6th World Media Economics Conference

Centre d'études sur les médias and Journal of Media Economics

HEC Montréal, Montréal, Canada
May 12-15, 2004

AOL Time Warner & WorldCom Inc.
Corporate Governance and Diffusion of Authority

Richard A. Gershon, University of Florida, United States
Abubakar D. Alhassan, University of Florida, United States

Starting in 2001, the U.S. economy began to experience a period of economic instability, somewhat reminiscent of the 1930s. What was similar was not the depth of the recession, but the level of corporate misconduct, failure of checks and balances,and total loss of investor confidence. Despite President George W. Bush's assertion that some corrupt individuals failed the system, the argument can be made that it was the unchecked system of deregulation that failed.

The purpose of this study is to understand the confluence of factors that led to corporate failure outcomes at AOL Time Warner and WorldCom. This paper argues that the corporate failure outcomes at AOL Time Warner and WorldCom were due to a confluence of factors, including 1) intimidating corporate culture, 2) corporate misconduct and 3) failures in corporate governance. The combination of factors led to a diffusion of authority, where neither the company's board of directors (nor individual person) were fully aware of or took responsibility for the actions of senior management. More specifically, corporate governance (and self-regulation) failed to provide the objective oversight necessary to ensure the proper execution of business strategy at AOL Time Warner and failed to prevent egregious forms of corporate misconduct at WorldCom.

Biography
Richard A. Gershon, Ph.D., (Ohio University, 1986) is Professor and co-founder of the Telecommunications & Information Management program at Western Michigan University where he teaches courses in Telecommunications Management and Law & Policy.

Dr. Gershon is the author of *Telecommunications Management: Industry Structures and Planning* Strategies (2001) and *The Transnational Media Corporation: Global Messages and Free Market Competition*, winner of the 1998 book of the year by the U.S. National Cable Television Museum.

Abubakar D. Alhassan completed his Masters degree in organizational communication in the Department of Communication at Western Michigan University. He is a Ph.D. candidate at the University of Florida. Mr. Alhassan is a graduate of Bayero University, Kano, Nigeria. His B.A. thesis was on the role of the media and the Nigerian banking crisis in the early 1990s.

INTRODUCTION

Starting in 2001, the U.S. economy experienced a period of economic instability, somewhat reminiscent of the 1930s. What was similar was not the depth of the recession, but the level of corporate misconduct, failure of checks and balances, and total loss of investor confidence (Nussbaum, 2002). How did this happen? The common element found in both time periods was the conflict of interest that benefited insiders (Kuttner, 2002). In contrast to the Chicago School of economic theory, which espouses the benefits of a deregulated economy, market forces were unable to detect or discipline the self-dealing and opportunism that proved irresistible during the high growth years of the 1990's. Despite President George W. Bush's assertion that some corrupt individuals failed the system, the argument can be made that it was the unchecked system of deregulation that failed ("Let the Reforms Begin," 2002).

The telecommunications industry in particular experienced a state of economic turmoil. Investors lost some $2 trillion as stock prices fell more than 95% from their previous highs. Since 2001, more than a half a million workers lost their jobs in what was once regarded as the strongest sector of the US economy. Dozens of debt ridden companies ranging from Winstar to Global Crossing have filed for bankruptcy. Starting in early 2002, long distance carrier WorldCom was targeted by US regulators and law enforcement officials after the disclosure that the company had improperly overstated its earnings by $3.8 billion in 2001 and the first quarter of 2002 (now estimated at $11 billion). It was the largest accounting fraud ever to occur by a US publicly traded company. WorldCom has subsequently filed for bankruptcy ("WorldCom Plans Bankruptcy Filing," 2002). In January 2003, the media news and entertainment industry experienced an unprecedented level of instability when transnational media giant AOL Time Warner posted a $99 billion loss for the previous year; considered to be the largest financial loss in US corporate history.

THE GLOBALIZATION OF MARKETS

Today, the globalization of markets involves the full integration of transnational business, nation-states and technologies operating at high speed. The basic requirements for all would-be players is an adherence to the principles of free market competition and a willingness to compete on an international basis. Global competition has engendered a new competitive spirit that cuts across nationalities and borders. A new form of economic Darwinism abounds, characterized by a belief that size and complementary strengths are crucial to business survival. As today's media and telecommunication companies continue to grow and expand, the challenges of staying globally competitive become increasingly more difficult. The relentless pursuit of profits (and fear of failure) have made companies around the world vigilant in their attempts to right-size, reorganize and reengineer their business operations.

The Deregulation Paradox

In principle, deregulation is suppose to foster competition and thereby open markets to new service providers. The problem, however, is that complete and unfettered deregulation can sometimes create the very problem it was meant to solve; namely, a lack of competition. Researchers like Mosco (1990) call it the "mythology of telecommunications deregulation." Other writers such as Demers (2000) refer to it as the "great paradox of capitalism." We simply call it the deregulation paradox. As Demers points out,

> The history of most industries in so-called free market economies is the history of the growth of oligopolies, where a few large companies eventually come to dominate. The first examples occurred during the late 1800s in the oil, steel and railroad industries... Antitrust laws eventually were used to break up many of

> these companies but oligopolistic tendencies continue in these and most other industries (p. 1).

The communications industry is no exception. Instead of fostering an open marketplace of new players and competitors, too much consolidation can lead to fewer players and hence less competition (Mosco, 1990; Gershon, 1997; Demers, 1999). Set against the backdrop of deregulation (and the need to meet Wall Street expectations), the pressures to stay globally competitive can sometimes cause senior level managers to adopt high-risk strategies and/or engage in corporate misconduct. As pressures arise, senior managers become increasingly more insulated from public accountability. Management decision-making, under such circumstances, becomes in the words of Charran & Useem (2002), "an incremental descent into poor judgment."

The events surrounding Enron, WorldCom and AOL Time Warner have caused a great deal of soul searching among those political representatives who have long championed the cause of deregulation such as Rep. Barton (R-Tex), who told *Business Week*, "We spent the last ten years breaking down walls between businesses, I think that's over" ("The Enron Scandal," 2002). Similarly, Congressman Peter DeFazio (D-OR) a long time critic of deregulation writes:

> Contrary to the claim of so-called experts, the rash of corporate scandals was entirely predictable. It was the inevitable result of a failed experiment with radical deregulation plans, and massive corporate influence over Congress and the Executive branch. (DeFazio, 2002, p.2)

The purpose of this study is to understand the confluence of factors that led to corporate failure outcomes at AOL Time Warner and WorldCom. Corporate failure can be described as a company that has experienced a major downturn in revenue, stock price and/or significant loss of market share. This paper argues that the corporate failure outcomes at AOL Time Warner and WorldCom were due to a confluence of factors, including 1) intimidating corporate culture, 2) corporate misconduct and 3) failures in corporate governance. The combination of factors led to a diffusion of authority, where neither the company's board of directors (nor individual person) were fully aware of or took responsibility for the actions of senior management. More specifically, corporate governance (and self-regulation) failed to provide the objective oversight necessary to ensure the proper execution of business strategy at AOL Time Warner and failed to prevent egregious forms of corporate misconduct at WorldCom.

INTIMIDATING CORPORATE CULTURE

Organizational culture (or corporate culture) refers to the collection of beliefs, expectations and values shared by an organization's members and transmitted from one generation of employees to another. As Pilotta, Widman & Jasko (1988) point out, organizations (even large ones) are always human constructions; that is, they are made and transformed by individuals. Culture is embedded and transmitted through both implicit and explicit messages such as formal statements, organizational philosophy, design of physical space, deliberate role modeling and teaching by leaders (Schein 1983; Pilotta et. al. 1988). Deal & Kennedy (1982) suggest that the more highly successful companies are those that exhibit a strong organizational culture. They identify several component parts to a strong organizational culture, including the importance of a strong value system. Values are the intrinsic beliefs that members hold for an organization. It represents the basic operating philosophy of the organization in terms of setting goals and expectations. Values also describes how the organization conducts itself in the marketplace with a view towards the competition.

Researchers like Schein (1984, 1983), Morley & Shockley-Zalabak (1991) and Gershon (2002, 1997) argue that the business strategies and corporate culture of a company are often a direct reflection of the person (or persons) who were responsible for developing the organization and its business mission. Bennis (1986) contends that the single most important determinant of corporate culture is the behavior of the chief executive officer. The CEO is the person most responsible for shaping the beliefs, motivations and expectations for the organization as a whole. The importance of the CEO is particularly evident when it comes to the formation of business strategy. That said, what happens when the overriding corporate culture is one where profits, deal-making or high-risk strategy supersede critical judgment and where corporate misconduct is tolerated?

CORPORATE MISCONDUCT

A basic assumption of welfare economics is that such players are expected to engage in rational self-interest. In principle, business and individual employees are said to engage in rational self-interest when they pursue legitimate goals without considering the full effect on third parties (Baumol, 1952). An important aspect of the problem concerns the question of externalities; that is, the effects of a voluntary transaction between two parties on third parties. The pursuit of rational self-interest can have both intended and unintended consequences (Wallis & Dollery, 1999). A scandal involving corporate misconduct such as the falsification of an earnings report can have a devastating effect on the company's standing and reputation in the marketplace. The lack of investor confidence can translate into billions of dollars in lowered stock value and the loss of working capital. In the worst case scenario, it can lead to corporate bankruptcy.

Self Dealing and Personal Enrichment

Today, falling markets and accounting scandals have tarnished the once-iconic image of the chief executive officer. The self-dealing that characterized a handful of CEO's have fostered public resentment and called into question a system that would allow senior level executives to enrich themselves at the public's expense. At issue, are the excesses of senior level executives who pursued personal enrichment schemes and cashed out millions in stock options while employees were losing their jobs and life savings. The problem of corporate misconduct is not unique to the telecommunications field.

Perhaps the most telling example of this was the case of Enron Corporation. President and CEO, Kenneth Lay, amassed $152 million in payments and stock. Similarly, Enron under the direction of Chief Financial Officer, Andrew Fastow engaged in a complex web of partnerships that was used to hide more than $1 billion in debt and inflate profits. Enron's subsequent bankruptcy caused thousands of company employees to lose their jobs and wiped out retirement savings for those employees who were required to hold on to company stock while seniors executives were allowed to cash out.

Who are the senior executives in question and how did the system of deregulation fail? Former Qwest CEO Joseph P. Nacchio sold $248 million worth of stock before he was pushed out of the scandal plagued company. Nacchio may be eleigible for a severance package worth more than $10 million. Global Crossing founder, Gary Winnick sold $734 million of his shares before his company filed for bankruptcy. Dennis Kozlowski, former CEO of Tyco, was charged with evading payment of more than $1 million in sales tax on paintings by Monet, Renoir and others. He is also accused of extorting some $70 million for personal gain. John Rigas, founder and CEO of Adelphia Communications received more than $67 million in undisclosed loans and received $1 million per month in soft cash for a period covering two years. And former WorldCom CEO., Bernard Ebbers, borrowed $408 million from his company before he was ousted with loans remaining to be paid. He was given a generous severance package, including a pension of $1.5 million a year for life. Table 1. provides a select set of examples of personal enrichment schemes and corporate misconduct of several notable US business and telecommunications firms. In some cases, the companies identified in this table have filed for bankruptcy. In some cases, the CEO and/or senior management executives were indicted for fraud. In all cases, the said companies listed have experienced a serious decline in stock value.

Table 1

Personal Enrichment & Corporate Misconduct: Select Examples

Company	Senior Executive	Personal Enrichment and Corporate Misconduct	Consequences
Adelphia Comm.	John Rigas President and Founder	received more than $67 million in undisclosed loans and received $1 million per month in soft cash for a period covering two years.	Rigas has been indicted for fraud.
Arthur Anderson	Joseph Beradino President & CEO	his company was found guilty of criminal obstruction of justice.	Beradino has resigned from the company. Anderson has discontinued its role as an auditor after 89 years.
	David Duncan Senior Accountant	engaged in criminal obstruction of justice by the improper shredding of documents	pleaded guilty
Enron Corporation	Kenneth Lay President & CEO	amassed $152 million in payments and stock. A complex web of partnerships was used to hide more than $1 billion in debt and inflate profits.	Enron has filed for bankruptcy
	Andrew Fastow	pled guilty to directing efforts to create highly questionable outside partnerships and then covering up such actions with deceptive accounting practices.	has been indicted for fraud
Global Crossing	Gary Winnick President & CEO	sold $734 million of his shares before his company filed for bankruptcy.	Global Crossing has filed for bankruptcy
Tyco Inc.	Dennis Kozlowski, President & CEO	was charged with evading payment of more than $1 million in sales tax on paintings by Monet, Renior and others. He is also charged with extorting some $70 million for personal gain.	Kozlowski has been indicted for fraud.
WorldCom	Bernard Ebbers President and CEO	borrowed $408 million from his company before he was ousted with loans remaining to be paid	WorldCom has filed for bankruptcy. Ebbers has been indicted for fraud.
`	Scott D. Sullivan Chief Financial Officer	inappropriately accounted for $3.8 billion in expenses, thereby inflating profits and falsifying reports to the SEC.	Sullivan has been indicted for fraud

Sources: Wall Street Journal, Business Week

CORPORATE GOVERNANCE

The role of a corporate board of directors is to provide independent oversight and guidance to a CEO and his/her staff of senior executives. Corporate boards provide a level of professional oversight that embodies the principles of "self regulation." This can involve everything from approving new strategic initiatives to reviewing CEO performance. A corporate governance system should function as a corporate tripod, comprising management (led by the CEO), the board of directors and the company's shareholders. In theory, the corporate tripod is suppose to provide a system of checks and balances. The reality, however, belies the fact that many of today's corporate governance structures are woefully out of balance (Monks & Minow, 1996). This has proven especially true in the fields of media and telecommunications (Lehn, 2002).

One of the important goals, of corporate governance should be to prevent significant mistakes in corporate strategy and to ensure that when mistakes happen, they can be corrected quickly (Pound, 2002). The problem occurs when a corporate board of directors ignores its fiduciary responsibility to company stockholders and employees by failing to challenge questionable corporate strategy and/or by permitting unethical business practices to occur. More problematic, is when a corporate board loses its sense of independence. In recent years, many CEOs have tended to operate with corporate boards that have proven highly compliant rather than objective. There are several reasons that help to explain why corporate governance systems can sometime fail. They include:

1. Senior management providing corporate boards with limited information
2. The pursuit of subgoals by senior managers that are contrary to the best interests of the company or organization.
3. Corporate cultures of intimidation where questioning senior management decision making will be met with unremitting resistance and the possibility of job loss.
4. Corporate board members who provide consulting services and are, thereby, beholden to senior management (Cohan, 2002; Turnbull, 2002; Siebens, 2002; Monks & Minow,1995).

In the worse case scenario, failures in corporate governance can lead to what (Cohan, 2002) describes as a diffusion of authority, where neither company or person is fully aware of or takes responsibility for the actions of senior management. Turnbull (2002) cites the example of Enron Corporation which illustrates what can happen when there is complete failure in corporate governance. This case more than any other, has lent new urgency to the debate about the way to properly manage large organizations.

The Lessons from Enron Corporation

The case of Enron Corporation case calls into question the rights of investors, workers and the obligations of a corporate board of directors to provide responsible corporate oversight. In 1999, accounting firm Arthur Anderson told the board's audit committee that Enron was a "maximum risk" client that was "pushing the limits" of appropriate accounting practices. The board chose not to challenge Enron's own internal accounting practices nor did it ask Arthur Anderson to take a more careful approach in auditing Enron's books (Byrne, 2002).

Equally revealing was the decision by the Enron board not to address the claims made by Enron employee Sharon S. Watkins in 2001 regarding the company's involvement in a series of highly complex multibillion off-the-books partnerships. In a presentation before a US Congressional subcommittee, Watkins described Enron as having a corporate culture of intimidation in which anyone who tried to challenge the business practices of Enron's former chief financial officer, Andrew S. Fastow, faced the prospect of losing their job. She further acknowledged that there was widespread internal knowledge of the company's shaky finances, but that no one felt confident enough to challenge former CEO Jeffrey Skilling or Andrew Fastow. "To do so, I believe, would have been a job terminating move." ("Lone Voice," p. C7)

What is clear is that Enron's Board of Directors knew about and could have prevented many of the risky business dealings and accounting practices that led to the company's dissolution. Enron's board was later faulted for failing to ask the kind of questions that needed asking and for failing to get involved in a meaningful way. When at last, the board did ask questions, they were not given the right answers. By failing to get involved, the board missed the chance to uncover serious problems in the company's accounting practices (Charran, & Useem, 2002). In a six month investigation, a US Congressional subcommittee, reported:

> .... that much of what was wrong with Enron was known to the board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-book activity and excessive executive compensation…
>
> By failing to provide sufficient oversight and restraint to stop management excess the Enron Board contributed to the company's collapse and bears a share of the responsibility for it. (Byrne, 2002, pp. 50-51)

AOL TIME WARNER

The company that was once known as Time Inc. has been a party to three major business combinations since 1989. In July 1989, Time Inc. and Warner Communications completed a corporate merger that made it the largest media company in the world. The Time Warner merger was conceived as a global strategy that would enable the company to compete head-to-head with the world's leading media companies. At the time, company strategists believed that by the year 2000 there would be an international oligopoly of five or six transnational media corporations (Saporito, 1989).

Both companies proved highly complementary in their assets. Time Inc. brought to the merger agreement such notable magazines as *Time, People, Fortune, Money* and *Sports Illustrated* . In 1988, the magazine group was the largest magazine publisher in the US. In addition, Time Inc. was America's leading pay-television programmer with *Home Box Office* and *Cinemax.* The company also owned America's second largest cable (MSO), *American Television & Communications*. The company was later renamed Time Warner Cable.

Warner Communications brought to the merger agreement a major presence in television/film studio production, including: *Warner Brother Studios* (one of Hollywood's top three studios) and *Lorimar Television Entertainment* (a leading producer of television programs). In addition, Warner Brothers studios was a key supplier of programming to the cable industry, including Time's very own HBO and Cinemax cable services. In the area of music entertainment, Warner Communications had a strong presence as well, including *Warner Brothers Records, Atlantic Records* and *Electra Entertainment*. (Gershon, 1997; Clurman, 1992). Despite a rough start, the combination of Time Inc.and Warner Communications proved to be an effective combination.

Time Warner Acquires Turner Broadcasting

For several years, Time Inc. had wanted to acquire CNN. The opportunity presented itself in September 1995 when the newly created Time Warner Inc. acquired Turner Broadcasting Systems in a stock swap valued at $8 billion. The rationale behind the purchase of Turner Broadcasting was to combine the news and programming assets of Turner Broadcasting with the highly complimentary assets of Time Warner. According to then Time Warner President and CEO, Gerry Levin,

> The complementary nature of the two organizations will allow us to maximize the value of our assets and distribution systems and position us as the leading media company in an increasingly competitive global marketplace. ("Time Warner and Turner Broadcasting System," 1995)

America Online Acquires Time Warner Inc.

On January 10, 2000, America Online (AOL), the largest Internet service provider in the U.S. announced that it would purchase Time Warner Inc. for $162 billion. What was particularly unique about the deal was that AOL with one fifth of the revenue and 15% of the workforce of Time Warner was planning to purchase the largest TNMC in the world. Such was the nature of Internet economics that allowed Wall Street to assign a monetary value to AOL well in excess of its actual value. What is clear, however, is that AOL President, Steve Case, recognized that his company was ultimately in a vulnerable position. Sooner or later, Wall Street would come to realize that AOL was an overvalued company with little substantive assets (Gershon, 2002).

At the time, AOL had no major deals with cable companies for delivery. Cable modems were just beginning to emerge as the technology of choice for residential users wanting high speed Internet access. Instead, AOL was dependent on local telephone lines and satellite delivery. Nor did AOL have any real content to speak of. As a company, AOL pursued what Aufderheide (2002) describes as a "walled gardens" strategy, whereby, the company attempted to turn users of the public Internet into customers of a proprietary environment. In looking to the future, AOL needed something more than a well constructed first screen experience. Enter Time Warner which was well positioned in both media content as well as the potential for high speed cable delivery.

The proposed venture between AOL and Time Warner was promoted as the marriage of old media and new media. In principle, an AOL Time Warner combination would provide AOL with broadband distribution capability to Time Warner's 13 million cable households. AOL Time Warner cable subscribers would have faster Internet service as well as access to a wide variety of interactive and Internet software products (Faulhaber, 2002; "Showtime for AOL Time Warner," 2001).

The AOL Time Warner merger may well be remembered as one of the worst mergers in US corporate history. The first signs of trouble occurred in the aftermath of the dotcom crash beginning in March 2000. AOL, like most other Internet stocks, took an immediate hit. AOL's ad sales experienced a free fall and subscriber rates flattened out. By 2001, AOL Time Warner stock was down 70% ("AOL, You've Got Misery," 2002).AOL's Robert Pittman was assigned the task of overseeing the post merger integration.

In the weeks and months that followed, the economic downturn and subsequent loss of advertising had a strong negative impact on AOL's core business. AOL found itself financially weaker than it was a year earlier because of rising debt and a falling share price which left it without the financial means to pursue future deals. As an example, AOL was counting on future cable television deals to deliver online entertainment and news services. AOL Time Warner executives, in the meantime, angered big institutional investors by missing growth targets and spinning financial reports to make their performance look better than it was. Adding to the tension were new questions about AOL's accounting practices ("AOL Reshuffles its Management Deck," 2002). The once hoped for synergies did not materialize, leaving the company with an unwieldy structure and bitter corporate infighting. The AOL Time Warner merger suffered from a faulty strategic rationale as well as post merger integration failures

Corporate Governance at Time Warner

Did the board of directors at Time Warner Inc. fulfill their responsibilities in monitoring the proposed AOL Time Warner merger? The answer to this question may have something do with what Collins (2002) describes as the problem of charismatic leadership and strong personalities. According to Collins, fellow managers and board members are less likely to challenge the strategic vision of a charismatic leader out of respect for his/her past success or out of fear of appearing contrary. Given their personality and leadership style, the charismatic leader is less likely to be challenged by individual board members when and if the situation requires it. What is important to remember, however, is that charismatic CEOs do make mistakes. According to one senior AOL Time Warner official, "Gerry had a firm grip on the board." ("AOL's Board," 2002)

> 'This deal was a big leap of faith,' says a person who was at the meeting. Yet the board jumped, assured by Time Warner CEO Gerry Levin that convergence of new and old media and the growth it would produce were real. (p. 46)

For Time Warner CEO, Gerald Levin, pursuing the AOL merger was intended to be his final legacy. It should be understood that Levin had a long history of strategic deal-making. After all, Levin was the leading force behind HBO's commitment to use satellite communication, thereby, redefining the future of long haul television distribution and giving new meaning to the term cable network services. Levin was also the same person who helped engineer Time's merger with Warner Communication. In 1996, he led the charge in acquiring Turner Broadcasting. And lastly, Levin was the man behind the AOL Time Warner merger.

In retrospect, Levin was a victim of empire building; that is, a love of deal-making and a singular willingness to decide what deals and strategies were best for his company, his shareholders and the public at large. As Lieberman (2002) notes, "he frequently made those decisions alone, without opening himself up to questions or critics" (p. 2B) Levin's single minded pursuit of the deal failed to give Time Warner an escape clause in the event that AOL's stock value dramatically changed prior to the deal's completion. Nor was this the only instance where Levin attempted to negotiate a deal without his board's approval. In the fall of 2001, Levin was intent on acquiring AT&T's broadband services. In speaking to a group of investors, he was quoted as saying: "I'm the CEO and this is what I'm going to do." ("How It All Fell Apart," 2002, p. 50) Steve Case, for one, challenged him on this question which led to a crisis in the boardroom. It was not so much the strategy idea as the way he went about it. Levin abruptly resigned from AOL Time Warner in December 2001.

In the end, Gerald Levin bet the future of Time Warner on the so-called marriage of old media and new media, leaving employees, investors and consumers questioning his judgment as well as having to sort through the unintended consequences of that action. In the aftermath of the AOL Time Warner merger, the company's new board has overseen in a dramatic shake-up at the senior executive level, including Levin's retirement from the company and Pittman's forced resignation in July 2002 ("Failed Effort," 2002). In January 2003, Steve Case stepped down as Co-CEO claiming that he did not want to be a further distraction to the company. In their place, company directors installed Richard Parsons as Chairman and CEO and two longtime Time Warner executives as his co-chief operating officers. In January 2003, AOL Time Warner reported a $99 billion loss from the previous year making it the highest recorded loss in US corporate history. Perhaps the most symbolic aspect of AOL Time Warner as a failed business strategy was the decision in September 2003 by the company's board of directors to change the name AOL Time Warner back to its original form, Time Warner Inc.

WORLDDCOM

Starting in the mid-1990's, Mississippi based WorldCom quickly rose to become the number two long distance telephone carrier in the US. Along the way, the company used its soaring stock to make 70 acquisitions, including a hostile takeover of MCI in 1998. MCI was at that time a company more than three times the size of WorldCom. The combination of WorldCom's UUNET network, coupled with MCI's Internet back-bone made the company the largest carrier of Internet traffic in the world. For a period of time, WorldCom was heralded as one of the great American telecommunications success stories.

WorldCom's Business Environment

By 2000, however, WorldCom began to experience a series of strategic and financial setbacks. The first setback occurred when the US Justice department blocked a proposed purchase of number three long distance carrier Sprint Corporation thus ending WorldCom's growth-through-acquisition strategy. By early 2001, investor disillusionment with the dotcoms (and tech stocks in general) coupled with enormous over capacity in the telecommunications field combined to slow the business of long distance telephony. In particular, was the huge impact of cellular telephony on the cost structure of long distance telephone communication. WorldCom, like other long distance carriers, was reeling from a significant decline in long distance revenues coupled with a precipitous fall in stock price.

Beginning in early 2002, WorldCom suffered a stunning reversal of fortune. The company became the focus of intense scrutiny by regulators and law enforcement officials after the disclosure that WorldCom had improperly overstated earnings by $3.8 billion in 2001 and the first quarter of 2002 ("Congress Begins," 2002). It was the largest accounting fraud in US history. The number has since grown to $11 billion. A US Congressional investigation into the WorldCom debacle reveals that WorldCom's accounting department under the direction of Chief Financial Officer (CFO) Scott D. Sullivan had manipulated the company's financial record keeping in order to paper over multibillion dollar losses. It was done with the intention of propping up WorldCom's financial standing on Wall Street.

WorldCom's Corporate Culture.

It isn't clear why WorldCom's misstatements weren't caught immediately by its outside auditors. The answer in part, can be explained by the accounting firm responsible for its financial audit; Arthur Anderson, the same company responsible for the Enron debacle and the shredding of documents. The firm signed off on WorldCom's financial statements. Anderson later issued a statement that CFO Sullivan had been deceptive in his financial reporting to the company's auditors. What ultimately brought about the accounting disclosure was the work of the company's internal auditing department headed by Cynthia Cooper. When Cooper went to Arthur Anderson to express her concerns regarding the company's financial record keeping, she was told in no uncertain terms that there was no problem. According to one *Time* magazine report, When she didn't relent, Sullivan angrily told Cooper that everything was fine

> and she should back off. He was furious at her… For many auditors, the word of the CFO and an Anderson partner would have been more than enough to leave the situation alone. 'You have to understand,' says a WorldCom employee, 'Scott was probably the most respected person in the company.' ("Persons of the Year," 2003, p.49)

This was the beginning and the end. On June 20th, Cooper and a member of the audit team went to Washington to meet with WorldCom's audit committee representing the company's board of directors. At the meeting, Cooper presented her findings as did Sullivan. Sullivan was unsuccessful in convincing the board of the strategy behind his actions. He was asked to resign and was later fired. Afterwards, WorldCom made public its findings regarding the accounting fraud. CFO, Scott Sullivan and accounting director Buford Yates were indicted in August 2002 by US Federal Prosecutors for fraud and misrepresentation. In 2004, former CEO Bernard Ebbers was indicted for fraud and misrepresentation to investors.

Following WorldCom's Chapter 11 bankruptcy filing, the company's newly appointed board of directors hired the law firm of Wilmer, Cutler & Pickering to conduct an internal investigation. Among the committee's many findings [henceforth referred to as Report of Investigation] was that "Ebbers created the pressure that led to the fraud."

> This culture began at the top. Ebbers created the pressure that led to the fraud. He demanded the results he had promised, and he appeared to scorn the procedures (and people) that should have been a check on misreporting. When efforts were made to establish a corporate Code of Conduct, Ebbers reportedly described it as a "colossal waste of time." He showed little respect for the role lawyers played with respect to corporate governance matters within the Company. While we have heard numerous accounts of Ebbers' demand for results—on occasion emotional, insulting, and with express reference to the personal financial harm he faced if the stock price declined—we have heard none in which he demanded or rewarded ethical business practices. (Report of Investigation, 2003, p. 19)

Corporate Governance and WorldCom

The story of WorldCom's corporate governance system illustrates the problems of a large company operating without a true independent board of directors. At issue, was the fact that WorldCom's nine member board was composed of corporate insiders; friends of Bernard Ebbers and executives from the acquired companies. The problem began in the early 90's when WorldCom (formerly LDDS) went on a buying spree acquiring some 70 plus companies. As WorldCom steadily snatched up companies, Ebbers established a pattern in which he would invite the CEO of the newly acquired company to join WorldCom's board of directors.

> 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. (Report of Investigation, 2003, p. 30)

Several of the more notable companies and exCEOs included: Max E. Bobbitt, Alltel Corporation; Bert C. Roberts, MCI Corporation and Francesco Galesi, real estate magnate and major investor in Advanced Telecommunications Corporation to name only a few. And four of the original board members were close insiders, euphemistically referred to as "Bernie's Boys." ("How Ebbers Kept the Board," 2002) The said board members proved to be ever loyal to CEO Ebbers. They, in turn, received multiple perks, including millions of dollars in WorldCom stock, use of the company's private jet and financial support to pursue a variety of individual projects. In one such example, Stiles Kellett, board member and Chairman of the compensation committee, was permitted to rent company aircraft for $1 a month, plus a $400-an-hour usage fee. The arrangement saved him more than $1 million a year. Ebbers also benefited from this relationship. In 2001, WorldCom's compensation committee headed by Kellett gave its approval to lend CEO Ebbers a $408 million loan so that he could cover a margin call on his personal investment in the company's stock. Later, as WorldCom's finances continued to deteriorate, Ebbers was asked to resign. He received a generous severance package, including a pension of $1.5 million a year for life.

Diffusion of Authority. Most of WorldCom's outside directors board did not have direct access or get involved with the company's day-to-day business operations. The outside directors had little or no contact with company employees other than during presentations at board meetings. Nor were there systems in place that would have allowed employees to contact the board with concerns about company finances or operational matters (Report of Investigation, 2003, p. 31). When problems did occur, most of the board members felt powerless or were so beholden to CEO Ebbers, that no one felt confident to come forward and raise the kinds of questions that needed asking concerning the company's business practices and finances.

> 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… (p. 32)

According to the Report of Investigation (2003), WorldCom's accounting fraud was the result of the way in which CEO Bernard Ebbers ran the company. The report points to a diffusion of authority problem and failures in the corporate governance system.

> The fraud did not involve WorldCom's network, its technology or its engineering. Most of WorldCom's people did not know it was occurring. Rather, the fraud occurred as a result of knowing misconduct directed by a few senior executives centered in its Clinton, Mississippi headquarters, and implemented by personnel in its financial and accounting departments in several locations…
>
> WorldCom's collapse reflected not only a financial fraud but also a major failure of corporate governance. The Board of Directors, though apparently unaware of the fraud, played far too small a role in the life, direction and culture of the Company. Although the Board, at least in form, appeared to satisfy many checklists of the time, it did not exhibit the energy, judgment, leadership or courage that WorldCom needed… We found no evidence that members of the Board of Directors, other than Ebbers and Sullivan, were aware of the improper accounting practices at the time they occurred. (p. 29)

Since the 2002 accounting disclosure, WorldCom has filed for bankruptcy and the fallout has been significant. Worldcom has discharged 17,000 of its employees (or 28% of the company's workforce). The company has seen its stock plummet from a one time high of $64.50 per share to stock that is trading at 83 cents per share. The company's bond holders and other creditors have also suffered heavy losses. WorldCom is carrying $30 billion in debt ("Woe is WorldCom," 2002). It must pay $172 million in interest and maturities in 2002, rising to $1.7 billion in 2003 and $2.6 billion in 2004. All this comes at a time when WorldCom's assets are worth far less than its $32 billion debt due to the softness of the telecommunications market. In the meantime, the California public employees' retirement system, the largest state pension fund in the US, is suing WorldCom to regain some $580 million in losses resulting from the accounting disclosures. As part of its chapter 11 reorganization plan, WorldCom has renamed itself MCI.

DISCUSSION

The challenges and difficulties faced by today's media and telecommunications companies call into question some basic assumptions regarding deregulation and the principle of self-regulation. This reality overturns several decades of conventional wisdom about the efficiency of free markets (Kuttner, 2002). The primary difficulty is that market discipline and self-regulation noticeably failed in several instances when it came to unscrupulous dealmaking, deceptive accounting practices and corporate governance. During the high water mark years of the 1990's, investors went along for the ride, delighted as long as stock performance kept rising. US regulators and corporate boards were unwilling (or unable) to spot and regulate fraud when it occurred. And given the respect accorded deregulation and the low esteem placed on government regulation, the US Congress would not permit regulatory agencies (i.e. the FCC, SEC, FTC) to challenge the activities of corporate America (Crew & Kleindorfer, 2002).

This paper has argued that the corporate failure outcomes at AOL Time Warner and WorldCom were due to a confluence of factors including 1) intimidating corporate culture, 2) corporate misconduct and 3) failures in corporate governance. The combination of factors led to a diffusion of authority, where neither the company's board of directors (or individual person) were fully aware or took responsibility for the actions of senior management. In the end, the problem is not deregulation or self regulation. Rather, the problem is a failure to recognize that there is no such thing as wholly free markets devoid of professional oversight both internal and external to the organization. More specifically, corporate governance (and self-regulation) failed to provide the objective oversight necessary to ensure the proper execution of business strategy at AOL Time Warner and failed to prevent egregious forms of corporate misconduct at WorldCom.

Rethinking Corporate Governance

In the aftermath of AOL Time Warner and WorldCom, researchers, policy analysts and US government legislators are recognizing the need to take a new level of activism in monitoring the actions of wayward corporations. Several have proposed regulatory and business reforms that would improve corporate governance. The solutions vary in size and scope ranging from Turnbull (2000) who proposes an alternative form of capitalism to Salmon (2000) who prescribes a series of incremental changes as a remedy. The passage of the *Sarbanes-Oxley Act* of 2002, for one, requires that financial reports submitted to the Securities Exchange Committee (SEC) must be accompanied by a written statement signed by the CEO and CFO that certifies that the enclosed financial statement fully complies with US securities law. Table 2. presents a series of current and proposed regulatory and business reforms.

Table 2.
Principles of Effective Corporate Governance

1. Board Independence: No more than two directors should be current or former company executives. No board member should be engaged in direct business dealings with the said company or accept consulting fees for services rendered beyond that of an appointed board member.

2. Make CEOs More Accountable: The SEC should endorse national guidelines for all publicly traded companies doing business in the US. Among the provisions CEOs and CFOs must personally certify the accuracy in reporting of the income statement. Passage of the *Sarbanes-Oxley Act* of 2002, requires that financial reports submitted to the SEC must be accompanied by a written statement signed by the CEO and CFO that certifies that the enclosed financial statement fully complies with US securities law.

3. Director Quality: Boards should include a minimum of two independent directors with experience in the company's core business. Ideally, one of the board members should be a CEO of an equivalent size company.

4. Board Activism: Boards should periodically meet without management present. The goal should be to monitor CEO and senior management performance. The board should be prepared to react to potential problem areas when such issues emerge.

5. Board Evaluation: There should be a proper mechanism for evaluating board members. The current practice where board members grade their own performance is no longer acceptable. Instead, directors should be subjected to the review of shareholders and regulators using a proper evaluation method.

According to Pound (2002), the first step to improving corporate governance is rethinking the role of directors. Corporate governance should not be about power but about ensuring that decisions are made effectively. In most companies, the role of the governance system is only to put the right managers in place, monitor their progress and replace them when they fail. Neither the board nor shareholders offer opinions on strategy or policy unless managers are clearly failing. What is needed is a system in which senior managers and the board truly collaborate on decisions and both regularly seek the input of shareholders. As Siebens (2002) points out, corporate boards must take into account the interests of all stakeholders, and demonstrate "a tendency toward a decent, fair and reliable direction…" (p. 110)

References

AOL's board digging in. (2002, August 19). *Newsweek*, pp.46-47.

AOL reshuffles its management deck. (2002, July 19). *USA Today*, pp. 1-2B

AOL, you've got misery. (2002, April 8). *Business Week*, pp. 58-59.

Aufderheide, P. (2002). Competition and commons: The public interest in and after the AOL-Time Warner merger. *Journal of Broadcasting & Electronic Media*, 46(4), 515-531.

Baumol, W. (1952). *Welfare economics and the theory of the state.* Cambridge, MA: Harvard University Press.

Bennis, W. 1986, *Leaders and Visions: Orchestrating the Corporate Culture*, Conference Board, New York.

Byrne, J. (2002, July 29). No excuses for Enron's board. *Business Week*, pp. 50-51.

Charran, R. & Useem, J. Why companies fail. (2002, May 27). *Fortune*, pp. 50-62.

Cohan, J. (2002). I didn't know and I was only doing my job: Has corporate ethics governance careened out of control? A case study of Enron's information myopia. *Journal of Business Ethics*, 40(3), 275-299.

Clurman, R. (1992). *To the end of Time.* New York, NY: Simon & Schuster.

Collins, J. (2001). *Good to great.* New York, NY: Harper Collins.

Congress begins WorldCom investigation. (2002, June 28) *The Wall Street Journal*, pp. A3, A9.

Crew, M. & Kleindorfer, P. (2002). Regulatory economics: Twenty years of progress? *Journal of Regulatory Economics*, 21(1), 5-22.

Defazio, P. (2002). Congressional Newsletter, available at: http://www.house.gov/defazio/July2002.pdf

Deal, T. & Kennedy, A. 1982, *Corporate Cultures*: *The Rites and Rituals of Corporate Life*, Addison Wesley, Reading, MA.

Demers, D. (2000). *Global Media News*, Newsletter. 2(1), 1.

The Enron scandal. (2002, January 28). *Business Week Online*. Available at: http://www.businessweek.com/magazine/content/02_04/b3767711.htm

Failed effort to coordinate ads signals deeper woes at AOL. (2002, July 18). *The Wall Street Journal*, pp. 1, A6.

Faulhaber, G. (2002). Network effects and merger analysis: instant messaging and the AOL Time Warner case. *Telecommunications Policy*. 26, 311-333.

Gershon, R.A. (2002). The Transnational media corporation and the economics of global competition. In Yahya R. Kamalipour (Ed.) *Global Communication*. (pp. 51-73). Belmont CA: Wadsworth.

Gershon, R. (1997). *The transnational media corporation: Global messages and free market competition.* Mahwah, NJ: Lawrence Erlbaum Associates, Inc.

How Ebbers kept the board in his pocket. (2002, October 14). *Business Week*, pp. 138-139.

How it all fell apart. (2002, December 9). *Newsweek*, pp. 53-58.

Kuttner, R. (2002, July 29). Today's markets needs new rules. *Business Week*, p 26.

Let the reforms begin. (2002, July 22). *Business Week*, pp. 26-37.

Lehn, K. (2002). Corporate governance in the deregulated telecommunications industry: lessons from the airline industry. *Telecommunications Policy*. 26, 225-242.

Lieberman, D. (2002, May 20). For better or worse, Levin traveled a rocky road. *USA Today*, p. 2B.

Lone voice: Excerpts from the testimony of an executive who challenged Enron: Sharon S. Watkins. (2002, February 15) *The Wall Street Journal*, p. C7.

Monks, R. & Minow, N. (1996). *Watching the watchers: Corporate governance for the 21st century.* Cambridge, MA: Blackwell Publishers.

Morley, D. & Shockley-Zalabak, P. (1991). Setting the rules: An examination of the influence of organizational founders values. *Management Communication Quarterly,* 4(4), 422-449.

Mosco, V. (Winter 1990). The mythology of telecommunications deregulation. *Journal of Communication*. 40(1), 36-49.

Nussbaum, B. (2002, July 8) Scandals in corporate America: Can trust be rebuilt? *Business Week Online*. Available at: http://www.businessweek.com/magazine/ content/02_27/b3790012.htm

Persons of the year. (2003, January 6). *Time,* pp. 45-56.

Pilotta, J., Widman, T., & Jasko, S. (1988). Meaning and action in the organizational setting: An interpretive approach. Communication Yearbook, vol. 11, pp. 310-334.

Pound, J. (2002). The promise of the governed corporation. *Harvard Business Review on Corporate Governance*. Boston, MA: Harvard Business School Press.

Report of Investigation (2003, June 9). Special investigative committee of the board of directors of WorldCom. Available at:
http://www.edgar-online.com/bin/irsec/finSys_main.asp?dcn=0000931763-03-001862&x=126&y=27

Salmon, W. J. (2002). Crisis prevention: How to gear up your board. *Harvard business review on corporate governance*. Boston, MA: Harvard Business School Press.

Saporito, B. (1989, November 20). The inside story of Time Warner, *Fortune*, pp.164-209.

Schein, E. (1984). Coming to a new awareness of organizational culture. *Sloan Management Review*, Winter, pp. 3-16.

Schein, E. (1983) The role of the founder in creating organizational culture. *Organizational Dynamics*, 11, pp. 13-28.

Siebens, H. (2002). Concepts and working instruments for corporate governance. *Journal of Business Ethics, 39*, 109-116.

Showtime for AOL Time Warner. (2001, January 15). *Business Week*, pp. 57-64.

Time Warner Inc. and Turner Broadcasting System, Inc. agree to merge. (1995, September 22). Time Warner Inc. Press Release, p. 1.

Turnbull, S. (2002). *A new way to govern: Organizations and society after Enron*. London, UK: New Economics Foundation.

Wallis, J. & Dollery, B. (1999). *Market failure, government failure, leadership and public policy.* New York, NY: St. Martin's Press.

Woe is WorldCom. (2002, May 6). *Business Week*, pp. 86-90.

WorldCom plans bankruptcy filing. (2002, July 22). *Wall Street Journal*, pp. A3 & A8.