by the perpetrator's ill-gotten gains. These "gains" came from the creditors, not the shareholders. This fundamental premise is, likewise, recognized in the Bankruptcy Code's distribution hierarchy which requires that creditors be repaid in full before equity holders are entitled to receive anything. [8]

Destroying MCI will not benefit the misled shareholders. The shareholders are deep into the process of using the legal system to obtain redress from the perpetrators of the fraud – the handful of rogue executives – rather than the MCI corporate enterprise which is itself a victim of fraud. MCI's creditors are entitled to rely on judicial and legal checks and balances - like adherence to statute and the legislative policies embodied in the federal bankruptcy laws. MCI's adversaries should not be permitted to make an end run around these laws and policies to serve their own parochial interests.

Decades of successful federal bankruptcy policy has been premised upon rehabilitation and reorganization, rather than liquidation, regardless of the cause of insolvency. Under the Bankruptcy Code, fraud that leads to bankruptcy does not in any way prevent or limit the reorganization of a corporate entity. Indeed, the recently-enacted Sarbanes-Oxley Act of 2002 continued and reaffirmed this policy by permitting corporations to obtain relief under the Bankruptcy Code from claims arising from fraud, while revoking that privilege for individuals who commit certain crimes. [9] This underscores the distinction between individual corporate officers that commit a fraud and the corporate entity that they victimized. This enables the business that was victimized by the criminal activity of its management to be rehabilitated and reorganized.

Further, the SEC has clearly voiced its support of MCI and its future success. [10] Specifically, the SEC sought to put MCI on stable ground and to help it reorganize, thereby preserving thousands of jobs and avoiding disruption of customer service, all while creating a model corporate citizen. In approving the settlement between MCI and the SEC, Judge Rakoff recently found that these efforts had been successful. In fact, the court noted that it was not aware of any large company so thoroughly having "divorced itself from the misdeeds of the immediate past and undertaken such extraordinary steps to prevent such misdeeds in the future." [11]

Additionally, Judge Rakoff dismissed the call for liquidation voiced by MCI's competitors, noting that liquidation would "unfairly penalize" MCI's "innocent" employees, "remove a major competitor from a market that involves significant barriers to entry, and set at naught [MCI's] extraordinary efforts to become a model corporate citizen." [12] Further, the court clearly showed its support for the bankruptcy policy of protecting creditors when it stated that liquidation would "unfairly impact creditors" and that it "would undercut the basic tenets of bankruptcy reorganization . . . ," which the court noted have "contributed materially to the conservation of economic resources and the stability of the U.S. economy." [13]

Accordingly, successful reorganizations by corporate debtors further national economic stability and growth. Without the ability to reorganize, corporate debtors would be forced to lay off thousands of employees annually, all while minimizing the return to creditors and reducing competition in the marketplace.

MCI's successful reorganization is critical to the nation's economy in that it will further competition and innovation. Consumers must have a robust field of telecom competitors to keep prices in check and to drive the development of new products and services. Without MCI, the telecommunications market would not be very different than it was prior to the breakup of AT&T.

MCI is a remade company prepared to emerge from Chapter 11 as a robust contributor to the global economy. In fact, MCI provides critical communication services for tens of thousands of businesses and government agencies around the world. It carries approximately 30% of the world's Internet traffic, with some of the world's most important financial institutions relying on MCI, including NASDAQ, the London and Stockholm Stock Exchanges, and the Chicago Board of Trade. Additionally, MCI provides key network and infrastructure support for numerous federal government security and service agencies, including, to name a few, the Department of Defense, the United States Navy and Coast Guard, the Federal Aviation Administration, the United States Postal Service, and the Social Security Administration.

MCI's former senior management and directors have been removed and its 55,000 innocent employees are working harder than ever to ensure future success. Federal bankruptcy policy is being fully satisfied and followed in MCI's bankruptcy case as MCI is being afforded an opportunity to reorganize while the value returned to its creditors is being maximized. It is time to move forward. MCI's new management and Board, and my Creditors' Committee, have worked tirelessly for more than a year to provide the building blocks for the emergence of MCI from bankruptcy and a chance to recover some of the billions of dollars lost at the hands of a few dishonest and misguided executives. This Chapter 11 case is an exemplar of how Congress envisioned the Bankruptcy Code to work. I can tell you from two decades of personal experience – it does not often work this well. The Company, its creditors, and the system are to be commended. Accordingly, the self-serving attempts by MCI's competitors to force liquidation find no support in the law, public policy, or common sense and should be dismissed.

Thank you Chairman Hatch and members of the Committee for allowing me to share my views.

Endnotes

1. H.R. REP. NO. 95-595, at 285 (1977) (acknowledging "the two strong bankruptcy policies of a fresh start for the debtor and the equality of treatment of all creditors").

2. "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors and produce a return for its stockholders. The premise of business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it can often be returned to a viable state. It is more economically efficient to reorganize than to liquidate because it preserves jobs and assets." *Id.* at 220. (emphasis added).

3. Richard Lessner, *Punishing Innocent Workers*, Sacramento Bee, July 14, 2003, at www.sacbee.com.

4. Bankruptcy is not a panacea. Although the commencement of a reorganization case has lost its stigma, the negative impact of a filing can be great. The filing of a reorganization case creates uncertainty with employees, whose loyalty and work ethic are critical to any successful restructuring. It also creates uncertainty with vendors who may be reluctant to provide goods and services for fear of not being paid, or who may impose draconian payment terms to try and protect their interests which adversely effects working capital. Customers may not wish to deal with a bankrupt entity and take their business elsewhere. MCI has experienced more than its share of these consequences, but new management has done a good job restoring confidence in MCI's long-term viability.

5. Based on reportable outages to the FCC in 2002. *See* chart attached as Exhibit A.

6. *See* chart attached as Exhibit B. Some of the major macroeconomic forces precipitating the decline beginning in March 2000 included:
   a. a perceived slowing in the growth rate of the Internet and data transmissions;
   b. a reduction in funding to negative cash flow Internet and technology companies;
   c. a surplus of data transmission capacity driven by technology advancements and prior investments in capacity; and
   d. a concomitant slowdown in capital expenditures.

7. *SEC v. WorldCom, Inc.*, No. 02 Civ. 4963, Tr. of Hearing 27 (S.D.N.Y. June 11, 2003) (comments of SEC).

8. Despite the clear statutory distribution priority, the Creditors' Committee, out of a sense of moral fairness approved a radical and voluntary departure from the priority and has consented to $750 million of value being distributed to security holders under MCI's plan of reorganization.

9. Sarbanes-Oxley Act of 2002, PL 107-204, § 803, 116 Stat 745 (2002).

10. *SEC v. WorldCom, Inc.*, No. 02 Civ. 4963, 2003 WL 21523992 at **2-3 (S.D.N.Y. July 7, 2003) (approving MCI settlement with SEC).

11. *Id.* at 5.

12. *Id.* at 6-7.

13. *Id.* at 7.

Exhibit A

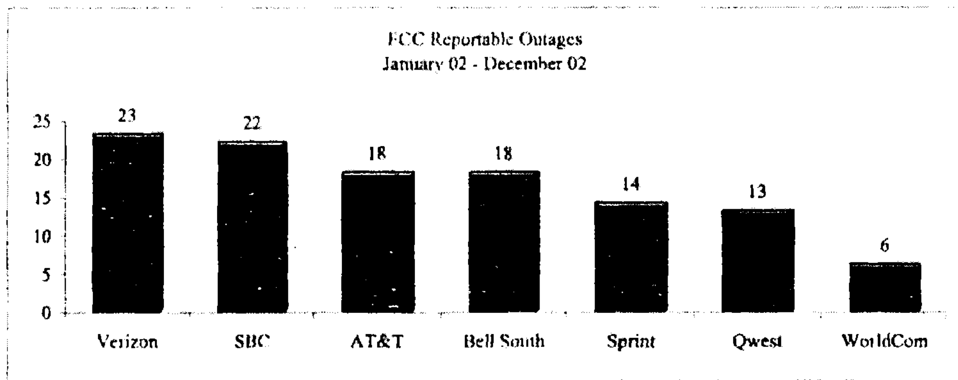
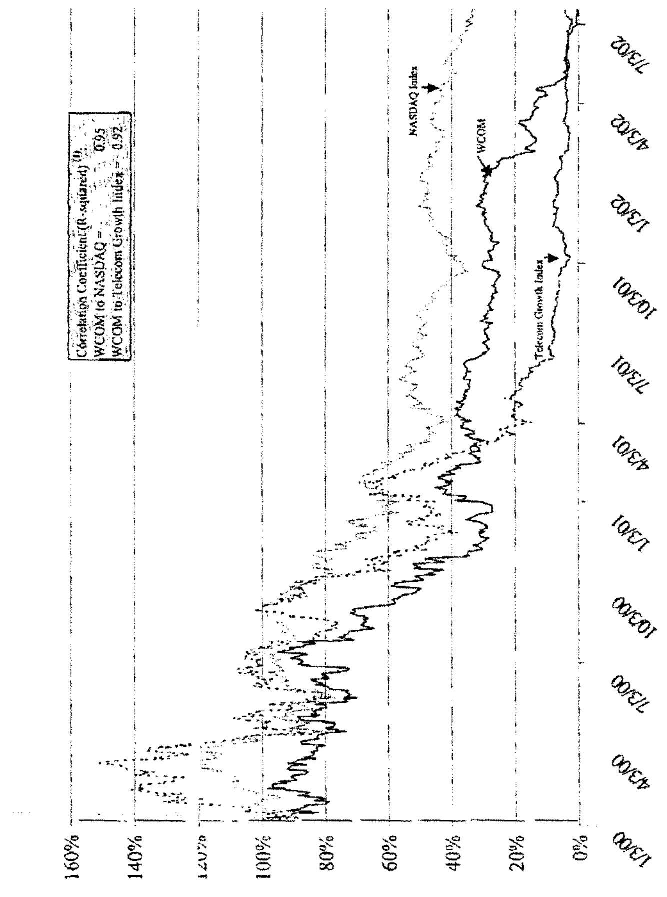

FCC Reportable Outages
January 02 - December 02
25
20
15
10
5
0
23
22
18
18
14
13
6
Verizon
SBC
AT&T
Bell South
Sprint
Qwest
WorldCom

Exhibit B



(1) Calculation period is from 1/3/00 to 6/25/02 (date the fraud was announced).
Telecom Growth Index includes: McLeod, XO, TWTC, ALGX, WCG, LVLT, ICG, 360Networks and Viatel

Statement of Dick Thornburgh, WorldCom Bankruptcy Examiner, Before the Senate Committee on the Judiciary Tuesday, July 22, 2003

Chairman Hatch and members of the Committee:

I appreciate this opportunity to appear before you today in connection with my responsibilities as the Examiner in the WorldCom bankruptcy proceedings – the largest bankruptcy in United States history. To date, my examination, which began in August 2002 and continues today, has resulted in two interim reports detailing my observations concerning the conduct of WorldCom management and others affecting the operations of the Company. I anticipate filing a third report this fall. Today, I intend to summarize for you the observations contained in my first and second interim reports, as well as describe the examination process.

On July 21, 2002, WorldCom and substantially all of its direct and indirect subsidiaries filed voluntary petitions seeking relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York. These petitions came just four weeks after the Company publicly disclosed on June 25, 2002 that it had discovered substantial accounting irregularities that would result in adjustments to its financial statements totaling more than $3.8 billion. The Company restated an additional $3.3 billion in August 2002. Still further adjustments were announced by the Company earlier this year and now appear to be on the order of $11 billion in total.

The day after WorldCom filed its bankruptcy petitions, Judge Arthur J. Gonzalez, the presiding Bankruptcy Court Judge, granted the motion of the United States Trustee for the appointment of an Examiner pursuant to Section 1104(c)(2) of the Bankruptcy

Code. On August 6, 2002, the Court approved my appointment as Examiner. The Court's Order provides that the Examiner "shall investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of [WorldCom] by current or former management, including but not limited to issues of accounting irregularities." The Court also directed me to coordinate with the United States Department of Justice, the United States Securities and Exchange Commission ("SEC") and other federal agencies investigating matters related to WorldCom to avoid duplication of effort. Further, the Court ordered me to file a report regarding my examination within 90 days of my appointment.

Upon my appointment, I promptly engaged professionals to assist me in discharging the broad mandate prescribed by the Court. I engaged my law firm, Kirkpatrick & Lockhart LLP, as my legal counsel. I also engaged J.H. Cohn LLP, as my forensic accountants and financial advisors. My professionals and I immediately set out toward our goal of assessing thoroughly, objectively, and responsibly the acts and omissions of current and former management, as well as the integrity of WorldCom's management, its accounting and financial reporting processes and its corporate governance practices and internal controls.

Our investigation has been, and continues to be, multi-faceted. We have reviewed millions of pages of documents received from numerous sources and conducted or participated in scores of interviews of persons with relevant information. Our document collection efforts and interviews continue today. I am pleased to acknowledge the cooperation of WorldCom and its counsel regarding these matters. I also acknowledge with appreciation the assistance provided by the Honorable Richard C. Breeden, the

Corporate Monitor appointed by the United States District Court for the Southern District of New York in a proceeding commenced by the SEC against WorldCom. Further, in an effort to avoid unnecessary duplication of effort and expense, I note that we have maintained an active dialogue regarding matters related to our examination with counsel and financial advisors for the Official Committee of Unsecured Creditors in the bankruptcy proceedings, as well as a Special Investigative Committee of the Company's Board of Directors and its professionals, and KPMG LLP, the Company's current outside auditors.

Consistent with the Court's initial directive, my professionals and I also have coordinated extensively with the Department of Justice, the SEC and other agencies that are investigating matters related to WorldCom. We have refrained from publishing certain findings or results of our investigation in deference to these ongoing prosecutorial and regulatory inquiries whom these agencies have represented to us that such disclosures may adversely affect the process of determining possible criminal or other wrongdoing by persons involved in these matters. Mr. Chairman, I respectfully request that you and other members of the Committee respect my inability to discuss these matters at today's hearing because of the related law enforcement and regulatory concerns. Similarly, I feel it would be inappropriate for me to discuss our ongoing fact-gathering efforts because any such comments may have a detrimental impact on our investigation. Accordingly, I intend to confine my remarks this afternoon to matters that have been addressed in my first and second interim reports of examination, which are a part of the public record.

As I stated earlier, the Court initially directed that I file a report of examination within 90 days of my appointment. Pursuant to that directive, I filed my First Interim

Report in a timely manner on November 4, 2002. The initial 90-day period obviously did not permit me the time necessary to explore all matters related to the conduct of WorldCom management. In addition, as I stated a moment ago, we omitted from the First Interim Report certain details – particularly items related to the specifics of the Company's accounting fraud – in deference to ongoing prosecutorial and regulatory interests. Therefore, the observations set forth in my First Interim Report were preliminary in nature. Nonetheless, as described in that Report, a picture had already begun to emerge regarding the deeply problematic culture and lack of corporate controls at WorldCom.

After I filed my First Interim Report, my professionals and I continued our investigative efforts to advance the preliminary observations contained in the First Interim Report. My Second Interim Report, filed June 9, 2003, summarized my observations based upon this additional investigation. As stated in that Report, the WorldCom story is not limited to the massive accounting fraud that has been publicly reported. We uncovered additional deceit, deficiencies, and a disregard for the most basic principles of corporate governance. My observations in that Report reflect a broad breakdown of the system of internal controls, corporate governance and individual responsibility, all of which worked together to create a culture in which all too few individuals took responsibility until it was too late.

Our investigation reflects that WorldCom was dominated by Bernard Ebbers and Scott Sullivan, its former Chief Executive Officer and Chief Financial Officer of the Company, respectively, with virtually no checks or restraints placed on their actions by the Board of Directors or other management. Significantly, although many present or former officers and directors of WorldCom told us that they had misgivings regarding decisions or actions by Mr. Ebbers or Mr. Sullivan during the relevant period, there is no evidence that these officers and directors made any attempts to curb, stop or challenge the conduct by Mr. Ebbers or Mr. Sullivan that they deemed questionable or inappropriate. Instead, as described in my Reports, it appears that the Company's officers and directors went along with Mr. Ebbers and Mr. Sullivan, even under circumstances that suggested corporate actions were at best imprudent, and at worst inappropriate and fraudulent.

There are many specific corporate governance failings identified in my First and Second Interim Reports. I will highlight only a few examples for you this afternoon. First, we observed no meaningful deliberative processes related to the Company's acquisitions. As stated in my Reports, WorldCom's dramatic rise in stock value throughout the fifteen years preceding its bankruptcy fueled numerous acquisitions that caused the Company to grow tremendously in both size and complexity in a relatively short amount of time. The Company's approach to such acquisitions was *ad hoc* and opportunistic. Acquisitions were completed with little meaningful or coherent strategic planning. WorldCom management routinely provided the Company's directors with extremely limited information regarding many of those acquisitions. In fact, several multi-billion dollar acquisitions were approved by the Board of Directors following discussions that lasted for 30 minutes or less and without the directors receiving a single piece of paper regarding the terms or implications of the transactions. Significantly, although persons involved with the Board's consideration of some of these matters informed us that they were disturbed at the time, no director or anyone else voiced any objection to cursory considerations by the Board.

Second, the Company's lack of internal controls infected its debt offerings and use of credit facilities. Indeed, there is no evidence that WorldCom management or the Board of Directors reasonably monitored the Company's debt level or its ability to satisfy its outstanding obligations. Messrs. Ebbers and Sullivan had virtually unfettered discretion to commit the Company to billions of dollars in debt obligations with virtually no meaningful oversight. WorldCom issued more than $25 billion in debt securities in the four years preceding its bankruptcy. With respect to such offerings, Messrs. Ebbers and Sullivan comprised the entirety of the Company's Pricing Committee. The Board passively "rubber-stamped" proposals from Messrs. Ebbers or Sullivan regarding additional borrowings, most often via unanimous consent resolutions that were adopted after little or no discussion.

It seems clear that WorldCom's ability to borrow monies was facilitated by its massive accounting fraud, which allowed the Company to falsely present itself as creditworthy and "investment grade." It also seems clear that the Company's ability to borrow vast sums allowed it to perpetuate the illusion of financial health created by its accounting fraud. As late as a few weeks before it disclosed its massive accounting irregularities, WorldCom used false financial statements to access all of a $2.65 billion line of credit, the proceeds of which it used to pay down another credit facility. As the Company's Treasurer told us in an interview, WorldCom merely "robbed Peter to pay Paul."

Third, our investigation raises significant concerns regarding the circumstances surrounding the Company's loans of more than $400 million to Mr. Ebbers. As detailed in my Reports, the Compensation and Stock Option Committee of the Board of Directors agreed to provide enormous loans and a separate guaranty for Mr. Ebbers without initially informing the full Board or taking appropriate steps to protect the Company. Further, as the loans and guaranty increased, the Committee failed to perform appropriate due diligence that would have demonstrated that the collateral offered by Mr. Ebbers was grossly inadequate to support the Company's extensions of credit to him, in light of his substantial other loans and obligations. Our investigation reflects that the Board was similarly at fault for not raising any questions about the loans and merely adopting the actions of the Compensation Committee.

I believe the loans to Mr. Ebbers are troubling for an additional reason. These extraordinary loans highlighted the extent of Mr. Ebbers' business activities that were not related to WorldCom. In my view, the Board should have questioned whether these non-WorldCom business activities were consistent with the need for Mr. Ebbers to devote his time and attention to managing the business of such a large and complex company as WorldCom. However, it appears that the Board did nothing to attempt to persuade Mr. Ebbers to divest himself of his other businesses or otherwise limit his non-WorldCom business activities. To the contrary, the Compensation Committee and the Board provided the massive funding that facilitated Mr. Ebbers' personal business activities.

Finally, the fact that WorldCom's accounting irregularities went undetected for so long provides further testament to the inadequacy of the Company's systems of internal controls. The Audit Committee of the Board of Directors and the Internal Audit Department appear to have acted in good faith. To their considerable credit, they took significant and responsible steps once accounting irregularities were discovered in the spring of 2002. Nonetheless, it seems abundantly clear that the Audit Committee over the years barely scratched the surface of any potential accounting or financial reporting issues. Moreover, the Internal Audit Department adopted an operational audit function; that is, it focused its efforts on efficiency and cost-savings concerns, rather than acting as WorldCom's "internal control police." Finally, it appears that the Audit Committee, the Internal Audit Department, and Arthur Andersen, the Company's former outside auditors, allowed their missions to be limited and shaped by Mr. Sullivan in ways that served to conceal and perpetuate the Company's accounting fraud.

All told, I believe that WorldCom's conferral of practically unlimited discretion upon Messrs. Ebbers and Sullivan, combined with passive acceptance of management's proposals by the Board of Directors, and a culture that diminished the importance of internal checks, forward-looking planning and meaningful debate or analysis formed the basis for the Company's descent into bankruptcy. In many significant respects, WorldCom appears to have represented the polar opposite of model corporate governance practices during the relevant period. Its culture was dominated by a strong Chief Executive Officer, who was given virtually unfettered discretion to commit vast amounts of shareholder resources and determine corporate direction with only minimal scrutiny or meaningful deliberation or analysis by senior management or the Board of Directors. The Board of Directors appears to have embraced suggestions by Mr. Ebbers without question or dissent, even under circumstances where its members now readily acknowledge they had significant misgivings regarding his recommended course of action.

Although the absence of internal controls and the lack of transparency between senior management and the Board of Directors at WorldCom does not directly translate to the massive accounting fraud committed by the Company, I believe that these corporate governance failings fostered an environment and culture that permitted the fraud to grow dramatically. A culture and internal processes that discourage or implicitly forbid scrutiny and detailed questioning can be a breeding ground for fraudulent misdeeds. They also can beget ill-considered and wasteful acquisitions, improperly managed and unchecked debt and poor credit management, a lack of due diligence regarding personal loans made by the Company to its Chief Executive Officer, and an effective neutering of other gatekeepers, such as the lawyers, the Internal Audit Department and the Company's outside auditors. In tandem with the accounting irregularities, these developments fostered the illusion that WorldCom was far more healthy and successful than it actually was during the relevant period. Ultimately, they also produced the largest bankruptcy in the history of the United States.

With that, Mr. Chairman, I will conclude my introductory remarks. I thank you for the opportunity to address the Committee this afternoon. With your permission, I will offer the summary sections of my First and Second Interim Reports, which outline more fully my observations based upon our investigation, to be entered into the record as a supplement to my statement.

Excerpted from the First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, Dated November 4, 2002

III. SUMMARY OF INITIAL OBSERVATIONS

Although we have conducted our examination over a relatively short period of time and are not drawing conclusions on many matters, a picture is clearly emerging of a company that had a number of troubling and serious issues. These issues relate to the culture, internal controls, management, integrity, disclosures and financial statements of the Company. The Company's June 25, 2002 disclosure of a $3.8 billion restatement regarding the line cost capitalization may be the largest issue in terms of dollars, but it was by no means the only significant problem related to the Company's financial reporting, public disclosures and related matters. Our initial observations, which are discussed more fully below, can be summarized as follows:

- WorldCom was a company that grew tremendously in both size and complexity in a relatively short period of time. Its management, systems, internal controls and other personnel did not keep pace with that growth.

- WorldCom grew in large part because the value of its stock rose dramatically. Its stock was the fuel that kept WorldCom's acquisition engine running at a very high speed. WorldCom needed to keep its stock price at high levels to continue its phenomenal growth.

- WorldCom did not achieve its growth by following a predefined strategic plan, but rather by opportunistic and rapid acquisitions of other companies. The unrelenting pace of these acquisitions caused the Company constantly to redefine itself and its focus. The Company's unceasing growth and metamorphosis made integration of its newly acquired operations, systems and personnel much more difficult. This dramatic growth and related changes also made it difficult for investors to compare the Company's operations to historical benchmarks.

- One person, Bernard Ebbers, appears to have dominated the course of the Company's growth, as well as the agenda, discussions and decisions of the Board of Directors.

Critical questioning was discouraged and the Board did not appear to evaluate proposed transactions in appropriate depth, even though several members of the Board had a significant percentage of their personal wealth tied to the value of the Company's stock.

- The Audit Committee of the Board of Directors did not appear to operate effectively or aggressively based on our preliminary review. We are in the process of further examining the work of the Audit Committee, as well as its relationships with the Company's Internal Audit Department and with the Company's independent auditors, Arthur Andersen LLP ("Arthur Andersen").

- The Compensation and Stock Option Committee of the Board of Directors seemed largely to abdicate its responsibilities to Mr. Ebbers. It approved compensation packages that appear overly generous and disproportionate to either the performance of the Company or competitive pressures. We are still in the process of reviewing the activities of this Committee.

- Arthur Andersen determined that WorldCom was a maximum risk client. Although we are still reviewing the audit work of Arthur Andersen, it does not appear that the audit procedures employed by Arthur Andersen were appropriate for the risk profile it ascribed to WorldCom.

- WorldCom's Internal Audit Department focused almost exclusively on operational issues – i.e., identifying potential inefficiencies and not financial or accounting matters. Given this focus on operational issues, it was a credit to the personnel of the Internal Audit Department that they investigated the line cost capitalization issue in 2002. WorldCom's failure to have its Internal Audit Department develop and implement a comprehensive risk-based and financial controls oriented internal audit plan contributed to the weakness of WorldCom's internal controls.

- The relationship between WorldCom and Salomon Smith Barney ("SSB"), its primary investment banker, seems to have been unusually close and potentially problematic. We are still investigating this relationship and we will report further on it in future reports. Some of the matters that we are investigating include the relationship of a SSB research analyst, Jack Grubman, with the Company, including his attendance at various meetings of the Company's Board of Directors and evidence that Mr. Grubman alerted the Company ahead of time to the questions he would ask in conference calls between securities analysts and WorldCom management, as well as the wildly enthusiastic analyst reports issued by SSB and others with respect to WorldCom at a time when the stock was plummeting.

- WorldCom put extraordinary pressure on itself to meet the expectations of securities analysts. This pressure created an environment in which reporting numbers that met these expectations, no matter how these numbers were derived, apparently became more important than accurate financial reporting.

- A second restatement in the amount of an additional $3.8 billion, which was announced by WorldCom in August 2002, includes the restatement of reserves of approximately

$2.3 billion. We have identified a number of other entries related to reserves that require review to determine if any were used to boost improperly WorldCom's earnings.

- To accomplish and conceal their financial manipulations, it appears that WorldCom personnel created several false internal financial reports. Although we have significant information on these reports, we are not including details in this First Interim Report in deference to the ongoing governmental investigations.

- It appears that if WorldCom's revenue figures did not meet or exceed the budgeted amounts, the Company would increase improperly revenues. Between the first quarter of 1999 and the first quarter of 2002, adjustments were made to approximately 400 items totaling over $4.6 billion. At least $423 million of this amount already has been restated by WorldCom. We have reached no conclusion on the other adjustments and will be reviewing them in a future report.

- WorldCom manipulated its reported financial performance by drawing down excess or other reserves into earnings. At around the time that the reserves were being drawn down, WorldCom agreed to combine with Sprint Communications, Inc. ("Sprint") in October 1999. This combination would have allowed the Company not only to replenish its reserves, but also to increase them dramatically. When the government ultimately refused to approve the Sprint merger in July 2000, and signaled that it would not be sanctioning other large mergers, WorldCom did not have adequate excess reserves to draw down as a vehicle to increase earnings going forward. Shortly after this time, the Company took the brazen and radical step of converting substantial portions of its line cost expenses into capital items. These conversions ultimately added approximately $3.8 billion improperly to income. The disclosure of these improprieties was the subject of the June 25, 2002 restatement announcement.

- Finally, it seems clear that there were numerous failures, inadequacies and breakdowns in the multi-layered system designed to protect the integrity of the financial reporting system at WorldCom, including the Board of Directors, the Audit Committee, the Company's system of internal controls and the independent auditors. The Company did not have in place sufficient checks to prevent the improper accounting machinations of the Company's management.

Excerpted from the Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, Dated June 9, 2003

III. SUMMARY OF OBSERVATIONS

The WorldCom story is not limited to the massive accounting fraud that has been publicly reported. Aside from these issues, the Examiner's continued investigation into other matters has uncovered additional deceit, deficiencies and a disregard for the most basic principles of corporate governance.

The Examiner has identified significant problems with respect to virtually every area reviewed, including acquisitions, strategic planning, debt management, credit facilities, loans to Mr. Ebbers, Mr. Ebbers' $70 million forward sale, employee compensation, and internal controls. The observations of the Examiner regarding these matters, which are detailed in later sections of this Report, may be summarized as follows:

- WorldCom was dominated by Messrs. Ebbers and Sullivan, with virtually no checks or restraints placed on their actions by the Board of Directors or other Management. Significantly, although many present or former officers and Directors of WorldCom told us they had misgivings regarding decisions or actions by Mr. Ebbers or Mr. Sullivan during the relevant period, there is no evidence that these officers and Directors made any attempts to curb, stop or challenge the conduct by Mr. Ebbers or Mr. Sullivan that they deemed questionable or inappropriate. Instead, it appears that the Company's officers and Directors went along with Mr. Ebbers and Mr. Sullivan, even under circumstances that suggested corporate actions were at best imprudent, and at worst inappropriate and fraudulent.

- The Company's approach to acquisitions and significant outsourcing transactions was *ad hoc* and opportunistic. Our examination has revealed little meaningful or coherent strategic planning at WorldCom. Further, in many instances, the Company's decision-making was marked by a striking absence of proper corporate governance protocols.

- WorldCom Management provided the Company's Directors with extremely limited information regarding many acquisition transactions. Several multi-billion dollar acquisitions were approved by the Board of Directors following discussions that lasted for 30 minutes or less and without the Directors receiving a single piece of paper regarding the terms or implications of the transactions.

- The process surrounding the Company's decision to acquire Intermedia Communications, Inc. ("Intermedia") in September 2000 is particularly troubling.

In what one former Director described an "ego deal" for Mr. Ebbers, WorldCom responded to a perceived threat that a competitor could acquire Intermedia (or Digex, Inc. ("Digex"), a Web hosting company controlled by Intermedia) by agreeing to pay $6 billion for the company, based upon approximately 60-90 minutes of due diligence and a 35-minute telephonic Board meeting for which some Directors received no more than two hours notice. The facts raise substantial doubt concerning Management's basis for recommending the transaction and the adequacy of the information provided to the Board. As a former Director stated, "God himself could not have made the decision in one day." The Directors were not provided with any written materials or analyses concerning this potential transaction. Although numerous people involved with the Board's consideration of the Intermedia transaction now state that they were disturbed by the deal at the time, no Director or anyone else voiced any objection to the cursory consideration by the Board.

- The concerns related to the Intermedia acquisition become even more acute when viewed in the light of subsequent developments. Shortly after the acquisition agreement was announced on September 5, 2000, minority shareholders of Digex filed a lawsuit challenging the transaction. This litigation, and the declining value of other Intermedia assets, gave WorldCom an opportunity to abandon the proposed acquisition. Rather than do so, WorldCom Management, at the apparent direction of Mr. Ebbers, and without consulting the Board of Directors, entered into an agreement to settle the Digex shareholder litigation and signed an amended merger agreement with Intermedia in February 2001. Although a February 15, 2001 WorldCom press release stated that the Board had approved the settlement, the Company's outside Directors were not even polled at the time with respect to whether they wanted to continue with the transaction. In March 2001, the Board passively adopted and endorsed the prior acts of Management, without objection. All told, the acquisition of Intermedia was a dismal failure, producing massive losses for WorldCom. The Examiner believes that a vigilant Board of Directors would have rejected Management's actions.

- Another troubling transaction is WorldCom's $2 billion acquisition of SkyTel Communications, Inc. ("SkyTel") in 1999. That transaction, which was of questionable strategic benefit to WorldCom, was approved by the Board after a presentation by Management lasting about 15 minutes and, again, without a single piece of paper being provided to the Board. The Board members interviewed by the Examiner did not appear troubled by this lack of consideration because the acquisition was for "only" $2 billion. The Examiner believes that a transaction of that magnitude deserved far greater consideration and deliberation.

- The Examiner also has substantial questions concerning the process by which WorldCom adopted its Tracker stock structure in November 2000. Our investigation identified little evidence of a thoughtful strategic plan for the Tracker stocks. Instead, it appears that, as stated by one former WorldCom Director, the Tracker stocks were merely the "flavor of the month."

- The Examiner also has concerns regarding the allocation of assets, debt and expenses between the WorldCom Group and the MCI Group under the Tracker stock structure. The Examiner is investigating whether these allocations were intended to burden disproportionately the MCI Group businesses and what the effect of such allocations may be on inter-company claims and creditors.

- The Examiner is also concerned about the Company's tendency to utilize its debt offerings and credit facilities to further a practice pursuant to which it paid off existing investors or lenders with newly-borrowed funds, while growing its debt to a level that became ultimately unserviceable. WorldCom's ability to borrow monies was facilitated by its massive accounting fraud, as it allowed the Company to falsely present itself as creditworthy and "investment grade," when in fact its debt was below "investment grade."

- There is no evidence of meaningful debt planning by WorldCom. Indeed, there is no evidence that Company Management or the Board reasonably monitored the Company's debt level or its ability to satisfy its outstanding obligations. A prime example of inadequate planning was the Company's use of the proceeds from a massive $11.9 billion debt offering in May 2001, which WorldCom projected would satisfy its cash needs for the ensuing 18 months. In fact, WorldCom spent the proceeds in about eight months.

- Messrs. Ebbers and Sullivan had virtually unfettered discretion to commit the Company to billions of dollars in debt obligations with virtually no meaningful Board oversight. WorldCom issued more than $25 billion in debt securities in the four years preceding its bankruptcy. With respect to such offerings, Messrs. Ebbers and Sullivan comprised the entirety of the Company's Pricing Committee. The Board passively "rubber-stamped" proposals from Messrs. Ebbers or Sullivan regarding additional borrowings, most often via unanimous consent resolutions that were adopted after little or no discussion.

- The Company's drawdown on a $2.65 billion line of credit in May 2002 raises significant issues. Despite public statements by Mr. Sullivan early in May 2002 that "certainly there is liquidity in the Company . . . we're in a very solid situation," the evidence establishes that WorldCom had a desperate need for cash at the time. The Company had to meet several large payment obligations and its debt had been downgraded. Moreover, Mr. Sullivan said that "the "money [from the credit facility] won't be used for anything. The money will be sitting on the balance sheet in cash; it will be invested for a few weeks" and repaid when WorldCom completed a $5 billion secured financing in June 2002. However, it appears that at the time Mr. Sullivan made those statements, WorldCom already had decided to use a portion of the proceeds from the line of credit to make payments with respect to the Company's accounts receivable credit program. As the Company's Treasurer told us in an interview, WorldCom merely "robbed Peter to pay Paul."

- The facts and circumstances surrounding the Company's loans of more than $400 million to Mr. Ebbers raise additional and very serious corporate governance concerns. The Compensation and Stock Option Committee of the Board of Directors (the "Compensation Committee") agreed to provide enormous loans and a guaranty for Mr. Ebbers without initially informing the full Board or taking appropriate steps to protect the Company. As the loans and guaranty increased, the Compensation Committee failed to perform appropriate due diligence that would have demonstrated that the collateral was insufficient to support the credit extended to Mr. Ebbers, in light of his substantial other loans and obligations. The Board was similarly at fault for not raising any questions about the loans and merely rubber stamping the actions of the Compensation Committee.

- A forward sale of three million WorldCom shares by Mr. Ebbers in September 2000, in which he received proceeds of over $70 million, also raises questions. Mr. Ebbers had a strong and widely known opposition to any WorldCom employee selling stock of the Company. In early September 2000, Mr. Ebbers received the first of his loans from WorldCom, for $50 million, because the Compensation Committee did not want him to make good on his threat to sell any of his WorldCom stock to meet margin obligations. At this same time, the Compensation Committee also awarded Mr. Ebbers a $10 million cash retention bonus. These amounts were apparently not enough, as Mr. Ebbers asked the Compensation Committee for an additional loan in late September 2000. When the Compensation Committee refused his request, Mr. Ebbers entered into a forward sale of three million shares of WorldCom stock and received a payment of over $70 million. Coincidentally or not, the price of WorldCom stock dropped $2.25 a share on October 4, 2000, the day after the public announcement of the forward sale. Instead of taking reasonable measures to protect WorldCom and its shareholders from Mr. Ebbers' deteriorating personal finances, the Compensation Committee later that month magnified the problem by providing a $75 million guaranty and an additional $25 million loan to Mr. Ebbers. Ultimately, the loans to Mr. Ebbers reached over $400 million.

- The timing and circumstances of the forward sale are also problematic in other respects. Specifically, WorldCom received legal advice from outside counsel for WorldCom that the proposed sale might be inappropriate, particularly since it was to occur shortly before a negative earnings announcement. Despite this, the Company permitted the sale by Mr. Ebbers without adequately investigating the likelihood that the sale violated insider trading laws and despite the fact that the sale violated a Company policy that prohibited such transactions near the time of an earnings announcement.

- The Ebbers loans, guaranty and forward sale of stock are troubling for an additional reason. These fundings revealed the extent of Mr. Ebbers' business activities that were not related to WorldCom. The Board should have questioned these extensive non-WorldCom business activities as inconsistent with the need for Mr. Ebbers to devote his time and attention to managing the business of a large and complex company such as WorldCom. The need for Mr. Ebbers to devote his full attention to WorldCom matters became even more urgent when the downturn in the telecommunications industry began in 2000. The Board, however, did nothing to attempt to persuade Mr. Ebbers to divest himself of these non-WorldCom businesses or otherwise limit his non-WorldCom business activities. To the contrary, the Compensation Committee and the Board provided massive funding that facilitated Mr. Ebbers' personal business activities.

- The Examiner is continuing to review the process by which salaries, bonuses, stock options and other compensation were determined at WorldCom. Our investigation has revealed that there was a significant disparity between the way compensation matters were supposed to be handled in theory, and how they were actually handled. Despite public pronouncements to the contrary, Mr. Ebbers dominated compensation decisions. He was, for example, given almost complete discretion to authorize and allocate a $240 million retention bonus program in 2000 that involved large, up-front cash payments to over 500 executives. Mr. Ebbers awarded Mr. Sullivan and himself $10 million cash bonuses under this program, notwithstanding the fact that they had received retention bonuses of $7.5 million and $1.85 million, respectively, one year earlier, and notwithstanding that other company executives received a combination of cash and stock as retention bonuses.

- Mr. Sullivan paid part of his $10 million cash bonus to some of his subordinates, many of whom had received large retention bonuses directly from the Company. Mr. Sullivan gave $10,000 personal checks to at least seven employees, and additional $10,000 personal checks to the spouses of several of these employees. Although the Examiner has not identified any information linking these payments to illegal conduct, four of the individuals who received these payments have pled guilty to criminal fraud charges relating to the Company's accounting practices.

- The fact that WorldCom's accounting irregularities went undetected for so long attests to substantial problems with the Company's internal controls. The Audit Committee of the Board of Directors and the Internal Audit Department appear to have acted in good faith and, to their considerable credit, they took significant and responsible steps once accounting irregularities were discovered in the spring of 2002. However, it seems clear that the Audit Committee over the years barely scratched the surface of any potential accounting or financial reporting issues. Moreover, the Internal Audit Department adopted an operational audit function, rather than acting as WorldCom's "internal control police." Finally, it appears that the Audit Committee, the Internal Audit Department and Arthur Andersen allowed their missions to be limited and shaped in ways that served to conceal and perpetuate the Company's accounting fraud.

- The Examiner is troubled by several of his preliminary observations regarding the "risk based" audits Arthur Andersen performed during the relevant period. Although Arthur Andersen considered WorldCom to be a "maximum risk" client, it appears that it designed the WorldCom audits to accommodate primarily the needs and desires of the Company's senior Management to the detriment of its own performance. The conduct of Arthur Andersen raises significant questions regarding its audit plan and communication with Management and the Audit Committee.

- WorldCom prepared MonRev reports, which identified the revenue of the Company on a monthly and quarterly basis. The Examiner is aware that "Special MonRev" reports were prepared for, and provided to, Arthur Andersen in the third and fourth quarters of 2001. These "Special" MonRev reports contained manipulated data that masked the amounts of certain "corporate adjustments, affecting revenues" and were different than the actual MonRev reports relied on by the Company.

- Accordingly, the Examiner has identified numerous occasions – on acquisitions, debt offerings, loans to Mr. Ebbers and other matters – on which the WorldCom Board was not adequately informed about significant corporate matters before giving its approval. The Examiner is troubled that no WorldCom attorneys (including in-house and outside counsel) appear to have believed that it was their responsibility to advise the Board of their fiduciary obligations to become adequately informed, even in instances where it seems likely that the Board lacked sufficient information. The Examiner recognizes that the WorldCom culture was not generally supportive of a strong legal function, but this should not have prevented counsel from fulfilling their obligations to their corporate client.

- All told, the Examiner believes that WorldCom's conferral of practically unlimited discretion upon Messrs. Ebbers and Sullivan, combined with passive acceptance of Management's proposals by the Board of Directors, and a culture that diminished the importance of internal checks, forward-looking planning and meaningful debate or analysis formed the basis for the Company's descent into bankruptcy.

As set forth above and in the remainder of this Second Interim Report, there are many persons and entities that share responsibility for WorldCom's downfall and the losses suffered by the Company's shareholders and creditors. While the degree of responsibility varies greatly, WorldCom could not have failed as a result of the actions of a limited number of individuals. Rather, there was a broad breakdown of the system of internal controls, corporate governance and individual responsibility, all of which worked together to create a culture in which few persons took responsibility until it was too late.

The Examiner understands that stepping forward to raise questions, whether it be on questionable accounting, lack of data provided to the Board of Directors, or other issues, would have involved acts of courage – possibly risking jobs in some instances. The Examiner further understands that WorldCom's most senior Management, especially Mr. Ebbers and Mr. Sullivan, enjoyed enormous power and substantial respect at various times, making the decision to take a stand that much more difficult. Nevertheless, the Examiner is disappointed that those with the responsibility to protect shareholders did not act sooner.

This Second Interim Report identifies a plethora of troubling and problematic matters. However, it should not be read as telling the entire or final story. Unfortunately, the Examiner believes that the extent of the breakdowns at WorldCom will eventually be determined to extend even beyond the Examiner's findings and observations that follow.