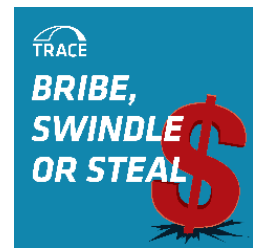


BRIBE, SWINDLE OR STEAL



MCI's Accounting Fraud – Walto Pavlo

[00:00:07] Welcome back to Bribe, Swindle or Steal. I'm Alexandra Wrage, and today, I'm speaking with my guest in the first part of a two-part interview. We've decided to break this into two podcasts because we're going to cover two very different topics, each fascinating in its own way. My guest is an acclaimed author and speaks frequently on white collar crime and law enforcement. He's a former finance executive, a midlevel manager and co-founder of Prisonology, which we'll discuss on tomorrow's podcast. This eclectic professional biography — finance, white collar criminal expertise and Prisonology — all makes sense when you know that he was one of a small handful of MCI WorldCom employees and executives to spend time in prison for that company's massive accounting fraud. The tally in that case ultimately reached US\$11 billion in accounting misrepresentations, landing the CEO, Bernie Ebbers, a 25-year prison sentence and the No. 9 Slot on Time Magazine's "10 Most Corrupt CEOs" list and landing our guest in prison for 24 months. Walt Pavlo, thank you for joining me and for your willingness to discuss the accounting fraud and this time in your life more generally.

[00:01:18] Thank you, Alexandra. Thanks for having me. I'm not quite sure that my parents had envisioned such a fine introduction.

[00:01:24] In many respects, your story was the scandal before the scandal — the world really focused on Bernie Ebbers' accounting fraud — but your story predates that in many respects. Maybe you can start with an industry primer for us. The telecommunications business of the late 1990s was pretty convoluted.

[00:01:46] If you look at what deregulation did to the telecommunications business, you look back and if I were to ask someone even at the time, "How many long-distance or telecom companies do you think that there are?" People who would guess high and say, "I bet there's 50." The truth is there were thousands. There were small telecom companies that were going all over the place that were really just marketing organizations trying to get people to use their long distance services, but in order to provide those services, they rode on the backbone of prime carriers, primarily at first AT&T, the original one, just like MCI did. Eventually, they start building their own networks, and one of the customers that I collected on at MCI or that I worked with at MCI as they were growing company was Bernie Ebbers at a little company called Long-Distance Discounters, which became LDDS, which became WorldCom. It was very much a wild west of very small startup companies that one would buy another over the years and try to bring the industry together through a lot of acquisitions. It was very much a wild west.

[00:02:54] Full disclosure: I worked for MCI, as you know, for a couple of years in the '90s, and one of the things that surprised me was everybody was moving traffic across the same fiber optic cable.

[00:03:05] That's correct. A lot of money was raised to build these fiber optic networks through bond offerings and through the stock market, capital raising. There were trenches being built all across the country and railways and pipelines in building this network and everybody, carriers and resellers, were buying and selling this capacity to the point where we had very much an over-capacity of network at the time. Back then, we didn't have Skype. We didn't have video. We didn't have a lot of the services. Cell

phones weren't even that big. There was a lot of bandwidth and very little applications to fill that bandwidth.

[00:03:45] There's an enormous amount of capacity, and everybody's chasing customers, and the standards for vetting those customers starts to decline. Is that fair?

[00:03:55] That's fair. The ones that tended to have the most profit, the ones that were most attractive to us were a group called Tier 3, and they're really some of the same culprits that are around today on the Internet — pornography, gambling, fortune telling. Those are drivers of business and highly profitable — back then, it was called the 900 business — but in the resale category, these were very profitable businesses. MCI, WorldCom, a lot of companies went after this group because they were highly profitable.

[00:04:33] You wrote what I think is just a fantastic book, "Stolen Without A Gun." I know it's not currently in print, but it's still available on Amazon, and I really recommend it. But you note in your book that there's no way to repossess minutes once they've been used. MCI was fronting huge sums of money to these guys, these "porn, numbers and fortune tellers," as you say, with no collateral. That sounds like a recipe for disaster.

[00:04:57] It is. There's a combination of things that happen. We have a very low barrier to entry into our business. We would allow anybody that would come on that had a good business idea. The switching equipment that they were using at the time was, for all intents and purposes, leased or rented. The building that it would be in is leased or rented, and then we're providing this intangible product called "long distance." It's really a virtual company, and I think what makes it even more risky is the ability for these companies to generate large amounts of revenue in a very short period of time. If you look at the size of the average home basement, that would be a multimillion-dollar long distance company, and you can run it out of your parents basement.

[00:05:43] You were in charge, as a member of the financial team, with keeping receivables under control. You've got these sometimes fly-by-night organizations that are running out millions of dollars in debt to MCI with no real assets. Your job is to recover money from them. How did you go about that? What sort of pressure are you under?

[00:06:05] When I first took the job — I'm an engineering undergraduate with an MBA with a concentration in finance. I am not a collections guy. And you're right. My Job was to bill and collect money to these resellers, but primarily, my job was interfacing with guys like Mr. Ebbers at WorldCom and people that worked for him or AT&T or Sprint. The majority of our revenue came from those, but these smaller companies started coming up, and that became more of a problem in collections because when I would go out to try to collect money from them — which, really, I'm not a very big guy, and I'm not an intimidating person — so when I walk in and I'm trying to collect money, what I found was some really tough people that were involved in some of these unscrupulous businesses who really just refused to pay. Sometimes I would go to pay a visit to say, "Hey, you owe MCI money," and I would find empty offices. I would find mail addresses that didn't exist, mailboxes, et cetera. They just couldn't find the clients. It became a very frustrating thing to know that millions of dollars were missing, and I really can't find the person, or when I do, they're not very receptive to me being there and paying the money. They have all the leverage. They owe me the money. I can disconnect service but that's about it.

[00:07:20] Why don't you describe some of the early accounting tricks, if you like, that were used to obscure the high levels of bad debt? Before things really went wrong, what was this slippery slope towards the accounting fraud?

[00:07:36] I think the slippery slope begins in MCI not unlike what happened in any other company. MCI made a number of large acquisitions where you're bringing in and blending together multiple billing platforms and multiple accounting platforms. Rather than integrate those together, what you end up with is a large number of manual overrides where, in essence, you're taking downloads from large mainframe computers, downloading it onto a PC of a 27-year-old who works for me, who manipulates those numbers and then uploads them to create accounting and invoice records. There were lots of errors trying to figure that all out. What we spend a lot of time early on doing was fixing those errors. The customer was under-billed. The customer was over-billed. We're entering credits to fix other problems. That was a that was a very common problem at MCI as it was in other growing companies. If you look at what the beginning of the problem was, it wasn't an opportunity. It was trying to bandaid a bunch of accounting systems together at one time. That was that was the beginning because at first you're fixing stuff, and then later it becomes an opportunity.

[00:08:55] When you realize how little oversight there is on what you're fixing, then that seems like license to get more creative.

[00:09:02] That's correct, and that's exactly what happened. Just as an example, you under-bill a customer, which could happen by hundreds of thousands or millions of dollars. You either can fix it or you cannot fix it, and then maybe it becomes an opportunity later where you can purposely under-bill or eliminate outstanding invoices that are there. That's exactly the way it was. I was able to sort of manipulate things as I just used the existing systems that were there.

[00:09:33] Why don't you talk about that a little bit — the transition from fighting and scrapping to trying to keep these receivables down legitimately on behalf of your employer to crossing over that line?

[00:09:47] The strategy was to go after the Tier 3 customers — the customers that were into these pornography, gambling, fortune-telling, high-risk debit prepaid cards — to go after them. Once they stopped paying and once we looked at it as like, "OK, what do we do? This company owes us US\$5 million. What do we do?" We as a group decided that we couldn't write it off or acknowledge that it was a write-off. We needed to delay it is long as we could until we could write it off. We could disconnect them, but in the meantime, we had to do something with the accounts receivable. We had to do something to prevent people from looking at this bad news.

[00:10:30] When you say, "We couldn't write it off," there was enormous pressure because it would affect the share price. It would make MCI look less profitable than management wanted it to look.

[00:10:39] Sure. I'm just a small segment — I wouldn't say a small segment — a segment of that. With the way the accounting works is that once you create usage on our network, you create an invoice, you create an asset on your balance sheet, which is in accounts receivable, and it's revenue on your income statement, for a period of time that looks good on the books. That looks like it's real. But when a customer doesn't pay you, you have to go back in and make another accounting entry — bad debt or a sales allowance. That would make, in turn, the books look bad. What we decided to do was to delay that or to not to make it happen at all. I did that through making accounting entries that made the accounts receivable look like it had been paid, like it had been put off into the future, like it didn't have a negative

impact. One of the things I like to say, Alexandra, is that back then that wasn't called "cooking the books." That was called helping, trying to help the company out until something better would happen. That just wasn't going to be the case.

[00:11:41] Was that the use of promissory notes? How do you get a debt that size off the books? Clearly there's no money to offset the removal of the debt, so how did that work as a practical matter?

[00:11:51] You find places to hide it in accounting. One of those is through a promissory note. You can work with a customer and turn the debt that they owe — several million dollars — into a promissory note, still an asset on MCI's books. That asset is going to be due in the future. Two years from now would be the equivalent of, "I'd signed up for a car lease, and I wasn't making note payments on my car lease," and they would say, "Hey, look. We don't really want to take the car back. How about if we refinance it, and you don't have to make any payments on this car now for two years? But if you promise to start paying them in the future, that would be great." That's pretty much what we did — still looks on the books as an asset, still looks like your strategy is a success. But in reality, you're just playing a shell game that is one day going to come to roost. You don't realize that when you're doing it, but it's just a shell game of moving dollars around.

[00:12:41] You say you don't realize it when you're doing it, but this sounds stressful.

[00:12:46] It's extremely stressful because you cannot make a plan that says, "I'm covering things up." You have to keep track of a lot of this stuff in your head, and that's what I was doing. You're trying to remember where all the buckets are, where all the bodies are buried, and you try to do it with the least amount of paper trail that there is. It's extremely stressful.

[00:13:11] In your book it's clear that you reach a point fairly suddenly, it seems — at least in the telling of the story — that, "This is all a farce anyway, and you might as well have a piece of it." Can you describe that period in this process?

[00:13:28] Sure. What I'm faced with Alexandra — and it's not to really justify what I did but certainly how I rationalized it at the time — was a number of carriers, telecom companies that are on MCI's network aren't paying their bills. They're making a lot of money. Internally, I'm just hiding all that debt. So, to me, it's like, "What is my purpose?" I confided in somebody outside of MCI about this problem that I'm having: "Customers aren't paying, I'm covering it up. I have no self-worth. What am I doing?" That person had an idea. He saw the opportunity, saw my frustration, and presented me with an opportunity to say, "I think that we can make these customers pay MCI. I think that I can make them good customers where they could add value to the business that they have. And number three, I think that I can make me and you, Walt, lot of money." And I was like, "Wow, how do we do number three? How do I make money at this?" That's when we devised a scheme to enrich ourselves using, basically, the platform of greed and deception that I had already been doing for well over a year.

[00:14:46] It's a pretty complicated scheme. I know you do a lot of public speaking on this whole story, so perhaps you can make that accessible for us. What was the scheme?

[00:14:59] The scheme was very easy, really. I go to customers that owe MCI millions of dollars and I would say that, "You either pay up, or you're going to be subject to being disconnected." In turn, they're distraught. "Walt's all of a sudden being a really tough guy on me."

[00:15:15] Their revenue flow stops the moment you disconnect them, so they're scrambling at this point.

[00:15:20] They're scrambling. They could be out of business or, at the very least, suffer some inconvenience. They're trying to find somewhere to go. "Where do I get money to pay MCI off?" Not knowing that there's a relationship between me and this other guy — I'll call him Harold — Harold walks into that business and says, "I'm a financier. I specialize in quick loans. I can give you a loan if you need one in a hurry. Capital or debt, whatever it is, I specialize in that." For the carrier, they were like, "My goodness, your timing couldn't be better. I need US\$2 million, and I need it very quickly." So Harold would act like he was going to put together a loan and he would say, "Here are the conditions. I want you to give me a down payment for putting this structure together, I want you to repay the loan over a period of time and I want you to give me a percentage ownership in your company. In turn I'm going to wire the money — the debt that you owe to MCI — I'm going to wire that money to MCI directly." The carrier was saying, "Let's do this deal. I am happy to enter into this agreement." But there was no money ever sent to MCI. All I did was cover up the millions of dollars of invoices for that particular customer, Harold would act like he had paid the debt to MCI and that carrier customer began paying money to the Harold by way of offshore banks. Really, that was it. That was the structure. We did that with just six customers over just six or seven months and had over US\$6 million in the Cayman Islands in hardly any time at all.

[00:16:54] But this only works if the customer is only speaking to you at MCI. If they call and get somebody else, anybody else is going to report that they haven't paid their debt.

[00:17:03] That may not have been true because if they looked on MCI books, those debts were, in fact, gone. They had, in fact, disappeared. They could have called anybody, and anyone would have looked at their accounting records and said, "We show that you guys made a payment." That was part of the magic of cooking the books that I had back then. Several million dollars had disappeared for the company, but in this case, a few million dollars disappeared for me.

[00:17:25] What you said earlier about this capitalizing on the chaos of the accounting system really resonates. You were able, first on MCI's behalf and later on your own behalf, to make millions of dollars disappear.

[00:17:39] Correct. In that chaos, Alexandra, one of the things that management looks for is good news. If I said a customer that was previously a bad-paying customer has all of the sudden paid, even with this backhanded deal through Harold, management tends to ask very few questions of that. Probably one of the key lessons that I learned in the middle of this is that nobody questions good news, and I'm giving good news. There's a solution for the carrier. They believe that Harold has provided paying their debt, and MCI looks like it's received a payment from a customer who was previously bad. Who's going to question that?

[00:18:17] On a previous podcast, I interviewed Eugene Soltes, who wrote, "Why They Do It," and he talks about how much easier it is to get involved in white collar crime because your victims are just an abstraction. Did you have the sense, at the time to the extent that you can really recall what you were thinking, that this was more or less victimless?

[00:18:41] Absolutely. I thought there was no victim. In fact, I went to elaborate means to set up this scheme so that it appeared to me to be no victim. I'm very distant from the money. There is no money

involved. Really, it's just numbers. It's just journal entries. There is no one being hurt here. The carrier is allowed to be on MCI's network. The company, I believed, wasn't going to acknowledge that this bad debt even existed. I came up with a solution that allowed the customer to stay on the network. They actually became a good-paying customer because Harold was actually involved in some of their infrastructure and determining what payments are going to be made, and I myself am receiving payments as a result. It just seemed like it's a win-win-win for everybody.

[00:19:30] When you say that they become a good paying customer, Harold takes care of their outstanding bad debt, but then the ongoing payments — the payments going forward — are going to MCI.

[00:19:39] They are going to MCI, and they're also going to the Cayman Islands. Harold did things like he gets rid of expensive cars at these companies. He gets rid of girlfriends. He gets rid of boyfriends. He gets rid of family members. He restructures the company so that they are more profitable. You've got to think that he's been able to reorganize their debt and, at the same time, put himself inside the company so that he's controlling cash flow and is a very influential member of the company. It's a backward way of being able to influence the company and, at the same time, enrich ourselves. Again, I went through very elaborate steps to make sure, "Wow everybody seems to be benefiting."

[00:20:19] Except the shareholders.

[00:20:21] Except the shareholders. That's a good point. In the short run, I convince myself that the shareholders were benefiting. I created a new entity in this carrier out here who is now well run and who would be a long-term customer. But that all fell apart. What I felt at the moment certainly wasn't a long-term strategy that was sustainable.

[00:20:42] How important was that justification to you? I'm sorry, we're getting a little off track from the scheme itself, but I'm just curious. How important was it to you that you tell yourself a story that nobody was getting hurt?

[00:20:56] I guess the best way to answer that — it would have been so easy for me to go to one of these carriers and say, "You owe me US\$2 million. I tell you what: Give me US\$500,000 in cash, and I will make US\$2 million disappear." That thought never even occurred to me until I was giving a talk one day at a top MBA school, and one of the members of the audience recommended that I should have done that, and I said, "You know what? I never thought of that. That sounds like stealing. That sounds like just stealing." So when I look back at what I did, the importance of me being able to justify every aspect of a crime to make it not look like a crime was the main purpose that I was trying to get at, more than the money, more than getting at the money. Make it look like no one's getting hurt here.

[00:21:50] In the end it's all made easier because — you and I have talked about this before — the scheme all just seems so ordinary. Clearly wrong and clearly illegal, but it wasn't flashy. There weren't any real obvious villains in this story. Maybe that's the nature of accounting fraud, but you were moving things around on paper.

[00:22:09] It was, and only to the extent do you realize how bad it was. I didn't realize how bad it was until it was all over. That's when victims present themselves. It's more than just shareholders. It's family members. It's people who trusted me, people who worked for me. It's people who I worked for. This is when victims present themselves because everyone thinks like, "The shareholders got hurt." Of course

they did. But in the scheme of things, the list of victims is much longer. Unintended consequences of people that were unintentionally hurt — that's what is so damaging about white-collar crime.

[00:22:54] Let's talk about that a little bit more. But first you were, of course, eventually caught. Can you describe the day that you fully realized that things had unraveled?

[00:23:06] I was on business in Palm Springs, California, and I can still remember it like it was yesterday. My boss had called, and he was going over a number of things with me, most innocuous business things, and then he got to a point where he said, "There's one journal entry, accounting entry that I'd like for you to look at. Somebody in accounting called, and they have a question, and you haven't returned their call. Can you get them off of our back and call them back?" And I said, "Sure." When he told me the name of the accounting entry, I knew that it was one of the deals that I had worked on with Harold, and I was like, "Oh my god. I'm caught. I don't know what to do. How am I going to get out of this? Nobody knows that I've done anything wrong, but they're pretty close." I pretty much resigned during that phone call. We talked about a couple of other things, but I said, "The work is just too much pressure." I just didn't have any answer. We talked earlier about some of the pressures of trying to keep track of all these things in my head, and then to be confronted with it was just too much. Then after a while, they wanted me to come back to work, and then all of a sudden, they had questions for me. That's when it really, truly unraveled. I think at that one phone call, I knew that it was going to be over, and it was going to end poorly. That was the beginning of the end.

[00:24:32] You describe talking to your wife about not wanting to go back and then pulling over and throwing your pager into a lake. Was that that day or did that come later?

[00:24:41] You're dating me now. We're talking about pagers. But that's true. That was sort of the moment when, I think, more than anything, Alexandra, I felt some sense of relief that it was going to be over with, that I didn't have to run anymore. "It's going to be tough to face it but I can't go back to work. I can't go back and face this. I'm going to have to face some consequence here." But at least I knew that it was over. That I didn't have to go in. I didn't have to shuffle anything around on paper anymore. I didn't have to lie to somebody, that I could somehow begin to put this behind me — knowing that there was a big mountain in front of me, but just the relief of, "Thank god the scheme itself has come to an end," because that was very painful.

[00:25:26] There's an amazing quote in your book where you're recounting a conversation with your wife. You say that it's all gone horribly wrong, and you're probably going to have to go to prison, but even that is a sort of relief because a prison sentence has an end, and this had been so open-ended. It's just startling for somebody outside the story to hear that perhaps even a prison sentence brings some kind of finality and relief.

[00:25:57] It starts to be a known quantity that this is going to be a reality. I'm sure that people have the same sort of experience with a terminal illness or something. I would equate it to that. It's sort of coming to grips with, "Wow. This is in front of me, and I'm going to have to do something to you know to address it." But, the other life. People would say, "Walt, are you sorry, or are you sorry you got caught?" Which is a fair question. I certainly wasn't looking to be caught doing something, but I can tell you that the life that I lead up to the point where I was caught was a miserable life. There was nothing glamorous about what I was doing in the way that I felt inside. So being caught and looking at prison as being a relief gives you an indication of how bad life was leading up to that.

[00:26:49] The charges in the end were obstruction of justice, money laundering and wire fraud. You served 24 months for that. There is a poignant point in your book where you've already told your wife and other family members but now you have to tell your sons. I think that that must be the point that everybody most dreads, and it's heartbreaking. You have to explain to them that you're going away.

[00:27:13] It's hard for everybody. When you always bring kids into anything, you're like, "Oh my gosh, kids are like kittens." It's always the toughest and the most emotional part. But I can tell you that telling my kids was extremely difficult. Telling my parents is difficult. Telling my neighbor is difficult. Telling aunts and uncles is difficult. Each one isn't like this interview, Alexandra, where we can sit and talk about it. It's emotional. How many times can you do that? It's not like you can just gather everybody into a room and do this. This is something that you tell everybody one-on-one. Telling my kids is extremely painful. I would say that it was probably no less painful than telling my parents or telling anybody else. It's that hard on every front, just confronting that, confessing to somebody, asking them to understand and try to tell them that you're a better person than this. Extremely difficult to do.

[00:28:12] I guess we worry more about kids just because two years is forever for children, and what two years means in the life of a child, the change in development is different than your parents and siblings. But, of course, the rest of it is all the same. It was your brother who drove you to prison, and that had to have been difficult in its own right.

[00:28:32] It is difficult because what you realize, too, is that you're putting a burden on somebody else that is self-inflicted. My brother had better things to do than drive me to prison. I do want to go back a little bit to my kids because you're right. They're so vulnerable, and they're trying to grasp and understand this. But the story that you tell an 8- or 9-year-old — which my children were at the time — versus the story that you tell them when they're 14 and 15, 18 and 19, 22 and 23, or 26 and 27 — which they are today — is different. There's more that they have questions on today. It's an evolving relationship that I've had with my kids about, "What went wrong? Why did you make the decision?" My kids are out in the business world now, and they look and they see things, and they look at the world differently. So, to me, it's really unique with the kids in that I've seen them grow as a person to the story that I told them initially to what their grasp and understanding is because I'm sure that they've gone through a cycle of emotions about wondering why I let them drown and then understanding on one point and then saying, "How could you do this?" That's a conversation we've had over decades now.

[00:29:43] That's a really interesting point for me, having read the book quite recently. Your kids were still stuck in those ages, 8- and 10-years-old. Of course they've evolved and grown, and the world has become more nuanced to them, and that hadn't occurred to me that they've grown up with this story. Why don't we wrap up this first segment with any advice you might have for people in the corporate world? You made the point a little earlier, "Ask questions when the news is good," and that's excellent advice. Nobody questions good news, or too infrequently people question good news. Do you have other comments to people who are working in the compliance field or just in the corporate world that might heighten their awareness of the likelihood of fraud in their midst?

[00:30:32] The best piece of advice that I can give to anybody in business is to ask questions. When I look back at my story, the inability or me not wanting to ask questions about some of the accounting things that we were doing and probing those led to an acceptance by others. I know that if somebody else would have asked a difficult question — "Shouldn't we write this off?" or "Shouldn't we acknowledge this?" — I know that I would have jumped in. I know that, in fact, though I didn't have the

courage at the time to ask a question. Questions spark debate. Debate leads to a solution. I think we were just looking for solutions without debate. If you present a solution and nobody questions it, a lot of people will march in that direction. I think the biggest thing that we can do in overcoming unethical behavior, illegal behavior, or whatever it is, is to ask good, probing questions that lead to debate.

[00:31:33] Thank you so much for joining me for part one of this two-part podcast. We can wrap today with the knowledge that you were headed off to serve two years in prison but then you emerged from prison, and one of the things that you do is co-found an organization called Prisonology. When we resume tomorrow, we're going to be talking about what Prisonology does and the need that it fills in the community. Thank you so much for joining me today, Walt.

[00:32:04] Thanks, Alexandra.