

Ring of Thieves

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(PFD File)

MCI introduced Walter Pavlo to a world of armed thugs, duffel bags stuffed with cash and phony accounting. Now, sitting in a South Carolina prison, he points a finger back at his former employer.

Walter Pavlo has plenty of time these days to walk the track inside South Carolina's secluded Edgefield prison. He takes a daily stroll with Mark Whitacre, the Archer Daniels Midland whistle-blower who is serving a ten-and-a-half-year sentence for fraud. Surrounded by drug convicts, camp fences and rolling woodlands, they chat about their pasts and draw parallels to the scandals swirling around big corporations now--at Enron, at Arthur Andersen, in telecom.

Pavlo, blond and still boyish at 39, committed his crimes at MCI as the telecom business roared in the mid-1990s. He is in the 15th month of a 41-month sentence for obstruction of justice, money laundering and mail fraud. An unremarkable rank-and-filer in a 25-person billing department, he says he cooked the books, under pressure from higher-ups, to help bolster MCI's growth. Pavlo employed an array of tricks--taught to him, he says, at MCI--to hide hundreds of millions of dollars in aging bad debts and clearly uncollectable receivables owed by a raft of upstart telecom resellers. In the process, he used the same sleight of hand to skim \$6 million on the sly for himself and a couple of partners; for that he is doing soft time.

The resellers stoked growth at a time when MCI, lit up by the halo of the Internet frenzy, was prettying itself up for a sale to someone bolder. The company, with Walter Pavlo's copious assistance, granted easy credit to dozens of fly-by-nights looking to lease its lines and resell service to businesses and consumers. It blithely let just about anyone, from raw rookies to pornographers and astrological touts, run up tens of millions of dollars in bills. Then, Pavlo says, MCI kept the receivables on its books long after any real hope of collecting had vanished--with the resellers themselves, in some cases. Banks, eager for high interest and fees, financed it all.

It was his job, he says, to hold these losses to a minimum, even if doing so required deceptive means. His actions benefited MCI. The company filed a proxy with the Securities & Exchange Commission recommending a \$20 billion buyout by British Telecom in 1997, just days after management knew it had fraud on its hands, according to a brief filed by a group of banks that sued MCI in 1997. That deal collapsed, and MCI then accepted a \$41 billion offer from WorldCom months later.

MCI denied the banks' allegations and has claimed it was duped by its own employees. At MCI only Pavlo and James B. Wilkie, a senior manager, have been punished (along with a third partner, an outsider named Harold R. B. Mann). For five years Pavlo has wondered when someone might take a hard look at the four levels above him, from his boss up to the chief financial officer--Douglas Maine, who later became chief financial officer at IBM and now runs its online arm--and above him to MCI chief executive Bert C. Roberts, who now is chairman of WorldCom.

And so when Pavlo learned one day in March, as he sat reading in the prison library, that the SEC is investigating whether there were any accounting misdeeds at WorldCom, he had one sentiment: "It's about time." He believes the remnants of his stunts are buried in a \$685 million pretax charge for bad receivables that WorldCom took in October 2000. The company blamed the big charge (\$405 million after tax benefits) on a handful of customers' going bankrupt in the previous quarter. Pavlo argues that the charge was, rather, a way to use the industry

downturn to mask the writeoff of receivables that had been rotting for years on the books of MCI and WorldCom, artificially boosting profits.

"This story is bigger than Walt Pavlo heisting money from MCI and going to jail," says Walt Pavlo. "This is about corruption of telecom, with lots of games. I didn't come to MCI knowing how to hide accounts receivable."

Pavlo is a convicted felon and an accomplished liar. But his claims have some supporters. A shareholder lawsuit, dismissed in April and now under appeal, makes the same claim about the October 2000 writeoff. The SEC seems to harbor similar suspicions, and in March it asked WorldCom to list the carriers included in the big charge, how much each owed and how old their debts were. WorldCom says the charge was proper but declines to comment about the SEC's inquiry or events at MCI.

Pavlo seemed an unlikely candidate for scandal. He grew up mostly near Sistersville, W. Va. and Savannah, Ga., with two younger brothers. His father describes Walter Jr. as a hard worker who started at quarterback in high school one season, more out of grit than athletic ability. Pavlo earned an industrial engineering degree at West Virginia University and an M.B.A. at Mercer in 1991. After working at Goodyear Aerospace, where he met his wife, Rhoda, he joined MCI in 1992 at age 29.

He was assigned to head a four-person group in the sleepy carrier finance department in Atlanta, which handled about \$240 million a month in billings in 1993. MCI and the entire telecom business were on the cusp of big change. After rising more than thirtyfold in 20 years, MCI's stock lost ground in 1994 and 1995. A year later deregulation promised to upend old monopolies and raze barriers to new competition, and soon MCI was in play. The smell of fast money was in the air.

A raft of new resellers began buying contracts to repackage MCI capacity as cut-rate long-distance, prepaid phone cards and caller-paid 900 numbers. For MCI and other big carriers it was a godsend. Consumer long distance was getting cutthroat. Margins on big corporate accounts were thinning. Resellers were another story. Most started small and paid rates with gross margins of 50% or more. Some doubled or tripled billings in a month.

The torrid growth set off a tug-of-war inside MCI: The sales side pursued resellers with alacrity, but the finance side worried about the resellers' ability to pay their bills. "Everyone who dealt with MCI considered them feudal and schizophrenic," says the chief of one prepaid-card service.

By 1995 Pavlo had risen to senior manager and the carrier finance unit had grown to 120 employees. It was handling \$650 million in collections a month. About 10% of sales, but a far larger slice of profits, came from resellers. At 32, Pavlo was the department's "target man," charged with handling high-risk accounts, collecting receivables and coming up with creative ways to dispose of them. It was a job Pavlo performed well, Ralph McCumber, his boss until the spring of 1996, stated in a deposition taken in the banks' 1997 lawsuit charging MCI with fraud.

But the job was taking a heavy toll on Pavlo. **MCI signed up resellers by the dozen and let bad billings mount. When Pavlo went out into the field to dun the debtors, he found a wild and woolly world.** One prepaid calling card outfit, Caribbean Telephone & Telegraph in Bloomfield Hills, Mich., signed on in early 1995. By midyear CT&T owed MCI \$30 million, Pavlo says. The small firm's debt swelled faster than MCI could even track it; MCI took 60 days to get a bill out and waited another 15 days before it came due. Pavlo visited CT&T's office in lower Manhattan, seeking payment, but owner James Franklin insisted he couldn't afford to pay. Really? Pavlo says he spotted duffel bags of cash, armed guards and money-counting

machines. Pavlo returned to Atlanta empty-handed and convinced that CT&T's pleas of poverty were a bit exaggerated. By February 1996 MCI had cut off service to CT&T, which had filed for Chapter 11 bankruptcy protection. Franklin blamed CT&T's problems on slow payments from its own customers.

At the Las Vegas office of one prepaid-card shop, Hi-Rim, a colleague of Pavlo's showed up to demand payment--and a Hi-Rim official threatened to go get his gun, the colleague says. Another reseller, Tel-Central, had a bit of star power: It was run by Dennis D. McLain, a 30-game winner as a Detroit Tigers pitcher who later was convicted of money laundering, theft and mail fraud. By early 1996 Tel-Central owed MCI up to \$30 million and had been cut off. McLain was indicted in 1998 along with John A. (Junior) Gotti in a phone-card scam, but the charges were dropped in 1999. McLain is now doing time for stealing \$3 million from Peet Packing's pension fund.

Big carriers added to the problems by locking resellers into "ramp-up" contracts that charged them set prices for an increasing number of minutes. Many soon found rivals retailing service at prices below what they had paid wholesale. For resellers, the choice was simple: Either keep collecting from their customers, stop paying MCI and pocket wads of cash--or pay MCI and go bankrupt. The uncollected bills got so bad that managers at MCI, WorldCom, Sprint and elsewhere discussed setting up a database to track offenders.

Pavlo was feeling the strain of it all. He was coming to work at 5 a.m. and staying late. He traveled constantly. Yet the more he worked, the worse the finances got. Until 1995 his group's bad debt had run \$10 million or so a year, well within range of the unit's 2% ceiling. Accounts more than 90 days past due remained in the 5% to 7% target range. But 1995 bad debt came in at \$90 million, and 90-days-late accounts had ballooned.

Pavlo sent his superiors a memo on Jan. 4, 1996, warning of \$88 million, and possibly more, in reseller receivables that MCI was unlikely to collect, the plaintiff banks allege. Accounting rules urge firms to write down such assets as soon as they realize they will not collect. But that means adding to bad debt reserves or posting a special loss, hurting earnings.

The banks alleged that James Folk, vice president in charge of revenue operations, revealed the threat to Don Lynch, a senior vice president reporting to Chief Financial Officer Douglas Maine. Pavlo says he got word back via Steven Rubio, an accounting senior manager: Whatever the numbers said, the 1995 carrier bad debt charge would be \$15 million. "We can't let this revenue get away. It's not in the plan," Pavlo says he was told. Folk, who has since left MCI, now lives in Olney, Md., Lynch is a telecom consultant in Fairfax, Va., Maine runs IBM.com and Rubio now is WorldCom's assistant controller. All four declined to comment.

Pavlo says he, Rubio and other MCI financial planners started meeting monthly to discuss the extent of the problem and how to make it go away. By early 1996 they had found an ingenious way to keep a creaky unpaid bill off the past-due ledger: Turn it into a promissory note. MCI's carrier finance group did this on a large scale for the first time in early 1996, decreeing that CT&T owed \$100 million on a promissory note. Recognizing that Hi-Rim was also going to welch, MCI disconnected it in March of 1996, wrote up a promissory note for at least \$35 million and carried the balance into 1997, according to the deposition testimony in the banks' lawsuit, taken from James Wanserski, director of finance for credit and collections and Pavlo's boss from March 1996 onward. Wanserski, who now works for Arthur Andersen in Atlanta, declined comment.

Pavlo says MCI had to have known the promissory notes were next to worthless but nonetheless told auditors it expected to collect 75% of face value.

Even the promissory gimmick, however, couldn't keep pace with MCI's rising balance of bills

90 days late. So Pavlo and colleagues resorted to another trick: misapplying so-called "unapplied cash," money customers sent in without specifying the bill it was intended for. At the end of each month a member of the carrier division went around asking, "Who needs money?" Typically, \$1 million to \$2 million was doled out to cover older accounts, according to Pavlo and two other former members of the department. Another tactic: postdating invoices.

"Accounting was real loose," says a former financial analyst in the department. "We'd move money around to keep over-90s down and managers off our backs."

"Placeholder credits" were another tool. The carrier finance department used them to credit a customer for up to several million dollars in payments as if the money had already been received, when it hadn't yet arrived at MCI. Sometimes the money behind a placeholder never showed up. In one case, Hi-Rim said it was sending a payment via FedEx. Pavlo's group credited its account and tracked the payment's progress. When the envelope was opened, says the former analyst, it was empty.

Placeholder credits apparently became common at MCI. "Competition among business divisions" over which one had the "youngest" receivables "has stimulated the posting of memo entries in advance of actuals," Folk, the revenue operations chief, wrote in a 1997 e-mail quoted in a lawsuit later filed by an MCI partner. "In time this practice became more the rule than the exception." Folk admitted in a deposition that this had led to "fudging" the age of receivables on MCI's books. What was in it for employees? "They get to keep their jobs."

Pavlo was stuck: He knew customers were taking in piles of cash yet refusing to pay their bills; he says his MCI bosses knew of the chicanery but refused to write off the receivable. Increasingly, he feared for his job and fretted about falling into legal jeopardy. He was drinking heavily--and growing resentful. Even if MCI sold out at a premium, Pavlo wasn't going to get rich like top managers. He earned \$70,000 and had vested options worth less than his salary.

"I'm getting instructions from other parts of MCI that aren't in writing, like 'Make the bad debt \$15 million,' but I'm the only one with my name all over this stuff," he says. "I started to feel I was going to be made into a scapegoat."

In early 1996 Pavlo complained to a pal and customer, Harold Mann of Iris Enterprises, a caller-paid 900 service that handled phone sex, a lottery for fishing licenses in North Dakota and fundraising for racist David Duke. Mann soon became a central player (and codefendant) in MCI's reseller scandal, along with James Wilkie, Pavlo's buddy and senior manager in MCI's carrier finance unit. Mann introduced Pavlo to Mark Benveniste, president of Manatee Capital, an Atlanta firm set up in 1994 to factor, or collect, debts, for caller-paid phone services, including Mann's Denmark Dial. Why not move up the food chain, acting, in effect, as a factor for MCI? Benveniste proposed that Manatee could deliver MCI's receivables in days instead of months by collecting from resellers' clients directly. The only catch was that factoring reseller receivables was risky. Benveniste told Pavlo the only way he could get bank financing was for MCI to cover any collections shortfalls. Why not? Pavlo figured. MCI was out the money anyway.

In March 1996 Pavlo met with Benveniste and several executives of National Bank of Canada at the swank Georgia Club in Atlanta. He told the bankers why MCI liked the factoring deal and said he was willing to sign a guarantee. After the meeting a loan officer called MCI's switchboard to make sure Pavlo worked there, according to court documents. That, it turned out, was the sum of due diligence for what turned out to be \$45 million in revolving credit set up for Manatee by National Bank of Canada, NationsBank (now part of Bank of America) and CIT Group--the banks that ended up suing MCI in the fallout in 1997. Never mind that Pavlo had the power to authorize credits of only \$50,000 at most, and that his superiors were

unaware of the guarantee. "It's absurd, but that was the level of greed at the table," Pavlo says.

Pavlo figured his superiors in finance would dislike the Manatee idea, so he pitched it to Dan Dennis, head of the \$7 billion (1996 revenue) carrier division, who loved it, he says. "Walt, you've cornered the market. You control the cash. This product is ingenious," is how Pavlo recalls Dennis responding. At Dennis' urging, Pavlov says he gave the program a name: Rapid Advance. Dennis, who has left MCI and now lives in Michigan, says he doesn't recall discussing such a program with Pavlo.

But Rapid Advance soon became big stuff in Dennis' division. In April 1996 MCI began using Rapid Advance to collect from delinquent resellers and lure new customers. It cranked out Rapid Advance banners, stopwatches and CD-ROMs. The sales force had Pavlo pitching it at its meetings. He was a star.

Little did MCI management know that Pavlo was working a side deal with Mann. Not long after Rapid Advance was up and running, Pavlo was griping to Mann over drinks at Taco Mac in Atlanta. He cited one reseller, Robert Hilby of Telemedia Networks, who owed MCI \$2 million and, Pavlo believed, had no intention of paying. Pavlo said he would love to rip off Hilby right back. Mann said he know how to make Hilby pay--and to pocket some cash in the process, according to Pavlo and Mann.

Mann contacted Hilby and offered to have his own factoring firm, Orion Management Services, pay off Telemedia's MCI debt in exchange for a \$200,000 upfront commission, 25% of Telemedia and a promise to pay back Orion over five years. Hilby took the offer, Pavlo says. He got a call from Hilby telling him of the Orion deal. Pavlo acted surprised and agreed. He wrote to Hilby, congratulating him for paying up. Then Pavlo and Mann flew first class to the Cayman Islands to party and deposit their \$200,000. Pavlo put his account in the name of Parnell Investments, after the street he had once lived on in Savannah. They checked in to the Coral Stone Club and celebrated with Cristal champagne and Cuban cigars. "I felt on top of the world sitting in the middle of Seven Mile Beach," Pavlo says.

Orion never paid MCI. Instead, Pavlo used tricks he had learned on the job, like diverting unapplied cash, to strike Telemedia's debt from MCI's books. Hilby could not be reached for comment, but in a deposition in the banks' suit against MCI, Hilby said he warned the carrier as early as October 1996 that he suspected a "conspiracy to defraud" MCI and its resellers.

All told, Pavlo, Mann, Wilkie and at least one other cohort signed on seven resellers with Orion. That included Tel-Central, Denny McLain's old outfit. They figured that by owning a piece of the resellers and forcing them into Manatee-style factoring deals, they could keep some money flowing to MCI and still skim off a nifty slice. Orion also skimmed money from four Manatee customers by making bogus claims against them and diverting payments as they came in, Pavlo says.

For a while, Pavlo says, he felt "bulletproof." Orion was bringing in tens of thousands of dollars a week and paying his wife \$100,000 a year (though she held a full-time job elsewhere). Pavlo was wearing custom-tailored suits, tooling around in limos and flying to the Caymans regularly. Orion even bought the little West Virginia steel business where his father worked. He knew his actions were wrong. "Was it legal? No. Was it unethical? Absolutely," he says. "I know that now. But at the time you find yourself in a situation like this and somehow justify it."

In August 1996 Pavlo visited Atlanta's exclusive Chateau Elan to brief senior MCI execs in town for the Summer Olympics. Pavlo says he reported that MCI held \$170 million in doubtful reseller accounts. Wanserski, who also attended the meeting, said in a deposition later that senior management discussed the debts of CT&T and the likelihood that writeoffs could soar.

"We just can't let this happen," Don Lynch, the senior vice president, responded in a conference call to the Atlanta group, Pavlo says. Pavlo left the meeting angry. The accounting games continued. Two months later, in October 1996, Wanserski flew to Washington D.C. to brief Chief Financial Officer Doug Maine on carrier bad debt. Maine declines to comment on the result. The following month, British Telecom announced plans to buy MCI for \$20 billion in the largest cross-border deal ever. If it went through, many senior MCI managers would reap overnight riches. It was then, Pavlo says, that his boss, Wanserski, took him into his office and told him: "You have to get us through this purchase."

But Pavlo was slipping. As the numbers mounted, it was becoming increasingly tough to disguise Orion's theft on MCI's books. Pavlo was gobbling Prozac and drinking a half-bottle of scotch a night. In January 1997 a carrier division analyst noticed that part of a \$41.5 million payment WorldCom had made for using MCI's network had been posted elsewhere. At first the analyst thought it was just another "covering of agings." But it was too big. Pavlo had shifted \$5 million to Denny McLain's Tel-Central in a desperate bid to cover his theft.

Wanserski sent an e-mail to Pavlo, who was at the Four Seasons at Rancho Mirage, Calif., and demanded a call at 4:30 local time the following morning, Pavlo says. He stayed up all night drinking and popping antidepressants. Wanserski wanted him back in the office immediately. Pavlo said there was nothing to talk about. Pavlo never returned to the MCI office. An investigation soon uncovered his role. According to a brief filed by the banks, by March 3, 1997 Wanserski and Folk knew MCI had fraud on its hands. Saying nothing, MCI filed a proxy four days later, recommending the BT merger.

Shortly afterwards James Folk, the boss of Pavlo's superior as vice president of revenue operations, discussed the events leading up to the fraud in an internal e-mail. "The second half of 1995 saw big growth in the carrier segment, which brought in unethical and shady companies," Folk wrote, according to a deposition he gave the following year in a breach-of-contract lawsuit that Manatee filed against MCI.

The banks, still counting on Pavlo's MCI guarantee, kept pushing Manatee to lend more. Unaware that Pavlo had been fired, they hiked Manatee's credit limit to \$30 million in March and to \$45 million two months later. The legal wrangling began in the fall of 1997 when, seven months after it uncovered Pavlo's scam, MCI reported it to the banks. Out at least \$28 million, they sued MCI for racketeering, fraud and breach of contract.

The suit, in the U.S. District Court in Atlanta, charged MCI with using Rapid Advance to keep overstated assets on its books, avoid writeoffs and "conceal misconduct, including the alteration and falsification of MCI's financial books and records." Manatee owner Jack T. Hammer sued MCI for breach of contract. MCI countersued the banks and Manatee for negligent misrepresentation, fraud and civil conspiracy. MCI claimed that Pavlo, Mann, Wilkie and Benveniste used Orion to divert funds from its resellers to accounts they controlled in the Caymans and then doctored MCI's accounts to hide the theft. Shortly thereafter, a grand jury began looking into the fraud charges against Pavlo and his co-conspirators. Wilkie turned himself in to federal prosecutors in 1998 and received jail time.

The maze of suits and countersuits was so complicated it took another two years to get to court. By then WorldCom owned MCI. It agreed in April 2000, on the second day of trial in the banks' case, to pay them \$8 million. Manatee owner Jack Hammer received \$1 million, though former president Benveniste is still fighting fraud charges in court and has pleaded not guilty.

After Pavlo was found out in early 1997, he was constantly looking over his shoulder, fearing he was being followed by the feds. Finally, in the summer of 2000, he walked into the FBI office in Atlanta to cut a deal. He entered a guilty plea in October 2000--the same month

WorldCom announced the \$685 million write-off now under SEC scrutiny. Pavlo entered prison in March of last year to serve 41 months but hopes to reduce it by 10 months by completing an alcohol treatment program. Harold Mann will begin a 54-month sentence this summer.

James Wanserski, Pavlo's ex-boss, stepped down when the scandal broke in October 1997. He was paid his \$138,752 salary, plus a \$50,000 incentive for cooperating in MCI's defense and for not disparaging the firm. The day after the agreement expired in 1998, he joined WorldCom's auditor, Andersen, in Atlanta.

The drama continues. Pavlo and Mann insist they have disgorged their entire ill-gotten gain--there's no stash on some island. The shareholder suit filed against WorldCom last year was dismissed by a judge in March but is on appeal. Along with the SEC investigation, it may or may not prove Pavlo to be a legitimate, whistle-blowing crook--just like Mark Whitacre of ADM. "I started out a company man but abandoned that to act selfishly, as I believed others were doing. I was wrong," Pavlo says. "But so were they."