A Cautionary Tale of Corporate Crime

By the time Bernie Ebbers was sentenced to 25 years in prison two months ago, Walter Pavlo had finished his time behind bars for wire fraud, money laundering, and obstruction of justice while working for MCI.

Fresh out of graduate business school in 1992, Pavlo, 29 years old at the time, joined MCI as manager of its carrier finance department in Atlanta. Over the course of four years, Pavlo manipulated the company's accounting records to hide hundreds of millions of dollars in uncollectible receivables and, with an outside partner, bilked MCI out of $35 million. The two pocketed $6 million for themselves.

Pavlo, who's on a speaking tour, told his story at a conference sponsored by the New York Society of Certified Public Accountants last June. It's an insider's account of intense pressure to "make the numbers," no matter how, at a high-flying company in the 1990s where stock options flowed like water. The culture was about pumping the stock price. Gung-ho salespeople signed any new customer. The carrier finance department waived these customers through, regardless of their creditworthiness. Management shunned bad debt write-offs. In this setting, the temptation to steal was great and, for some people, too great. Walt Pavlo was one of them.

At MCI in 1992, roughly 80% of its revenue and less than 20% of its profit came from low-risk/high-volume resellers of telecom capacity such as AT&T, Sprint, and Qwest. Some of these accounts were money losers for MCI; others had profit margins of no more than 2%. But the high-risk/low-volume customers—a raft of start-up companies selling prepaid phone cards and 900-number services carried over MCI's network—were pulling in less than 20% of revenues and 80% of profits. Margins on these accounts exceeded 100%.

But MCI didn't do a credit check on these companies. There was no security deposit required, no background check, no financial analysis of the customer's ability to pay. These resellers soon learned they could default on or delay payments to MCI with impunity. They had no assets. If MCI disconnected their service, the reseller would be out of business. That would ensure MCI would never get paid.

As total reseller billings grew from $250 million a month in 1992 to more than $1 billion a month by 1995, aging receivables mounted as well. Pavlo told his superiors about the delinquent accounts, and they said, "We can't write it off; it's not in the plan." The company enthusiastically reported most of its high-risk sales, meeting analyst expectations. In reality, though, Pavlo was constantly chasing these high-risk resellers for unpaid balances. He visited them across the U.S., trying to set up payment plans, usually to no avail.

Under pressure within MCI to hold the losses to a minimum, Pavlo began hiding bad debt—at first as a temporary fix—but the need for it continued, on and on.

Because he designed the accounts receivable system, he knew how to detect anomalies and how to hide them. He used unapplied cash to cover receivable balances, applied current payments to old balances, accelerated credits from unsigned contracts, and delayed credits from signed contracts. Companies that were disconnected for nonpayment were held on the books as collectible revenue. If a customer said, "The $5 million check is in the mail," Pavlo would have that posted immediately.

One such customer was Caribbean Telephone & Telegraph (CT&T) out of Bloomfield Hills, Mich. CT&T sold prepaid international calling cards to immigrants in inner cities. The company had cigarette and beverage delivery people sell the cards to retailers. Within months after getting on MCI's network, CT&T owed MCI $30 million. The $30 million quickly ballooned to $100 million.

Pavlo visited CT&T's office in lower Manhattan, but the owner insisted he couldn't afford to pay. Although Pavlo saw bags of cash, armed guards, and money-counting machines, he returned to Atlanta empty-handed. He instructed CT&T to execute a promissory note in the amount of $100 million and moved $100 million from current accounts receivable to short-term notes receivable. His superiors instructed him to tell MCI's young auditors from Arthur Andersen that there was a high probability MCI would collect that $100 million. In any case, the external auditors were going by revenues, not profits, and mostly examined MCI's large, low-risk accounts, Pavlo said.

Finally, Pavlo wrote a memo to his superiors in late 1995 saying that bad debt in 1996 would exceed $80 million—excluding the $100 million note from CT&T. Further, there was a likelihood of an additional $70 million in bad debt in the next 12 months. Their response was swift: Your 1996 budget for bad debt write-offs is $15 million. The goals of the company were going to be met.

Stung by management's reaction and running out of places to hide aging receivables, Pavlo confided in a friend, a former MCI reseller, who said he had a solution. This is how it worked:

Pavlo visited a start-up reseller that owed MCI $2 million and pressured them to pay, threatening to disconnect or sue them. Several days later, his partner, Harold R. B. Mann, visited the company, purporting to represent European investors who, he said, were very interested in investing in U.S. telecommunications companies. Mann then brought in legitimate auditors who pored over the books and found the money owed to MCI. The business owner said, "Yeah, we've got to take care of that," and Mann said, "I'll tell you what: I'm going to take care of that debt. I'm going to pay that $2 million. I want you to be a more responsible customer, then we can grow. We can get you more money down the line. For arranging this financing I'm going to get a fee of $250,000. I'm going to get 25% ownership of your company. And you're going to pay me back on a promissory note over three years in the amount of $10,000 a week. All funds are going to be paid to the European investors through banks in the Cayman Islands."

Back at MCI, Pavlo sent the reseller a bogus letter on MCI stationery, claiming that the debt had been paid by the "investor." He hid the $2 million receivable, making it appear that MCI was paid in full. Within six months, Pavlo and Mann had seven MCI customers join the scheme and $6 million in Cayman banks.

Pavlo justified it this way: The resellers weren't going to pay MCI anyway. MCI hadn't realized any bad debt. Profit goals were met. MCI's stock continued to rise. Stock option values climbed. There were no victims. Or so it seemed.

But soon after, the reality of what he had done hit him, Pavlo said. He realized he had a conscience, and his conscience sought to destroy him. He began drinking excessively and popping prescription pills. He was on the cusp of a nervous breakdown.

While away on business in early 1997, he got a call from an MCI official. They had detected an anomaly in accounting they didn't have an answer for. Would he come back and fix it? He knew he was caught, even though they didn't know it yet, and he resigned on the spot.

MCI began to get information from the resellers about the scheme and discovered what had become a $35 million fraud. Three years later, after multiple negotiations between Pavlo's lawyer and the FBI, Pavlo had had enough. Exhausted, broke, and emotionally spent, he pled guilty to wire fraud, money laundering, and obstruction of justice in October 2000. He was sentenced to 41 months in federal prison and ordered to pay a restitution of $5.9 million. (Harold Mann was later sentenced to 54 months in prison.)

That same month, WorldCom, which had acquired MCI in 1998, announced a $405 million charge against revenues because of uncollectible reseller accounts.

Before MCI, Pavlo never dreamed he would ever do anything criminal. But he's learned that almost anyone is vulnerable to committing an unethical act or white-collar crime. What's different today, he believes, is that tighter internal controls and ethics training protect people from harming themselves. ■