(Excerpts from)

REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE

OF THE

BOARD OF DIRECTORS OF WORLDCOM, INC.

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2. **<u>Adequacy of Board's Oversight of Company</u>**

The Board and its Committees did not function in a way that made it likely that they would notice red flags. The outside Directors had little or no involvement in the Company's business other than through attendance at Board meetings. Nearly all of the Directors were legacies of companies that WorldCom, under Ebbers' leadership, had acquired. They had ceded leadership to Ebbers when their companies were acquired, and in some cases viewed their role as diminished. Ebbers controlled the Board's agenda, its discussions, and its decisions. He created, and the Board permitted, a corporate environment in which the pressure to meet the numbers was high, the departments that served as controls were weak, and the word of senior management was final and not to be challenged.

The Audit Committee in particular needed an understanding of the Company it oversaw in order to be effective. However, the Audit Committee members do not appear to have had a sufficient understanding of the Company's internal financial workings or its culture, and they devoted strikingly little time to their role, meeting as little as three to five hours per year. WorldCom was a complicated Company in a fast-evolving industry. It had expanded quickly, through a series of large acquisitions, and there had been virtually no integration of the acquisitions. WorldCom had accounting-related operations scattered in a variety of locations around the country. These facts raised significant accounting, internal control and systems concerns that required Audit Committee knowledge and attention, and that should also have elicited direct warnings from Andersen. However, the Audit Committee members apparently did

Not even understand— though the evidence indicates that Andersen disclosed— the nontraditional audit approach Andersen employed. To gain the knowledge necessary to function effectively as an Audit Committee would have required a very substantial amount of energy, expertise by at least some of its members, and a greater commitment of time.

Neither WorldCom's legal department nor Internal Audit was structured to maximize its effectiveness as a control structure upon which the Board could depend. At Ebbers' direction, the Company' s lawyers were in fragmented groups, several of which had General Counsels who did not report to WorldCom' s General Counsel for portions of the relevant period; they were not located geographically near senior management or involved in its inner workings; and they had inadequate support from senior management. Internal Audit— though eventually successful in revealing the fraud— had been structured in ways that made this accomplishment more difficult: it reported in most respects to Sullivan, and until 2002 its duties generally did not include financial reporting matters.

The outside Directors had virtually no interaction with Company operational or financial employees other than during the presentations they heard at meetings. While in this respect the Directors were far from unique among directors of large corporations, this lack of contact meant that they had little sense of the culture within the Company, or awareness of issues other than those brought to them by a few senior managers. They were not themselves visible to employees, and there were no systems in place that could have encouraged employees to contact them with concerns about either the accounting entries or operational matters. In short, the Board was removed and detached from the operations of WorldCom to the extent that its members had little sense of what was really going on within the Company.

Ebbers was autocratic in his dealings with the Board, and the Board permitted it. With limited exceptions, the members of the Board were reluctant to challenge Ebbers even when they disagreed with him. They, like most observers, were impressed with the Company's growth and Ebbers' reputation, although they were in some cases mystified or perplexed by his style. This was Ebbers' company. Several members of the Board were sophisticated, yet the members of the Board were deferential to Ebbers and passive in their oversight until April 2002.

The deference of the Compensation Committee and the Board to Ebbers is illustrated by their decisions beginning in September 2000 to authorize corporate loans and guaranties that grew to over $400 million, so that Ebbers could avoid selling WorldCom stock to meet his personal financial obligations. This was not the first occasion on which Ebbers had overextended himself financially and borrowed from the Company: he had done so in 1994 as well. On neither occasion did anyone on the Board challenge Ebbers with respect to his use of WorldCom stock to extend his personal financial empire to the point that it threatened to cause involuntary liquidation of his stock. The approach of the Board, as one member characterized his own view, was to say nothing to Ebbers because they thought Ebbers was a grownup and could manage his own affairs— even though Ebbers' management of his own affairs involved the use of Company funds, eventually to the tune of hundreds of millions of dollars.

We believe that the extension of these loans and guaranties was a 19-month sequence of terrible decisions— badly conceived, and antithetical to shareholder interests— and a major failure of corporate governance. Indeed, we do not understand how the Compensation Committee or the Board could have concluded that these loans were an acceptable use of more than $400 million of the shareholders' money. These decisions reflected an uncritical solicitude for Ebbers' financial interests, a disregard of the incentives the situation created for Ebbers' management of the Company, and a willingness to subordinate shareholders' interests to Ebbers' financial wellbeing.

A second example of the Board's deference is its failure to challenge Ebbers on the extent of his substantial outside business interests (and the resulting claim on his time and energies). Those interests included a Louisiana rice farm, a luxury yacht building company, a lumber mill, a country club, a trucking company, a minor league hockey team, an operating marina, and a building in downtown Chicago. We do not believe most properly-run Boards of Directors would permit a Chief Executive Officer to pursue an array of interests such as these, certainly not without careful examination of the time and energy commitments they would require. Yet we have seen no evidence of any such challenge.

VIII. CORPORATE GOVERNANCE ISSUES

WorldCom's collapse reflected not only a financial fraud but also a significant failure of corporate governance. We have seen no evidence that the Board of Directors was aware of the fraud while it was occurring. However, the Board played far too small a role in the life, direction and culture of the Company. The Audit Committee did not engage to the extent necessary to understand and address the financial issues presented by this large and extremely complex business: its members were not in a position to exercise critical judgment on accounting and reporting issues, or on the non-traditional audit strategy of their outside auditor. The Compensation Committee dispensed extraordinarily generous rewards without adequate attention to the incentives they created, and presided over enormous loans to Ebbers that we believe were antithetical to shareholder interests and unjustifiable on any basis.

We have examined the Board's role generally, as well as several specific incidents involving the Board or its members. These include the question of whether the Board knew or should have known of the accounting improprieties discussed above; its decisions to extend loans and guaranties in excess of $400 million to Ebbers; certain sales of stock by Ebbers and two other Directors; and certain arrangements relating to airplane use. We also set out our views on a number of governance issues raised by these events. First, however, we provide some background on the membership and functioning of the Board and its committees.

A. WorldCom's Board of Directors and Its Committees

1. The Membership and Functioning of the Board

From 2000 to June 2002, the Board of Directors of WorldCom consisted almost entirely of individuals who had been owners, officers, or directors of companies that WorldCom had acquired over the preceding decade. As a result, some had enjoyed very great financial benefits from Ebbers' deals.

The Directors during this period were the following: Clifford Alexander, Jr., James Allen, Judith Areen, Carl Aycock, Max Bobbitt, Bernard Ebbers, Francesco Galesi, Stiles Kellett, Jr., Gordon Macklin, John Porter, Bert Roberts, Jr., John Sidgmore, Scott Sullivan, Lawrence Tucker, and Juan Villalonga. All of these Directors granted interviews to the Special Committee, with the exception of Ebbers and Sullivan. Membership remained relatively constant during the period addressed in this Report, with most Directors serving for the entire period. None of these individuals remains on the Board of Directors today.

The longest-standing members were Aycock and Ebbers, who had both invested in LDDS and joined the LDDS Board in 1983. Beginning a few years after graduating from college and until 1992, Aycock was employed by LDDS and then another company, Master Corporation, controlled by Ebbers. Porter came to LDDS when it acquired a company he owned in 1988. Kellett joined the LDDS Board in 1989 when a company he served as the Chairman of the Board was acquired by LDDS. Bobbitt, Galesi and Sullivan all came to LDDS by virtue of its merger with Advanced Telecommunications Company ("ATC") in 1992. Galesi owned 25% of ATC, and Bobbitt was President and Chief Operating Officer of a subsidiary of ATC. Both of them joined the LDDS Board after the ATC merger. Sullivan had been part of ATC's financial leadership and became LDDS's Chief Financial Officer in 1994. He joined the Board two years later. Sidgmore and Allen were both senior executive officers at companies WorldCom acquired—MFS (1996) and Brooks Fiber (1998), respectively. Roberts, Alexander, Areen and Macklin were members of the MCI Board of Directors (Roberts was also the Chief Executive Officer) and joined the WorldCom Board after the MCI merger in 1998. Villalonga joined thE

Board when the company of which he was Chief Executive Officer, Telefonica, entered into a strategic alliance with WorldCom in 1998; he left the Board in mid-2000, after that alliance had terminated. Tucker, an officer of a major investor in LDDS, served on the Board officially during 1992 and from 1995 until late 2000; after that, he served in an unofficial advisory capacity on the Board because of possible competition-law issues raised by his other directorships.

The position of Chairman of the Board was largely an honorary title at WorldCom. WorldCom's bylaws provided that either the Chairman or the Chief Executive Officer could preside at Board meetings, "if requested to do so." These ambiguous provisions in the bylaws did not clarify who would make the request, and, in practice, the Chief Executive Officer—Ebbers—presided at Board meetings and determined their agenda. Roberts held the position of Chairman from 1998 until his resignation in 2002.

Directors received compensation consisting of both cash and stock options, with overall compensation heavily weighted toward the latter. Directors received an annual retainer of $35,000 plus $1,000 for each Board meeting they attended. Committee members received $750 for each meeting attended on the same day as a Board meeting and $1,000 for each meeting attended on a day when a Board meeting did not also occur. Committee chairpersons received an additional $3,000 per year. Directors could elect to receive in stock all or a portion of their annual retainer for services as a Director and chairperson of a committee.

Directors also received options to buy shares of Company stock. In 1999, non-employee Directors were granted options to purchase 15,000 shares. In 2000 and 2001, non-employee

Directors were granted options to purchase 10,000 shares. Officer Directors were granted options during those years to purchase amounts ranging from 240,000 to 1.2 million shares.

Because many of WorldCom's Directors had held substantial stakes in companies acquired by WorldCom, they owned a significant amount of WorldCom stock. At some point between 1999 and 2002, eight of the fifteen Directors each owned over a million shares of WorldCom stock. None owned more than one percent of WorldCom's outstanding stock.

The Board held regular meetings between four and six times per year and held special meetings as needed. Approximately one week before each regular meeting, the Directors received packets of materials including an agenda, financial information from the previous quarter, draft minutes of the previous meeting, information from the Investor Relations department such as analyst call summaries, and resolutions to consider for the upcoming meeting. There was little interaction between the outside Directors and WorldCom management and employees outside of Board meetings, which more than one Director stated was not the case with other Boards (including MCI's) on which they served.

Ebbers dominated the Board meetings, which followed a consistent format. Each meeting opened with a prayer. A series of presentations—generally done fairly quickly— followed. Typically, the Chairmen of the Audit Committee and Compensation and Stock Option Committee, Bobbitt and Kellett, respectively, each reported to the Board. Michael Salsbury, General Counsel, reported on legal and regulatory issues.

The Board heard presentations by Sullivan and, on occasion, Ron Beaumont (Chief Operating Officer, WorldCom Group). Financial discussions at Board meetings were "high level" and, while not extremely detailed, presented a degree of detail consistent with what we believe most boards received during that period. Sullivan's presentations typically lasted about 30 minutes. We were told the Board's members—like most of the outside world—considered Sullivan an outstanding Chief Financial Officer and believed his presentations were forthright, professional, polished, and showed intimate knowledge of the Company's business and its financial information. We were told that he gave clear and detailed responses to questions. Board members did not extensively question him—something they credited to his thoroughness and credibility. Sullivan never referred to notes, yet he was always able to answer questions in detail.

Beaumont made presentations to the Board about the Company's operations. In general, they lasted about fifteen minutes and Directors did not question him extensively about the information he presented to them. His presentations also sometimes addressed capital expenditures. These discussions focused on the operational aspects of the Company's capital expenditures, and not on the accounting treatment of those expenditures. In addition, Wayne Huyard (Chief Operating Officer, MCI Consumer Services) sometimes reported on MCI-related issues.

The Board met in Executive Session as a part of regular meetings. These sessions usually excluded all non-Director employees and generally involved reports on topics such as upcoming deals, industry trends, development of individuals at the Company and regulatory issues. The sessions, which Ebbers conducted, were informal and generally no one took official notes at them. The outside Directors never held a separate meeting before April 2002, when they met to discuss the events leading up to Ebbers' resignation.

Bruce Borghardt, General Counsel-Corporate Development at WorldCom, drafted most Board meeting minutes from late 1998 until early 2002. At that time, Salsbury assumed those duties.

The Board had three standing committees during the relevant period: the Nominating Committee, the Compensation and Stock Option Committee (the "Compensation Committee") and the Audit Committee. The Nominating Committee was an inactive Committee and only occasionally acted, when it was necessary to fill a Board vacancy.[85] The Compensation Committee and Audit Committee are described more fully below, as well as the role of counsel in advising the Board and its Committees.

2. <u>The Compensation Committee</u>

Throughout the relevant period, the members of the Compensation Committee were Kellett (Chairman), Bobbitt, and Macklin. Tucker was a member until late 2000, and an honorary member thereafter. The Compensation Committee met regularly, between seven and seventeen times per year between 1999 and 2001. Many of the meetings were by telephone and related solely to the loans to Ebbers (after those loans had gained public attention and as the Committee began running into difficulties). The Committee relied heavily on compensation data collected by Tucker and on Tucker's experience from serving on many other boards of directors. Ebbers sometimes attended meetings.

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[85] The members of the Nominating Committee during the relevant period were Alexander, Aycock, Kellett, Porter and Ebbers. Porter, Ebbers and Aycock all served as Chairman at some point during the relevant period. Under currently-recognized best practices, it is not generally considered appropriate for the Chief Executive Officer of a company to sit on, let alone to chair, the company's Nominating Committee.

Formal Authority. The Compensation Committee had ambiguous authority and a lack of formal procedures. Its authority was set forth in a vague 1993 charter that stated that the Committee's power was to supervise the compensation of officers, directors and other employees, administer all stock option plans, and make recommendations to the Board regarding such compensation. The Company's proxy statements characterize the Committee's authority more broadly, however, and appear to give the Committee more authority with regard to the setting of salaries and bonuses, stating that the Committee was charged with determining the salaries, bonuses and other benefits of executive officers. This lack of clarity was highlighted when the Compensation Committee approved substantial loans to Ebbers without Board approval, only later asking for Board ratification after the borrowed funds had been disbursed to Ebbers. (These loans are discussed more fully in Section VIII.C below.)

Compensation Levels. The Compensation Committee was responsible for setting the salary and bonuses of the top executive officers at WorldCom. It was also responsible for administering WorldCom's stock option plan. We were told the Committee consulted materials such as peer group comparisons, charts and data from consulting firms to determine compensation. The comparisons and reports were generally provided by Tucker, who had access to them through his other work in the industry.

The Compensation Committee set the salary and bonus of Ebbers, Sullivan and Roberts. In 1999, it also set the compensation of John Sidgmore (then Chief Operations Officer) and one other senior executive, and in 2001 it set the compensation of Beaumont. Ebbers' recommendation was of paramount importance in setting executive base salaries: for example, it was at his urging that Roberts' salary was maintained at $1,050,000 after the MCI merger (though Roberts no longer received a bonus). Ebbers maintained Roberts' salary even though

Roberts' role in the Company had become modest and Roberts' employment agreement had expired on December 31, 1999. Several Directors, including one member of the Compensation Committee, told us they were doubtful about this decision and even though this was a matter committed to the Committee's judgment, the members deferred to Ebbers' preference.

The Compensation Committee reported that Ebbers' and Sullivan's compensation was usually in the median to high range in the industry. In fact, Ebbers was ranked among the highest paid Chief Executive Officers in the nation several years in a row, and Sullivan was ranked among the highest paid (and, according to one commentator, most overpaid) Chief Financial Officers in new economy businesses (indeed, he was among the highest paid in *any* business).[86] From 1998 through 2001 Ebbers received approximately $1 million per year in base salary plus options for well over one million shares of stock per year. For the same time period, Sullivan received annual compensation between $600,000 and $700,000 in base salary plus options for 600,000 to 900,000 shares of stock per year. Ebbers and Sullivan also each received a $10 million retention bonus in 2000.

Despite the very high level of his compensation, Ebbers put a great deal of his resources into business unrelated to WorldCom. (See Section VIII.C below.) A member of the Compensation Committee told us he was not aware of Ebbers' other business activities before learning of Ebbers' personal financial crisis in September 2000. When the members of the Compensation Committee learned of these activities, they did not object or insist that Ebbers, in

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[86] Printouts of Forbes Lists from the Forbes website indicate that Ebbers was one of the highest paid CEOs from 1999-2001; A 2000 Compensation Survey by Towers Perrin and CFO Magazine, dated June 1, 2000, and an article by Steven Taub, *The Most Overpaid CFOs?*, December 6, 2002, *available at* CFO.com, which covered the period from December 1998-December 2001, name Sullivan as one of the highest paid CFOs.

return for the substantial compensation packages he received, divest himself of the large investments that could have distracted him from his WorldCom duties.[87]

The Compensation Committee's hands-off approach to commitments that could be inconsistent with the demands on the Chief Executive Officer continued even after Ebbers' departure. John Sidgmore succeeded Ebbers as Chief Executive Officer in April 2002. He was also the Chief Executive Officer and Chairman of another company (eCommerce Industries, Inc. or "ECI2"), and in addition served on several other corporate boards. The Compensation Committee does not appear to have raised any concerns about these other obligations. (After serving as WorldCom's Chief Executive Officer for a few weeks, Sidgmore decided to step down from his position as Chief Executive Officer at ECI2.) Nor did the Chairman of the Compensation Committee, when approached for approval, raise concerns about an irregular arrangement Sidgmore requested under which his compensation would be split between himself and two employees he brought over from ECI2 when he became Chief Executive Officer. Other Board members did object, and the arrangement was eventually terminated.[88]

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[87] We also note that after the early 1990s, Ebbers did not have an employment agreement with WorldCom, which was unusual for large public companies.

[88] After he was named Chief Executive Officer in April 2002, Sidgmore requested that his salary of $1,000,000 be allocated among himself and two ECI2 executives, Paula Jagemann (who would receive $220,000) and Martina Knee (who would receive $110,000). Both had been employees of UUNet, and Knee had served as a lawyer at WorldCom (and did so again after April 2002). Kellett told Borghardt that the Compensation Committee's role was to approve Sidgmore's compensation, and that it was up to Sidgmore how he wished to allocate that compensation. However, other members of the Board, led by Judith Areen, objected to the arrangement. It appears that for a short period of time at the beginning of June 2002, Jagemann's and Knee's salaries were deducted from Sidgmore's salary; however, that arrangement was terminated and Sidgmore's salary was returned to the initial $1,000,000, and Jagemann and Knee were paid through normal payroll procedures. Jagemann left the Company in late 2002 and Knee left in January 2003.

Bonus Programs and Stock Option Plan. The Compensation Committee administered two bonus programs during the relevant period. The Company's Performance Bonus Plan, which began in 1997, required, among other things,[89] that an executive officer achieve a ten percent increase in revenue for his or her unit over the same time period the previous year. This focus on revenues is noteworthy: it created an incentive to sustain even unprofitable operations that provided revenue and it created great pressure to report double-digit revenue growth. This latter incentive may have played a role in motivating the improper entries that inflated revenues to that level during portions of 2000 and 2001. As it happened, however, the Compensation Committee ultimately elected not to award Performance Plan bonuses in 2000 because of the Company's deteriorating stock price, and awarded a bonus only to Beaumont in 2001.

Under a second bonus program, the Compensation Committee awarded retention bonuses in 2000 and 2001. With the decline in WorldCom's stock price and the failed merger with Sprint, the Board was concerned about low morale at the Company, so it instituted a retention bonus program intended to keep key employees in place. The plan required an employee to commit to staying at WorldCom through July 2002. In 2000, 558 employees were awarded upfront90 bonuses totaling nearly $238 million cash, plus roughly 10 million options. In addition, Ebbers and Sullivan each received a $10 million retention bonus. Employees other than Sullivan

[89] The 2001 Proxy Statement states that the 2000 performance goal "was based on the attainment of a specified percentage increase in consolidated gross revenues . . . ." The proxy also states that the amount awarded under the Performance Plan is based on changes in the common stock price; Ebbers' recommendations; an officer's individual performance; changes in an officer's level of responsibility and the current salary of the officer.

[90] The Company awarded bonuses up front because, we were told, it would be viewed as a show of good faith of some sort. This followed a model used at MFS, and no Director disagreed with it. It should be noted that the current overwhelming market practice (excluding companies contemplating bankruptcy) is to pay retention awards in arrears. There is good reason for this practice, as demonstrated by the litigation WorldCom had to pursue to recover bonuses paid to employees who left before July 2002.

and Ebbers were given bonuses in a mix of cash and options, while Sullivan and Ebbers received cash only. (The size of the bonuses awarded is in striking contrast to the retention bonus program approved by the Corporate Monitor after WorldCom's bankruptcy, in which $25 million was shared by 325 employees.) It does not appear that anyone challenged the necessity for such substantial payments under the 2000 program, which were made ostensibly to prevent people from leaving, particularly in light of the locations of WorldCom's principal operations.

The Compensation Committee was also responsible for administering WorldCom's stock option plan. It determined the number of options to be awarded to Ebbers. The Company's proxy statement indicates that the Committee granted options to executive officers based on the same subjective factors it considered in awarding base salaries. Although not clear, it appears from meeting minutes that the Committee approved grants to other WorldCom officers or employees as recommended by Ebbers.

3. The Audit Committee

From November 1999 through July 2002, the Audit Committee consisted of Bobbitt (Chairman), Allen, Areen and Galesi. They met between three and five times per year between 1999 and 2001. Meetings lasted about one hour except that the February 2002 meeting, likely in response to heightened awareness growing out of the Enron scandal, lasted closer to two hours. The Audit Committee held no special meetings until June 2002 when it became aware of the accounting irregularities.

All members received a packet of materials several days prior to each meeting that contained an agenda; minutes of previous meetings; and various documents pertaining to the planned discussion, including such materials as lists of proposed, in progress and completed internal audits, key internal audit issues and recommendations, and Andersen audit plans.

WorldCom's Audit Committee was responsible for overseeing three functions: the Internal Audit department, the external auditors, and management's financial reporting. More specifically, the Committee was charged with reviewing the Company's annual financial statements with management and the external auditor; reviewing Internal Audit's reports to management and management's responses to those reports; recommending selection of the external auditors to the Board; discussing the Company's accounting, financial reporting and internal controls with Internal Audit and the external auditors outside the presence of management; and reviewing and concurring with management's selection or termination of the head of Internal Audit.

The Internal Audit department, headed by Cynthia Cooper (Vice President of Internal Audit), monitored the operational systems and internal controls of the Company. The Audit Committee retained Arthur Andersen as WorldCom's external auditor until April 2002.

Representatives of Andersen and Internal Audit attended every Audit Committee meeting. While the Chairman of the Audit Committee has stated that a representative from Internal Audit always attended Andersen presentations, the minutes from the meetings where such presentations were given do not indicate that a representative from Internal Audit was present.

4. The Role of Counsel

WorldCom's legal department, like much of its operations, was an agglomeration of carryovers from various mergers. The largest component was the former legal department of MCI, located in Washington, D.C. and run by Salsbury. Called the Law and Public Policy Department, it had responsibility for commercial and regulatory support in the United States and the European Community, and for most litigation. Salsbury had been given the right to attend Board meetings at the time he was asked to stay on after the MCI merger. He was not given authority over the various other general counsels who had remained after the acquisitions of their companies, and there were at times several of these. The WorldCom Directors who had come from MCI occasionally consulted Salsbury on corporate matters, but the other Directors did not.

The Board and the Compensation Committee were generally advised by Bruce Borghardt, an attorney whose title was General Counsel-Corporate Development. He had worked as outside counsel and then, beginning in 1993, as in-house counsel for LDDS. He reported directly to Ebbers. His office was located in St. Louis, Missouri, although WorldCom did not have substantial executive operations there. His duties included corporate legal matters, support in employee stock option-related litigation, and legal aspects of the Company's public reporting. He did not report to Salsbury (until 2002) and, in light of what he described as Ebbers' strong feelings about controlling discussions within the Company, did not regularly consult Salsbury or provide him copies of corporate-related documents. When outside legal advice was required on corporate legal matters, Borghardt generally consulted lawyers from Bryan Cave LLP in St. Louis during the period in question.

Borghardt attended Board meetings and portions of Compensation Committee meetings, and prepared minutes of both. He was excluded from portions of many meetings of the Compensation Committee. In those instances, Kellett gave Borghardt notes from the portions of the meetings during which Borghardt was absent, which he incorporated into the full draft of the minutes. Borghardt did not attend Audit Committee meetings.

The fragmentation of the legal department was Ebbers' choice. None of the Company's senior lawyers was located in Jackson. He did not include the Company's lawyers in his inner circle and appears to have dealt with them only when he felt it necessary. He let them know his displeasure with them personally when they gave advice—however justified—that he did not like.[91] In sum, Ebbers created a culture in which the legal function was less influential and less welcome than in a healthy corporate environment.

B. The Role of the Board and the Audit Committee

We have carefully examined the available information pertinent to the Board's activities from 1999 until 2002, to answer two basic questions: Did the Board or the Audit Committee know of the improper accounting? If not, should they have detected it? We have found no evidence that the Board or Audit Committee in fact knew of the accounting improprieties. Nor have we found any glaring red flags that should have led the Board or Audit Committee to become aware of it. The Board and the Audit Committee were given information that was both false and plausible.

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[91] We were told of two specific examples. One was his displeasure with Salsbury when Salsbury had insisted on certain public disclosures relating to the Company's loans to Ebbers. Another was his displeasure with Borghardt over Borghardt's favoring of Company interests over Ebbers' interests in connection with the terms of the loans—something Borghardt's duties clearly required.

However, we believe the Board—and in particular the Audit Committee—played so limited a role in the oversight of WorldCom that it is unlikely that any but the most flagrant and open financial fraud *could* have come to their attention. Until April 2002, the Board and the Audit Committee did not exert independent leadership.

2. <u>The Quality of Board and Committee Oversight</u>

The Board and the Audit Committee did not function in a way that made it likely that red flags would come to their attention. Boards are indisputably reliant on information they receive from others. However, they must create the environment and the opportunities that give them the best chance of learning of issues requiring their attention. The WorldCom Board and the

Audit and Compensation Committees were distant and detached from the workings of the Company. Ebbers controlled the Board's agenda, its discussions, and its decisions. The Board did not function as a check on Ebbers and he created a corporate environment in which the pressure to meet the numbers was high, the departments that served as controls within the Company were weak, and the word of senior management was final and not to be challenged.

The Directors had a number of tools available to increase the chances of detecting acts of corporate wrongdoing that may be filtered by top management. Among them were the following: maintaining enough involvement in the Company's business to enable the Board to exert some control over the agenda; ensuring the presence of strong "control" functions within the Company; communicating throughout the Company the value of high ethical standards; having some familiarity and direct contact with people throughout the Company (as well as suppliers and customers); and keeping a close and open relationship with the outside auditors. The WorldCom Board and its Committees were simply out of touch with the Company below the level of Ebbers and Sullivan. Indeed, to the extent they sent signals to employees, those signals were counterproductive.

Involvement in the Company's Business and Control of the Agenda. It is easiest for management to deceive or mislead the Board when management is in complete control of the agenda: a Board that is deeply familiar with the Company's business and competitive environment, and focusing on the issues confronting the Company, is less likely to be misled or deceived by management. At WorldCom, however, management had full rein over the agenda. Management almost never consulted with Directors outside of Board meetings, and Ebbers was unchallenged at the Board meetings.

We were told that the members of the Board (other than Ebbers, Sullivan and, for a time, Sidgmore) had little or no involvement in the Company's business other than through attendance at Board meetings. With the exception of Bobbitt and Kellett, Chairmen of the two active Committees, none of the outside Directors had regular communications even with Ebbers or Sullivan—much less with operating personnel—between meetings. And even Bobbitt and Kellett did not often speak with Ebbers or Sullivan outside of Board or Committee meetings.

Although a number of Directors asked questions from time to time, we are aware of no occasions on which a Board member, other than Sidgmore, seriously challenged management until April 2002—when, we must note, the Board acted vigorously in demanding Ebbers' resignation.[96] Nearly all of the Directors were legacies of companies that WorldCom, under Ebbers' leadership, had acquired. They had ceded leadership to Ebbers when their companies were acquired, and in some cases viewed their role as diminished. Moreover, there was no cohesiveness and only limited respect—which later deteriorated into outright hostility—among many of the Directors who came from the different acquisitions.

Bert Roberts was particularly well suited to provide independent judgment, but did not do so. He was the former Chief Executive Officer of MCI, had extensive experience and stature in the industry, had the title of Chairman of the Board of Directors of WorldCom, and was paid more than $1 million a year. Yet he was generally passive at Board meetings and exerted little influence.

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[96] Areen threatened to resign in January 2002 because she felt Ebbers was the wrong person to lead the Company. She acceded to Ebbers' request that she remain on the Board until after the 2002 annual meeting, scheduled for June 2002.

Even when Directors had doubts, they deferred. One example is the Board meeting at which the plan to create tracker stocks was presented, on September 7, 2000. Ebbers and Sullivan delivered a presentation at the Executive Session following the quarterly Board meeting, in which they discussed options for restructuring the Company and emphasized the desirability of issuing a tracker stock for the low-growth businesses. Borghardt's notes from that session indicate that Allen commented that Ebbers' plan was the equivalent of trying to hide "manure in the closet," where it would "still smell." Alexander has told us that he also opposed the tracker plan and preferred a spin-off. Notwithstanding these objections, the Board unanimously approved Ebbers' restructuring plan as of October 31, 2000.[97]

Bobbitt and Kellett did on occasion express opinions about possible business combinations, although both avoided confrontation with Ebbers[98] and neither of them pressed his views with the Board when doing so would involve a challenge to Ebbers. The only Board member (other than Sullivan) who appears to have engaged vigorously concerning the direction of the Company was John Sidgmore. Sidgmore had a number of active battles with Ebbers and Sullivan over corporate strategy and potential transactions, but then largely withdrew from his active role within the Company when he was overruled. From this point on, Sidgmore—though knowledgeable and in a position to make a significant contribution—became a largely passive

[97] Formal action by the Board occurred later, but was treated as having been accomplished on October 31, and minutes reporting that the Board had acted at an October 31 meeting were approved by the Board.

[98] When confronted with what Kellett and Bobbitt viewed as an outright lie by Ebbers at a Board meeting regarding who proposed the loans from the Company, Kellett did not challenge Ebbers about the lie because he did not think it was in the best interests of the Company to confront him in front of other Directors. Bobbitt actually supported Ebbers' statement at the Board meeting (even though he later said it was a lie) because he did not wish to embarrass Ebbers. Also, Kellett chose to express his opposition to the Intermedia deal in a telephone call to Ebbers rather than discuss it at a Board meeting.

observer. The result of all of this was a Company in which the Board was far too disengaged from the Company's activities and its oversight. This increased the Board's reliance on senior management.

The need for an understanding of the Company is particularly important to the effective functioning of the Audit Committee. However, its members do not appear to have been sufficiently familiar and involved with the Company's internal financial workings, with weaknesses in the Company's internal control structure, or with its culture. WorldCom was a complicated Company in a fast-evolving industry. It had expanded quickly, through a series of large acquisitions, each of which raised both accounting and internal control and systems concerns that deserved Audit Committee knowledge and attention. These acquisitions had not been integrated, posing serious challenges for the Company and the Audit Committee. WorldCom had accounting-related operations scattered in a variety of locations around the country. To gain the knowledge necessary to function effectively as an Audit Committee would have required a very substantial amount of energy, expertise by at least some of its members, and time—certainly more than the three to five hours a year the Audit Committee met.

The Presence of Strong Control Departments. WorldCom's legal departments and its Internal Audit department were not structured in ways that would make them effective as a control of management wrongdoing. As noted above, the Company's lawyers were in fragmented groups, they were not located geographically near senior management or involved in its inner workings, there was no coherent reporting structure or hierarchy, and they had limited support from senior management. Even at the Board level, it was not until weeks after the Compensation Committee caused the Company to lend tens of millions of dollars to Ebbers that any lawyer at the Company was informed of it. In such an environment, it is not surprising that employees distressed by the accounting irregularities did not think of the legal departments as logical avenues of recourse. The Board did not create these conditions, but it should have been aware of them and concerned about them.

Internal Audit, of course, ultimately did succeed in revealing the financial fraud that had been occurring for several years. The Chairman of the Audit Committee, Max Bobbitt, supported Internal Audit when it began having conflicts with Sullivan in early 2002, and as it was pursuing the investigation that brought to light the capitalization of line costs. This was the right way to interact.

Internal Audit accomplished this despite a structure that we believe had four serious weaknesses. *First,* it reported to the Chief Financial Officer for many purposes. This made it more difficult for Internal Audit to challenge the Chief Financial Officer, and may have deterred employees from going to Internal Audit with their concerns about the accounting entries.

Second, it had (until early 2002) limited its efforts to operational audits, and left financial issues to the outside auditor. This meant that an important internal control over the accounting process was absent, there was no year-round review, and the input of employees with their own perspective and information sources was eliminated from the control process. It is striking that when Internal Audit began looking at financial issues in late 2001 and early 2002, two of its first audits (Wireless bad debt reserves and capital expenditures) found serious problems. (See Section IV.D.4 above.)

Third, the Audit Committee's role in Internal Audit's activities was very limited. It reviewed the list of audits scheduled for each year, and was provided general updates and summaries of information that Internal Audit thought important. However, the Audit Committee did not play a substantial role in setting priorities or in the follow-up on problems found in the course of its audits.

Fourth, WorldCom's Internal Audit department was understaffed and underbudgeted when compared to peers in the industry. According to a 2002 Institute of Internal Audit Benchmarking Study comparing the Internal Audit department at WorldCom to those at other telecommunication companies that was shown to the Committee in May 2002, WorldCom had more employees and higher revenues per auditor than its competitors by a huge margin—nearly twice as many employees per auditor, and more than three times the revenues per auditor.[99] Even allowing for some difference because Internal Audit performed only operational audits, this disparity reflected a serious underallocation of resources.

Communication of the Value Placed on High Ethical Standards. A Board can communicate the value it places on high ethical standards—most convincingly through its own conduct (discussed in Sections that follow), but also through other means. While focusing on ethical conduct is important in every company, it is particularly important in a company that has gone through major acquisitions, because "[e]xperience shows that unless high-level attention is given, the combined company's ethical values find the *lowest* common denominator."[100] The means for a Board to do this includes making ethical conduct a clear part of the compensation process (it was not at WorldCom[101]), seeking opportunities to highlight corporate and individual

[99] WorldCom had 3,111 employees per auditor and $1.3 billion in revenues per auditor. In comparison, according to one study, other telecommunications companies had 1,639 employees per auditor and $408 million in revenues per auditor.
[100] PRICEWATERHOUSECOOPERS, CORPORATE GOVERNANCE AND THE BOARD WHAT WORKS BEST 25 (2000).
[101] WorldCom's new Chief Executive Officer, Michael Capellas, and the Corporate Monitor developed an employment contract for Mr. Capellas that includes several provisions intended to

actions exemplifying ethical conduct, and—most commonly employed—adopting and emphasizing a corporate code of ethical conduct.[102]

WorldCom had no code of ethical conduct during the relevant period. The only mention of ethics in its Employee Handbook was contained in a two-page section that simply stated that fraud and dishonesty would not be tolerated and advised employees to report to their managers and/or the Human Resources department any unlawful or unethical behavior. MCI, in contrast, had a 24-page Code of Ethical Conduct at the time of its merger with WorldCom.

WorldCom only began drafting a Code of Ethics in early 2000. A draft was prepared by a senior attorney in the Law and Public Policy Department in Washington. The draft was not acted upon for nearly a year, until the drafting process resumed in May 2001. Between May 2001 and January 2002, counsel distributed drafts to a number of high-level managers and received approval from Sullivan and other senior executives to finalize a Code. However, Ebbers, when presented with a draft, reportedly called a Code of Ethics a "colossal waste of time." The Company formally adopted a Code of Business Ethics in the Fall of 2002—after the fraud was discovered—and posted it to WorldCom's internal website in early October 2002.

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promote healthy governance practices. These include tying all incentive payments to performance standards, use of restricted stock grants rather than stock options to provide equity incentives, and the use of an "Ethics Pledge" as part of the agreement. The Pledge requires the Company under his leadership to make full and candid disclosures concerning all areas of its business, extending beyond SEC requirements. The Pledge calls for investment in a strong and robust compliance system, and making integrity and ethics an integral part of how the Company does business. This Ethics Pledge has subsequently been signed by the Company's most senior managers as well.

[102] Report of the National Commission on Fraudulent Financial Reporting (1987) ("Treadway Report"). Compliance is generally monitored by the Audit Committee.

Direct Contact with People Throughout the Company. The outside Directors had virtually no interaction with Company operational or financial employees other than during the presentations they heard at meetings. They were not themselves visible to employees. While in these respects the Directors were far from unique among directors of large corporations, this lack of contact meant that they had little sense of the culture within the Company, or whether the tone they believed was being set by themselves and senior management was being received at other levels of the Company. Moreover, there were no systems in place that could have encouraged employees to risk contacting the outside Directors with concerns they had about the accounting entries or operational matters.

A Close and Open Relationship with the Outside Auditors. The Audit Committee met regularly with Andersen, heard and relied upon comforting reports, and received no indication that there were matters that should be of concern to it. We have not seen any evidence that the Committee placed pressure on Andersen to perform fewer tests than required in Andersen's professional judgment, or that it failed to support Andersen in any respect.

In its auditors' reports accompanying the financial statements in the annual report, Andersen stated that the Company's financial statements were fairly presented and in accordance with GAAP. In its 2001 audit report provided to the Audit Committee, Andersen reported on whether the Company's processes were "effective," "ineffective" or "effective but need work." These three categories were represented in the report as green, red or yellow, respectively. The 2001 report was awash in green, without even a single yellow or red mark. Committee members believed that this was a perfect report that showed that the Company had excellent controls and was financially healthy.

Nevertheless, there was a serious failure of communication between Andersen and the Audit Committee. Part of it was clearly Andersen's fault. As we described in Section VII above, we have seen no evidence that Andersen informed the Audit Committee of either the concerns that led it to rate WorldCom a maximum risk client or that it was being denied access to WorldCom's General Ledger by management. The Audit Committee was entitled to know these things.

The Audit Committee members, for their part, apparently did not understand—though the evidence indicates that Andersen disclosed—the non-traditional audit approach Andersen employed. As described in our discussion of Andersen, this approach emphasized determining specific business risks, reviewing controls in place to monitor those risks, and only testing those areas where residual risk was perceived. In contrast, a traditional audit places greater emphasis on "verif[ying] . . . information maintained in accounting records and financial statements." Whether Andersen's non-traditional approach was wise or not, it should have been a matter for greater scrutiny by the Audit Committee and discussion with Andersen.

Counterproductive Signals. Board members convey their receptiveness to comments critical of management principally through their actions. The Board's principal role is oversight of management, and its decisions send a message about its independence and objectivity. While we discuss our views of the loans and guaranties to Ebbers and certain other arrangements below, we note here that one of the serious adverse consequences was the message these arrangements conveyed. Employees will not believe that the Board can be approached with concerns about the Chief Executive Officer or his top management when they see the Board using shareholder funds to bail the Chief Executive Officer out of his financial distress, or when they become aware of transactions such as the undisclosed lease of a corporate airplane to a

Director on favorable terms. Related party transactions in general, and these in particular, damage employee confidence in the Board's willingness to stand up to senior management.

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In sum, the Board served as passive observers in a Company thoroughly controlled by Ebbers. We cannot know whether an active Board would have prevented or even more quickly detected the accounting fraud that occurred here. But this Board did not give itself enough of a chance.