UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE WORLDCOM, INC.
SECURITIES LITIGATION

MASTER FILE NO.
02 Civ. 3288 (DLC)

JURY TRIAL DEMANDED

This Document Relates to:

02 Civ. 3288	02 Civ. 4990	02 Civ. 9513
02 Civ. 3416	02 Civ. 5057	02 Civ. 9514
02 Civ. 3419	02 Civ. 5071	02 Civ. 9515
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CORRECTED FIRST AMENDED CLASS ACTION COMPLAINT OF LEAD PLAINTIFF ALAN G. HEVESI, COMPTROLLER OF THE STATE OF NEW YORK, AS ADMINISTRATIVE HEAD OF THE NEW YORK STATE AND LOCAL RETIREMENT SYSTEMS AND AS TRUSTEE OF THE NEW YORK STATE COMMON RETIREMENT FUND, ON BEHALF OF PURCHASERS AND ACQUIRERS OF ALL WORLDCOM, INC. PUBLICLY TRADED SECURITIES

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Alan G. Hevesi, Comptroller of the State of New York, as Administrative Head of the New York State and Local Retirement Systems and as Trustee of the New York State Common Retirement Fund (the "NYSCRF"), as the Court-appointed Lead Plaintiff, together with Additional Named Plaintiffs, Fresno County Employees Retirement Association ("FCERA"), the County of Fresno, California ("Fresno") and HGK Asset Management, Inc. ("HGK'), bring this federal securities law class action individually and on behalf of all other persons and entities who purchased or acquired publicly traded shares, bonds or notes of WorldCom, Inc. ("WorldCom" or

the "Company") between April 29, 1999 and June 25, 2002 (the "Class Period"), based on the misrepresentations and material omissions asserted herein, and were injured thereby.

NATURE OF ACTION

1. This case arises from the largest corporate fraud and accounting scandal in United States history, a fraud that inflicted billions of dollars of damage across a broad swath of the investing public and triggered the largest bankruptcy in United States history. The fraud asserted in this Amended Complaint was perpetrated by, among others, senior officers of WorldCom, its directors, its outside auditor Arthur Andersen LLP ("Andersen"), the investment banking firm of Salomon Smith Barney, Inc. ("Salomon"), and a syndicate of underwriters, in violation of the Securities Act of 1933 (the "Securities Act") and the Securities and Exchange Act of 1934 (the "Exchange Act").

2. The scheme entailed the dissemination of materially false and misleading information concerning quarterly and annual financial statements of WorldCom in press releases; in each of the Company's filings with the United States Securities and Exchange Commission ("SEC"); in the registration statements issued for acquisitions initiated by WorldCom; and in the registration statements for Offerings of Senior Notes ("Notes") issued by WorldCom. The cornerstone of the scheme involved gross overstatements of earnings – well over $9 billion – in WorldCom's financial statements for the years 1999, 2000, 2001 and the first quarter of 2002.

3. As was ultimately revealed, this scheme was simple to perpetrate and even easier to discover, had the gatekeepers for the investing public – the auditors, underwriters and ostensibly independent research analysts – not averted their eyes. After each quarter, senior WorldCom officers reviewed the Company's results in order to determine how far those results fell below the consensus estimates of Wall Street analysts. They would then conspire to hide what in some cases were nine-figure shortfalls by making bogus entries in WorldCom's general ledger, reclassifying

line cost expenses to a variety of capital asset accounts without any supporting documentation or legitimate business rationale. According to the former WorldCom Controller who played a major role in the execution of the fraud: "I was instructed on a quarterly basis by senior management to ensure that entries were made to falsify WorldCom's books to reduce WorldCom's reported actual costs and therefore to increase WorldCom's reported earnings." See "Former WorldCom Exec Pleads Guilty," Associated Press, Sept. 27, 2002. The magnitude of this part of the fraud was first disclosed on June 25, 2002, when WorldCom announced that it would have to restate the certified financial results for all four quarters of 2001 and the first quarter of 2002 because it had, among other things, improperly treated more than $3.8 billion in ordinary costs as capital expenditures, in violation of generally accepted accounting principles ("GAAP").

4. These practices were patently criminal – the former Controller and three other WorldCom executives subsequently pleaded guilty to securities fraud and related charges – and they enabled WorldCom to report earnings that were inflated by billions of dollars. This in turn enabled the Company to meet Wall Street's estimates, thereby artificially inflating the price of WorldCom's stock and bonds in the secondary market. In addition, the scheme enabled WorldCom and one of its principal underwriters, Salomon, to defraud investors into purchasing approximately $17 billion in ostensibly "investment grade" Notes in May 2000 and May 2001 when, in fact, the Company was in dire financial straits.

5. The Company has further admitted that senior WorldCom executives also fraudulently manipulated reserves – amounts set aside primarily in connection with WorldCom's mergers to cover bad debt, merger costs and other problems – by deliberately setting aside too high a dollar figure in reserve accounts and then dipping back into the reserve accounts to make up for gaps in projected and actual profits. WorldCom has to date estimated the impact of these

maneuvers as adding an additional $3.3 billion in improperly reported earnings before interest, taxes, depreciation and amortization ("EBITDA") for the years 1999, 2000, 2001 and the first quarter 2002. WorldCom has also admitted that it improperly booked close to $1 billion in revenue during the Class Period. In sum, as of the filing of this Amended Complaint, WorldCom has admitted that its financial statements for the years 1999 through 2002 were overstated by well over $9 billion. WorldCom has also written off approximately $80 billion of the stated book value of the assets on its balance sheet as of June 25, 2002.

6. WorldCom's disclosures wreaked havoc on the financial markets. WorldCom common stock dropped from a Class Period high of approximately $96.75 per share to pennies, leading to its delisting from the NASDAQ exchange. The impact on WorldCom bonds was also catastrophic. For example, on June 27, 2002, WorldCom 8% Notes, which had a value of $62.25 a few days prior to the announcement, traded at $11, a loss of over 80%. These Notes once traded as high as $106. Published estimates place the losses of WorldCom bondholders alone at more than $9 billion. On July 21, 2002, WorldCom filed for protection under Chapter 11 of the Bankruptcy Code in this District – the largest bankruptcy ever.

7. The reaction of the Nation's senior leadership to the unfolding WorldCom debacle was immediate and fierce. The President called the revelations "outrageous." The Chairman of the SEC labeled the accounting manipulations "fraud, not mistake." On June 26, 2002, the day after WorldCom's announcement of the initial $3.8 billion restatement, the SEC filed a complaint in this District accusing the Company of securities fraud. One day later, Congress launched an investigation of WorldCom. On July 8, 2002, the House Committee on Financial Services held a hearing regarding WorldCom. Rather than answer the Committee's questions concerning what had occurred at WorldCom, Bernard Ebbers ("Ebbers"), WorldCom's former CEO, and Scott Sullivan

("Sullivan"), WorldCom's former CFO, invoked their Fifth Amendment right against self-incrimination and refused to testify.

8. The scope and audacity of the fraud also triggered a swift response by the United States Attorney for this District. Sullivan and WorldCom's former Controller, David Myers ("Myers"), were arrested on August 1, 2002 and charged with seven felonies, including securities fraud, conspiracy to commit securities fraud, and filing false statements with the SEC. Myers pleaded guilty to those charges several weeks later; Sullivan did not, and was indicted on those charges on August 28, 2002. Named as a co-defendant with Sullivan in that indictment was Buford Yates, Jr. ("Yates"), the former WorldCom Director of General Accounting. Yates pleaded guilty to those charges on October 7, 2002. On October 10, 2002, two other senior WorldCom employees, Betty Vinson ("Vinson") and Troy Normand ("Normand"), pleaded guilty to charges of securities fraud and conspiracy to commit securities fraud. Myers, Yates, Vinson and Normand, who are cooperating with the U.S. Attorney in the continuing investigation of the WorldCom fraud, each told the Court that they were instructed to cook the books at WorldCom by their superiors in management.

9. The fraud could not have succeeded to the extent it did without the active participation and collaboration of Salomon. Salomon was a co-lead underwriter for two huge public offerings of WorldCom Notes that generated a staggering $17 billion for WorldCom in one twelve-month span. Like the other underwriters on those debt offerings, Salomon is liable under § 11 of the Securities Act for the materially false and misleading statements and omissions regarding WorldCom's financial condition and business affairs that were set forth in the registration statements issued in connection with those offerings. As described more fully below, Salomon is also liable for fraud in connection with those offerings because, under § 10(b) of the

Exchange Act, at the time the offerings were made, Salomon knew, or recklessly disregarded, that WorldCom's financial condition and other material facts were not as the offering documents represented them to be.

10. Salomon's knowledge, or reckless disregard, of the falsity of statements regarding WorldCom's financial condition and matters pertaining to its business was not limited to the two bond offerings. Throughout the Class Period, Salomon's "star" telecommunications analyst, Jack Grubman ("Grubman"), issued dozens of analyst reports touting WorldCom and urging investors to, in Grubman's words, "load up the truck" with WorldCom stock. However, as was ultimately revealed, Grubman's analyst reports and the public offerings underwritten by Salomon – which generated tens of millions of dollars in underwriting fees and brokerage commissions for Salomon – were part of a shell game that WorldCom and Salomon played on investors. Purchasers of WorldCom's stocks and bonds were never told that the purportedly "independent" raves from Grubman had in fact been purchased as an integral part of the investment banking services that Salomon provided to WorldCom.

11. Nor were investors apprised that WorldCom officers and directors received millions in profits through "hot" offerings in initial public offerings ("IPOs") underwritten by Salomon. From the late 1990s through 2001, Salomon and Grubman routinely allocated to WorldCom executives, including Ebbers and Sullivan, extremely valuable, coveted shares in companies that Salomon was about to take public. Ebbers sold many of these shares soon after the IPOs, making millions of dollars. The NYSCRF's investigation has determined that when then-CFO Sullivan complained to Salomon and Ebbers that his share of the allocations was in his view too low, Salomon responded by increasing Sullivan's allocation – and Ebbers pacified his confederate by sharing his profits from these sales. In turn, Ebbers and Sullivan ensured that the lion's share of

WorldCom's investment banking business went to Salomon; between October 1997 and February 2002, Salomon made more than $107 million from this relationship. As noted above, as a crucial part of this illicit arrangement, Grubman agreed to write extremely positive – and materially false – research reports about WorldCom, continually pumping the stock regardless of merit. In October 1999, when the analytical "cash flow" model that Grubman used to value telecom companies threatened to expose WorldCom's financial deterioration just as the Company announced plans to use its stock to fund the acquisition of Sprint Corporation ("Sprint"), Grubman abruptly changed to use a different "cash earnings" model for WorldCom – even though he continued to use the cash flow model for all the other telecom stocks for another two years. Grubman did so in order to deflect attention away from WorldCom's faltering financial condition – a circumstance well known to Grubman by virtue of the incomparable access that he and his research team enjoyed with respect to the WorldCom financial data. Unbeknownst to investors, Grubman's compensation depended upon the amount of investment banking business he brought in, and WorldCom was his cash cow. Thanks largely to WorldCom, Grubman made approximately $20 million per year in his final years at Salomon, and Grubman knew that would continue only so long as WorldCom's stock remained at levels high enough to allow the Company to continue to pursue its acquisitions and conduct public offerings.

12. Grubman's efforts to persuade the investing public that WorldCom was much healthier than he knew it to be were not limited to his own materially false statements and omissions. As described below at ¶¶ 319-326, Grubman went so far as to script false and misleading public statements by Ebbers and others at WorldCom instructing them on what to say to the investing public in order to ease investors' concerns about WorldCom.

13. In its original complaint filed in October 2002, the NYSCRF illuminated additional facts about the nefarious relationship between Ebbers and Salomon that had not been previously disclosed. Starting in the fall of 1999, for example, Grubman and others at Salomon helped Ebbers to obtain a series of secret loans on the order of a half billion dollars from The Travelers Insurance Company ("Travelers"), which like Salomon is wholly owned by Citigroup, Inc. ("Citigroup"). To disguise the identity of the borrower, the loans were made to a shell corporation named Joshua Timberlands LLC ("Joshua Timberlands"), which Ebbers set up in Mississippi just a few weeks before the first loan was made. Ebbers then used that money to buy over 548,000 acres of land in Alabama, Tennessee, Mississippi, and Louisiana for his own personal use.

14. The timing and nature of these loans – and the relationship among the various decision makers within Citigroup – confirm that Citigroup used the lure of multi-hundred million dollar loans to WorldCom's CEO to complement what one prominent regulator called the "commercial bribery" of IPO spinning and corrupted analyst reports. In the Fall of 1999, as Citigroup's Travelers was secretly arranging to loan Ebbers' timber company the first installment of funds – $290 million – Citigroup's Salomon was at the same time lobbying to be selected by Ebbers' telecommunications company as its investment banker for the largest, and most lucrative, corporate deal in history: WorldCom's prospective $129 billion takeover of Sprint. Among the people at Salomon eager to land that piece of investment banking business was Michael Carpenter ("Carpenter"). Carpenter held a number of positions within Citigroup that would facilitate his and Salomon's effort to win WorldCom's business, for at the same time that Carpenter was serving as CEO of Salomon, he was also serving as chairman of the Travelers board of directors that approved the first $290 million loan to Ebbers. The Travelers' board, which also included Sanford Weill's

son, Marc Weill, approved this enormous loan just before WorldCom announced its intent to buy Sprint – with Salomon as its investment banker.

15. The use of huge, secret loans to curry favor with WorldCom's CEO did not end in 1999. Ebbers received another $209 million in loans from Travelers in February 2000 – just prior to WorldCom selecting Salomon as co-lead underwriter for its $5 billion bond offering in 2000 and its approximately $12 billion bond offering in 2001– the largest in history.

16. As explained more fully below in ¶¶ 349-370, the loans allowed Ebbers access to enormous sums of cash without having to sell his WorldCom shares. In some instances, land acquired with the loans from Travelers was immediately re-sold to third parties who paid cash to Joshua Timberlands, without any corresponding payment to reduce the loan balance. In addition, documents obtained from state agencies in Mississippi, Alabama, Tennessee and Louisiana show that Travelers had, on hundreds of occasions throughout the balance of the Class Period, affirmatively released its collateral interest in timber on the acquired property – allowing Ebbers to cut that timber for cash – without any commensurate paydown of the Travelers loans.

17. As noted in the NYSCRF's original complaint, at least one press report in Alabama indicated that the Travelers loans were secured by Ebbers' WorldCom stock. Though Citigroup has since specifically denied that the Travelers loans were so secured, it declined to deny that there were other loans to Ebbers secured by his WorldCom shares. A December 31, 2002 article in The Wall Street Journal reported that over $50 million in loans to Ebbers by yet another Citigroup entity – Citibank – were in fact secured by Ebbers' WorldCom stock; thus, by mid-1999, Salomon's parent was on the hook for huge loans whose value rode on the strength of WorldCom's stock – powerful incentive to make sure that the public perception of the Company, and its share price, did not suffer.

18. The NYSCRF's ongoing investigation has unearthed even more evidence of the secret links between Ebbers and various arms of Citigroup. For example, on the same day Ebbers received the block of loans totaling $209 million in early 2000, his Joshua Timberlands executed documents memorializing a billion dollar mortgage owed to Travelers. The mortgage, dated February 15, 2002, refers to some (though not all) of the $499 million in loans given to Ebbers through that date, and notes the possibility of additional indebtedness by Ebbers to Travelers to be covered by the mortgage.

19. Moreover, in addition to the staggering amounts of money that Citigroup secretly loaned to Ebbers, the NYSCRF has located state records filed in Tennessee which show that Travelers had become an equity partner with WorldCom's CEO in Joshua Timberlands. In a filing required to identify each member of a limited liability company doing business in Tennessee during 2000, the submission for Joshua Timberlands lists Travelers as one of only three equity members.

20. None of these facts was disclosed to WorldCom investors. Investors were never informed of the quid pro quo arrangements between WorldCom and Salomon, nor were they informed that each of the bond offering registration statements and "buy" recommendations upon which they relied had been purchased by WorldCom and was an integral part of an investment banking package of services. They were not informed that Grubman's positive ratings for WorldCom were issued in exchange for WorldCom's investment banking business, that Grubman had altered his valuation model in order to obscure WorldCom's deteriorating finances, that Grubman was orchestrating misleading public statements by senior WorldCom managers, and that Grubman's compensation depended on issuing his overheated and deceptive ratings. Investors were not informed of the $499 million in loans to WorldCom's CEO by the corporate sibling of the lead underwriter for WorldCom's bond offerings. They were not informed that Ebbers and

Salomon's corporate sibling were business partners in a sprawling timber enterprise. They were not cautioned that the CEO of the nation's second largest telecommunications company was so highly leveraged that he faced personal financial ruin if the price of WorldCom stock dropped, or that he would undoubtedly be distracted by the demands of running that timber empire and the myriad other businesses of which so many of these defendants were aware.

21. In addition, the Examiner and Special Committee Reports (defined below) published since this action was commenced confirm that the underwriters for the $17 billion in WorldCom bonds sold in May 2000 and May 2001 did no due diligence on behalf of the investing public. Among other things, the underwriters failed to conduct any due diligence to determine whether WorldCom had the means, intent, and ability to satisfy the staggering amount of debt it was accumulating. Had they looked, the underwriters would have seen that WorldCom's board of directors was utterly derelict in fulfilling the most basic functions of a true board; that the Board typically failed to consider many significant multi-billion dollar acquisitions WorldCom had made; that there was no legitimate business purpose for these transactions, which were in fact having an extremely negative impact on WorldCom's business; that WorldCom's officers and directors had spent little, if any, time discussing or examining the Company's increasing accumulation of debt, even during board meetings immediately before and after the debt offerings; that WorldCom had no projections or models assessing whether the Company could sustain the enormous amount of debt it was incurring; and, incredibly, that WorldCom did absolutely no strategic debt planning that would have enabled the Company to understand and monitor its debt. Had the underwriters conducted proper due diligence, they would have also learned that the Company had no means by which to monitor its debt, and that it had no plans for how it intended to satisfy its massive debt. Had the bankers seriously weighed the import of the WorldCom board minutes, they would have

seen what the Examiner and Special Committee found immediately apparent: the WorldCom board was nothing more than a "rubber stamp" and was in no way an internal check and balance on WorldCom's management. Incredibly, not only were these highly material facts not disclosed to investors, there were no risk disclosures in the registration statements issued in connection with the May 2000 and May 2001 Offerings. Simply, the underwriters failed to examine and identify risks to potential purchasers of these securities – including the risk that WorldCom did not even have the ability to monitor its debt – let alone pay it off.

22. Had these and other material facts discussed herein been disclosed to investors, the debt offerings would not have occurred and the price of WorldCom's securities would never have reached the heights they attained.

JURISDICTION AND VENUE

23. Certain of the claims asserted herein arise under and pursuant to Sections 10(b) and 20(a) of the Exchange Act, 15 U.S.C. §§ 78j(b), 78r and 78t(a), and Rule 10b-5 promulgated thereunder by the SEC, 17 C.F.R. § 240.10b-5. Certain other of the claims asserted herein arise under and pursuant to Sections 11, 12 and 15 of the Securities Act, 15 U.S.C. §§ 77k, 77l(a)(2) and 77o.

24. This Court has jurisdiction over the subject matter of this action pursuant to Section 22 of the Securities Act, 15 U.S.C. § 77v, Section 27 of the Exchange Act, 15 U.S.C. § 78aa, and pursuant to 28 U.S.C. § 1331, in that this is a civil action arising under the laws of the United States.

25. Venue is proper in this District pursuant to Section 22 of the Securities Act, 15 U.S.C. § 77v, Section 27 of the Exchange Act, 15 U.S.C. § 78aa, and pursuant to 28 U.S.C. § 1391(b). Many of the acts and transactions constituting the violations of law alleged herein, including the preparation, issuance, and dissemination of materially false and misleading

statements, occurred in this District. For instance, WorldCom's quarterly and year-end financial statements were transmitted to the New York, New York offices of Merrill Communications LLC, a filing agent that assists companies in electronically filing periodic reports with the SEC, and were thereafter transmitted electronically by a Merrill Communications subcontractor, located in New York, New York, to the SEC and were filed electronically with the SEC. In addition, certain of the individual defendants reside in this District, as do most of the underwriter defendants.

26. In connection with the acts alleged in this Amended Complaint, defendants, directly and indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the United States mails, interstate telephone communications and the facilities of the national securities exchanges.

PARTIES

Lead Plaintiff

27. The NYSCRF purchased or acquired WorldCom securities during the Class Period and suffered damages as a result of the federal securities law violations alleged herein. As established by Article 9 of the New York Retirement and Social Security Law, the NYSCRF holds and invests the assets of the New York State and Local Employees' Retirement System and the New York State and Local Police and Fire Retirement System (combined, the "New York State Local Retirement Systems"). The NYSCRF is the second largest public pension fund in the nation. As of December 31, 2002, it had approximately 950,000 active members, retirees, and other beneficiaries and approximately $100 billion in assets. Alan G. Hevesi, the Comptroller of the State of New York, is the sole trustee of the NYSCRF. During the Class Period, the NYSCRF purchased 15,315,138 shares of WorldCom stock, 267,499 shares of WorldCom MCI tracking stock, and $1,001,400 worth of WorldCom debt securities. As a result of these purchases of WorldCom securities, the NYSCRF suffered losses in the amount of $317,492,544.54. On August

12, 2002, the Honorable Denise L. Cote appointed the NYSCRF as Lead Plaintiff for this litigation.

Additional Named Plaintiffs

28. The Fresno County Employees Retirement Association purchased or acquired WorldCom securities during the Class Period and suffered damages as a result of the federal securities law violations alleged herein. FCERA is an entity formed under the State of California's County Employees' Retirement Law of 1937. FCERA invests funds for the exclusive purpose of providing retirement compensation, death benefits and disability benefits to participants in the pension or retirement system for Fresno County employees and their beneficiaries. As of June 30, 2002, as of June 30, 2003, it had approximately 13,000 active members, retirees, and other beneficiaries and over $1.4 billion in assets. During the Class Period, FCERA purchased 511,800 shares of WorldCom stock, 33,700 shares of WorldCom MCI tracking stock, and $8,198,295.50 worth of WorldCom debt securities, including over $3,500,000 of Notes in the May 15, 2001 Note Offering (the "May 2001 Offering"). As a result of these purchases of WorldCom securities, FCERA suffered losses in the amount of $11,121,591.57. FCERA, which is not a Lead Plaintiff in this Action, has joined in this action as a Named Plaintiff and proposed Class Representative.

29. The County of Fresno, California ("Fresno") purchased or acquired WorldCom securities during the Class Period and suffered damages as a result of the federal securities law violations alleged herein. Fresno is a political subdivision of the state of California that invests general funds of the County of Fresno, California under California law for the benefit of its citizens. During the Class Period, Fresno purchased $6,352,697.37 worth of Notes in the May 24, 2000 Note Offering (the "May 2000 Offering"). As a result of these purchases of WorldCom securities, Fresno suffered losses in the amount of $5,537,702.37. Fresno, which is not a Lead Plaintiff in this Action, has joined in this action as a Named Plaintiff and proposed Class Representative.

30. HGK Asset Management, Inc. purchased or acquired WorldCom securities during the Class Period and suffered damages as a result of the federal securities law violations alleged herein. HGK is a registered investment advisor under the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1, et seq. and acts as a fiduciary to its union-sponsored pension and benefit plan clients under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 et seq. As of October 10, 2002, HGK had more than 80 client relationships and managed over $2 billion in assets. HGK is authorized to bring the claims asserted herein. During the Class Period, HGK purchased 456,300 shares of WorldCom stock and $133,458,993.25 worth of WorldCom debt securities, including over $41,000,000 of Notes in the May 2000 Offering and approximately $30,000,000 of Notes in the May 2001 Offering. As a result of these purchases of WorldCom securities, HGK suffered losses in the amount of $28,871,449.14. HGK, which is not a Lead Plaintiff in this Action, has joined in this action as a Named Plaintiff and proposed Class Representative.

Defendants

31. Defendant Ebbers was President, Chief Executive Officer and a Director of WorldCom at all relevant times until approximately April 29, 2002, when he was forced to resign from the Company. Ebbers signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and the May 2001 Offering.

32. Defendant Sullivan was Chief Financial Officer and a Director of WorldCom at all relevant times until June 25, 2002, when he was terminated by the Company. Between April 30, 2002 and June 25, 2002, he also served as Executive Vice President. Sullivan signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; the

Company's Quarterly Reports for each quarter of the years 1999 through 2001 and the first quarter of 2002 on Forms 10-Q; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and May 2001 Offering. On August 1, 2002, Sullivan and former WorldCom Controller Myers were arrested by the Federal Bureau of Investigation ("FBI") and charged in a criminal complaint dated July 31, 2002 with seven felonies, namely, conspiracy to commit securities fraud, securities fraud, and five false filings with the SEC. On August 28, 2002, a federal grand jury empanelled in this District returned an indictment that charged Sullivan and Yates, former WorldCom Director of General Accounting, with seven felonies, namely, conspiracy to commit securities fraud, securities fraud and five counts of false filings with the SEC. On December 5, 2002, this Court entered an order staying the prosecution of this litigation against Sullivan.

33. Defendant Myers was Controller and a Senior Vice President of WorldCom at all relevant times until June 25, 2002, when he resigned his positions at WorldCom. As noted above, Myers was charged with seven felonies in a criminal complaint and, like Sullivan, was arrested by the FBI on August 1, 2002. On September 26, 2002, Myers pled guilty to a three count criminal information charging him with conspiracy, securities fraud and filing false documents with the SEC. On December 5, 2002, this Court entered an order staying the prosecution of this litigation against Myers.

34. Defendant Yates was, at all relevant times, the Director of General Accounting at WorldCom. As noted above, Yates was charged with seven felonies in an indictment. He was arrested by the FBI on August 28, 2002. On October 7, 2002, Yates pled guilty to two counts of the indictment, namely, conspiracy to commit securities fraud and securities fraud. By stipulation and order dated May 6, 2003, this litigation against Yates was stayed.

35. Defendant James C. Allen ("Allen") was, at all relevant times, a Director of WorldCom and a member of the Audit Committee of the Board. Allen signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and May 2001 Offering.

36. Defendant Judith Areen ("Areen") was, at all relevant times, a Director of WorldCom and a member of the Audit Committee of the Board. Areen signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and May 2001 Offering.

37. Defendant Carl J. Aycock ("Aycock") was, at all relevant times, a Director of WorldCom. Aycock signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and May 2001 Offering.

38. Defendant Max E. Bobbitt ("Bobbitt") was, at all relevant times, a Director of WorldCom and the Chairman of the Audit Committee of the Board. Bobbitt signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and May 2001 Offering.

39. Defendant Francesco Galesi ("Galesi") was, at all relevant times, a Director of WorldCom and a member of the Audit Committee of the Board. Galesi signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its

registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and May 2001 Offering.

40. According to WorldCom's filings with the SEC, defendants Bobbitt, Allen, Areen and Galesi were members of the Board's Audit Committee from 1999 through 2002. According to WorldCom's Proxy Statements for the years 1999 through 2002, the Audit Committee performed the following functions during the relevant period: (a) review of periodic financial statements; (b) communication with independent accountants; (c) review of internal accounting controls; and (d) recommending selection of independent accountants to the Company's Board of Directors.

41. Defendant Clifford L. Alexander, Jr. ("Alexander") was, at all relevant times, a Director of WorldCom. Alexander signed the Company's annual reports filed with the SEC for the years 1999 and 2000 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and the May 2001 Offering.

42. Defendant Stiles A. Kellett, Jr. ("Kellet"), was, at all relevant times, a Director of WorldCom and Chairman of the Board's Compensation Committee. Kellett signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and the May 2001 Offering.

43. Defendant Gordon S. Macklin ("Macklin") was, at all relevant times, a Director of WorldCom. Macklin signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2002; and the registration statements related to the May 2000 Offering and the May 2001 Offering.

44. Defendant John A. Porter ("Porter") was a Director of WorldCom until September 2001. Porter signed the Company's annual report filed with the SEC for the year 1999 on Form 10-K; the registration statement for WorldCom's acquisition of Skytel Communications in 1999; and the registration statements related to the May 2000 Offering.

45. Defendant Bert C. Roberts, Jr. ("Roberts") was, at all relevant times a Director of WorldCom and further served as Chairman of the Board. Roberts signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2002; and the registration statements related to the May 2000 Offering and the May 2001 Offering.

46. Defendant John W. Sidgmore ("Sidgmore"), was, at all relevant times, a Director of WorldCom and further served as Vice Chairman. Sidgmore signed the Company's annual reports filed with the SEC for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2001; and the registration statements related to the May 2000 Offering and the May 2001 Offering.

47. Defendant Lawrence C. Tucker ("Tucker") was, from May 1995 to November 2000 a Director of WorldCom. Tucker signed the Company's annual reports filed with the SEC for the year 1999 on Form 10-K; the registration statement for WorldCom's acquisition of Skytel Communications in 1999; and the registration statement related to the May 2000 Offering.

48. Defendants Ebbers, Sullivan, Myers, Yates, Allen, Areen, Aycock, Bobbitt, Galesi, Alexander, Kellett, Macklin, Porter, Roberts, Sidgmore, and Tucker are collectively referred to herein as the "Individual WorldCom Defendants."

49. Defendant Andersen was formerly a "Big 5" firm of certified public accountants. At all times relevant to this action, Andersen provided auditing and accounting services to WorldCom,

including but not limited to, undertaking audits of the Company's year-end financial statements and reviews of its quarterly statements. In connection therewith, Andersen issued unqualified audit reports relating to WorldCom's financial statements, for inclusion in each of the Company's annual reports for the years 1999 through 2001 on Forms 10-K; each of its registration statements for WorldCom acquisitions between 1999 and 2002; and for the registration statements related to the May 2000 Offering and May 2001 Offering. Andersen further performed reviews on each of WorldCom's quarterly financial statements issued with respect to the first three quarters of 1999, the first three quarters of 2000, the first three quarters of 2001, and the first quarter of 2002. On or about May 14, 2002, Andersen was replaced as WorldCom's outside auditor by KPMG LLP.

50. Defendant Salomon, now d/b/a Citigroup Global Markets Inc., is a subsidiary of defendant Citigroup, a financial services institution that, through its subsidiaries and divisions, provides commercial and investment banking services and commercial loans to corporate entities. Salomon was the book running manager and co-lead underwriter for the May 2000 Offering. It sold $518,750,000 worth of the 8% Notes due May 15, 2006, which were sold in that Offering. Salomon also was the joint book-runner and co-lead underwriter for the May 2001 Offering. In connection with that Offering, Salomon sold $480,000,000 worth of the 6.50% Notes due 2004; $1,290,000,000 worth of the 7.50% Notes due 2011; $1,472,000,000 worth of the 8.25% Notes due 2031; and through its affiliate, Defendant Salomon Brothers International Limited, €403,125,000 worth of the Euro 6.75% Notes due 2008 and £160,000,000 worth of the Sterling 7.25% Notes due 2008. (Together, Defendants Salomon and Salomon Brothers International Limited are referred to as the "Salomon Underwriters".) Salomon further served in numerous other capacities with respect to, among other things, WorldCom's acquisitions and mergers during the Class Period, WorldCom's corporate stock option plans, and WorldCom employees' stock transactions.

According to a Complaint filed in September 2002 by the New York Attorney General against Ebbers and other beneficiaries of Salomon's IPO "spinning" scheme (described in **&&** 253-262 below), between October 1997 and February 2002, Salomon advised WorldCom on approximately twenty-three investment banking deals and garnered investment banking fees of approximately $107 million from those deals.

51. Defendant Citigroup, an international financial services company, was formed in 1998 by the merger of Citicorp and Travelers. Citigroup, which services more than 200 million customer accounts in more than 100 countries, is the corporate parent and 100% owner of defendant Salomon and reports Salomon's financial results in its consolidated financial statements. Through its corporate control over its subsidiary, Salomon, Citigroup was able to control, and did control, the financial analyst reports published by Salomon during the Class Period.

52. Defendant Grubman was the primary telecommunications industry analyst at Salomon and a managing director until August 15, 2002, when he resigned from Salomon. Salomon reportedly earned more than $856 million in investment banking fees during 1999-2001 from telecommunications companies that Grubman covered. According to the New York State Attorney General, Grubman earned an average of $20 million a year between 1999 and 2001. Additionally, upon his termination from Salomon, it has been widely reported that he received a severance package valued at approximately $32 million. This package consisted of $4 million in cash, $13 million in deferred compensation, and forgiveness of $15 million in loans. The package provides Grubman with $200,000 per year and a staffed office to facilitate his work on "legal matters."

53. Defendant J.P. Morgan Chase & Co. ("J.P. Morgan") is a financial services institution that, through its subsidiaries and/or affiliates, including Defendant J.P. Morgan

Securities, Inc. and Defendant J.P. Morgan Securities, Ltd., provides commercial and investment banking services and advisory services. Defendant J.P. Morgan Securities, Inc., was co-lead underwriter for the May 2000 Offering. It sold $375,000,000 worth of the 8% Notes due May 15, 2006, which were sold in that Offering. J.P. Morgan Securities, Inc. also was the joint book runner and co-lead underwriter for the May 2001 Offering. In connection with that Offering, J.P. Morgan Securities, Inc. sold $480,000,000 worth of the 6.50% Notes due 2004; $1,290,000,000 worth of the 7.50% Notes due 2011; $1,472,000,000 worth of the 8.25% Notes due 2031; and Defendant J.P. Morgan Securities, Ltd. sold €403,125,000 worth of the Euro 6.75% Notes due 2008 and £160,000,000 worth of the Sterling 7.25% Notes due 2008. Together, Defendants J.P. Morgan, J.P. Morgan Securities, Inc. and J.P. Morgan Securities, Ltd. are referred to as the "J.P. Morgan Underwriters."

54. Defendant Banc of America Securities LLC ("Banc of America") is a subsidiary of Bank of America Corp., a financial services institution that, through its subsidiaries and divisions, provides commercial and investment banking services and commercial loans to corporate entities. Banc of America was an underwriter for the May 2000 Offering, and sold $93,750,000 worth of the 8% Notes due May 15, 2006, which were sold in that Offering. Banc of America was also a joint lead manager of the May 2001 Offering. In connection with that Offering, Banc of America sold $165,000,000 worth of the 6.50% Notes due 2004; $440,000,000 worth of the 7.50% Notes due 2011; $506,000,000 worth of the 8.25% Notes due 2031; and, through its affiliate, Defendant Banc of America Securities Limited, €137,500,000 worth of the Euro 6.75% Notes due 2008 and £55,000,000 worth of the Sterling 7.25% Notes due 2008. During and prior to the Class Period, Banc of America further extended personal loans to defendant Ebbers, in amounts totaling approximately $200 million, backed by Ebbers' own WorldCom stock as collateral. When the

price of WorldCom fell, Banc of America made certain margin calls, which were paid by loans extended by WorldCom's Board to Ebbers. Together, Defendants Banc of America and Banc of America Securities Limited are referred to as the "Banc of America Underwriters".

55. Defendant Deutsche Bank Securities Inc., now known as Deutsche Bank Alex. Brown Inc. ("Deutsche Bank"), is a subsidiary of Deutsche Bank AG, a financial services institution that, through its subsidiaries and divisions, provides commercial and investment banking services and commercial loans to corporate entities. Deutsche Bank was an underwriter for the May 2000 Offering. It was also a joint lead manager of the May 2001 Offering. In connection with that Offering, Deutsche Bank sold $120,000,000 worth of the 6.50% Notes due 2004; $320,000,000 worth of the 7.50% Notes due 2011; $368,000,000 worth of the 8.25% Notes due 2031; and, through its affiliate, Defendant Deutsche Bank AG London, €100,000,000 worth of the Euro 6.75% Notes due 2008 and £40,000,000 worth of the Sterling 7.25% Notes due 2008. Together, Defendants Deutsche Bank and Deutsche Bank AG London are referred to herein as the "Deutsche Bank Underwriters".

56. Defendant Chase Securities Inc. ("Chase") was an underwriter for the May 2000 Offering, and sold $93,750,400 worth of the 8% Notes due May 15, 2006 issued in that Offering.

57. Defendant Lehman Brothers Inc. ("Lehman Brothers") was an underwriter for the May 2000 Offering, and sold $93,750,000 worth of the 8% Notes due May 15, 2006 issued in that Offering.

58. Defendant Blaylock & Partners, L.P. ("Blaylock") was an underwriter for the May 2000 Offering, and sold $18,750,000 worth of the 8% Notes due May 15, 2006 issued in that Offering. Blaylock also was a co-manager of the May 2001 Offering and, in connection with that Offering, sold $7,500,000 worth of the 6.50% Notes due 2004; $20,000,000 worth of the 7.50%

Notes due 2011; $23,000,000 worth of the 8.25% Notes due 2031; €6,250,000 worth of the Euro 6.75% Notes due 2008; and £2,500,000 worth of the Sterling 7.25% Notes due 2008.

59. Defendant Credit Suisse First Boston Corp. ("CSFB") was an underwriter for the May 2000 Offering, and sold $18,750,000 worth of the 8% Notes due May 15, 2006 issued in that Offering.

60. Defendant Goldman, Sachs & Co. ("Goldman Sachs") was an underwriter for the May 2000 Offering, and sold $18,750,000 worth of the 8% Notes due May 15, 2006 issued in that Offering.

61. Defendant UBS Warburg LLC ("UBS Warburg") was an underwriter for the May 2000 Offering, and sold $18,750,000 worth of the 8% Notes due May 15, 2006 issued in that Offering.

62. Defendant ABN/AMRO Inc. ("ABN/AMRO") is a large integrated financial services institution that provides commercial and investment banking services and commercial loans to corporate entities. ABN/AMRO was a joint lead manager for the May 2001 Offering. In connection with that Offering, ABN/AMRO sold $120,000,000 worth of the 6.50% Notes due 2004; $320,000,000 worth of the 7.50% Notes due 2011; $368,000,000 worth of the 8.25% Notes due 2031; and, through its affiliate, Defendant ABN AMRO Bank N.V., €100,000,000 worth of the Euro 6.75% Notes due 2008 and £40,000,000 worth of the Sterling 7.25% Notes due 2008. Together, Defendants ABN/AMRO and ABN AMRO Bank N.V. are referred to as the "ABN/AMRO Underwriters".

63. Defendant Utendahl Capital Partners, L.P. ("Utendahl") was a co-manager of the May 2001 Offering. In connection with that Offering, Utendahl sold $7,500,000 worth of the

6.50% Notes due 2004; $23,000,000 worth of the 8.25% Notes due 2031; and £2,500,000 worth of the Sterling 7.25% Notes due 2008.

64. Defendant Tokyo-Mitsubishi International plc ("Mitsubishi") was a senior co-manager for the May 2001 Offering. In connection with that Offering, Mitsubishi sold $30,000,000 worth of the 6.50% Notes due 2004; $80,000,000 worth of the 7.50% Notes due 2011; $92,000,000 worth of the 8.25% Notes due 2031; €25,000,000 worth of the Euro 6.75% Notes due 2008; and £10,000,000 worth of the Sterling 7.25% Notes due 2008.

65. Defendant Westdeutsche Landesbank Girozentrale ("Westdeutsche") was a senior co-manager for the May 2001 Offering. In connection with that Offering, Westdeutsche sold $30,000,000 worth of the 6.50% Notes due 2004; $80,000,000 worth of the 7.50% Notes due 2011; $92,000,000 worth of the 8.25% Notes due 2031; €25,000,000 worth of the Euro 6.75% Notes due 2008; and £10,000,000 worth of the Sterling 7.25% Notes due 2008.

66. Defendant BNP Paribas Securities Corp. ("BNP") was a co-manager of the May 2001 Offering. In connection with that Offering, BNP sold $15,000,000 worth of the 6.50% Notes due 2004; $40,000,000 worth of the 7.50% Notes due 2011; $46,000,000 worth of the 8.25% Notes due 2031; and, through its affiliate, Defendant BNP Paribas, €12,500,000 worth of the Euro 6.75% Notes due 2008 and £5,000,000 worth of the Sterling 7.25% Notes due 2008. Together, Defendants BNP and BNP Paribas are referred to as the "BNP Underwriters".

67. Defendant Caboto Holding SIM S.p.A. ("Caboto") was a co-manager of the May 2001 Offering. In connection with that Offering, Caboto sold $15,000,000 worth of the 6.50% Notes due 2004; $40,000,000 worth of the 7.5% Notes due 2011; $46,000,000 worth of the 8.25% Notes due 2031; €12,500,000 worth of the Euro 6.75% Notes due 2008; and £5,000,000 worth of the Sterling 7.25% Notes due 2008.

68. Defendant Fleet Securities, Inc. ("Fleet") was a co-manager of the May 2001 Offering. In connection with that Offering, Fleet sold $15,000,000 worth of the 6.50% Notes due 2004; $40,000,000 worth of the 7.50% Notes due 2011; and $46,000,000 worth of the 8.25% Notes due 2031.

69. Defendant Mizuho International plc ("Mizuho") was a co-manager of the May 2001 Offering. In connection with that Offering, Mizuho sold $15,000,000 worth of the 6.50% Notes due 2004; $40,000,000 worth of the 7.50% Notes due 2011; $46,000,000 worth of the 8.25% Notes due 2031; €12,500,000 worth of the Euro 6.75% Notes due 2008; and £5,000,000 worth of the Sterling 7.25% Notes due 2008.

70. The Salomon Underwriters, the J.P. Morgan Underwriters, the Banc of America Underwriters, the Deutsche Bank Underwriters, Chase, Lehman Brothers, Blaylock, CSFB, Goldman Sachs, UBS Warburg, the ABN/AMRO Underwriters, Utendahl, Mitsubishi, Westdeutsche, the BNP Underwriters, Caboto, Fleet and Mizuho are collectively referred to herein as the "Underwriter Defendants."

71. It is appropriate to treat defendants Ebbers, Sullivan, Myers and Yates as a group for pleading purposes and to presume that the false and misleading information conveyed in the Company's SEC filings and press releases as alleged herein are the collective actions of this narrowly defined group of defendants. Each of these defendants, by virtue of his high-level position with the Company, directly participated in the day-to-day management of the Company, and was privy to confidential information concerning the Company and its business, operations and accounting results. Each of these defendants was responsible for the Company's accounting practices, and was involved or participated in the drafting, producing and/or disseminating of the false and misleading statements alleged herein.

Related Non-Party

72. WorldCom, now d/b/a MCI Inc., was the second-largest long-distance telephone company in the United States. During the five fiscal years prior to its bankruptcy filing in July 2002, WorldCom grew tremendously through acquisitions, using billions of dollars of its stock as the currency for those acquisitions and issuing approximately $25 billion of debt. During the Class Period, WorldCom acquired Sky-Tel Communications on October 1, 1999, in a merger pursuant to which Sky-Tel shareholders received 23 million shares of WorldCom stock in exchange for their stock in Sky-Tel; the Company also acquired Intermedia Communications, Inc., on July 1, 2001, in a merger in which Intermedia shareholders received 57.1 million shares of WorldCom stock and 2.3 million shares of WorldCom's MCI Tracking stock. The Company issued approximately $17 billion of new debt securities in the May 2000 Offering and the May 2001 Offering.

73. It is now clear that this growth by acquisition, and the enormous sale of debt securities, was fueled by overstated financial statements and other fraudulent public statements which had the effect of presenting WorldCom as a profitable company when, in fact, it was losing money and artificially inflating the market prices of its publicly traded securities. On July 21, 2002, WorldCom filed the largest bankruptcy proceeding in U.S. history, and therefore may not be named as a defendant in this Amended Complaint. But for the filing of bankruptcy proceedings, WorldCom would be a defendant in this action.

74. On November 26, 2002, WorldCom announced it had reached a partial settlement with the SEC, agreeing to the entry of a permanent injunction barring it from further violations of securities laws. On July 2, 2003, the civil penalty aspect of the SEC's action was presented to the court for approval. WorldCom consented to a penalty of $2.25 billion, which, after treatment in the bankruptcy proceedings, would result in a settlement payment of $750 million. On July 7, 2003,

Judge Jed S. Rakoff approved the settlement in the District Court. Approval by the Bankruptcy Court is pending.

CLASS ALLEGATIONS

75. Lead Plaintiff NYSCRF and Named Plaintiffs FCERA, Fresno, and HGK (together, "Plaintiffs") bring this action on their own behalf and as a class action pursuant to Rule 23(a) and Rule 23(b)(3) of the Federal Rules of Civil Procedure on behalf of a class (the "Class") consisting of: all persons and entities who purchased or otherwise acquired publicly traded securities of WorldCom, Inc. during the period beginning April 29, 1999 through and including June 25, 2002, and who were injured thereby, including all persons or entities who acquired shares of WorldCom common stock in the secondary market or in exchange for shares of acquired companies pursuant to a registration statement, and all persons or entities who acquired debt securities of WorldCom in the secondary market or pursuant to a registration statement. Excluded from the Class are: (i) defendants; (ii) members of the family of each individual defendant; (iii) any entity in which any defendant has a controlling interest; (iv) officers and directors of WorldCom and its subsidiaries and affiliates; and (iv) the legal representatives, heirs, successors or assigns of any such excluded party.

76. Throughout the Class Period, shares of WorldCom common stock were traded actively on the NASDAQ National Market System and WorldCom debt securities were traded on various national and international securities markets, all of which are efficient markets. The members of the Class, as purchasers of the stock and debt securities, are so numerous that joinder of all members is impracticable. While the exact number of Class members may only be determined by appropriate discovery, Plaintiffs believe that Class members number in the hundreds of thousands. There were approximately 2.96 billion shares of WorldCom stock issued and outstanding at times relevant hereto, and approximately $17 billion of debt securities issued by

WorldCom, through the Underwriter Defendants, during 2000 and 2001, in addition to the Company's pre-existing debt securities.

77. Plaintiffs' claims are typical of the claims of the members of the Class. Plaintiffs and other members of the Class acquired their WorldCom common stock and/or debt securities pursuant to registration statements or on the open market, and sustained damages as a result of defendants' wrongful conduct complained of herein.

78. Plaintiffs will fairly and adequately protect the interests of the other members of the Class and have retained counsel competent and experienced in class action securities litigation.

79. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. Because the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it virtually impossible for Class members individually to seek redress for the wrongful conduct alleged herein.

80. Common questions of law and fact exist as to all members of the Class and predominate over any questions affecting solely individual members of the Class. Among the questions of law and fact common to the Class are:

(a) Whether the federal securities laws were violated by defendants' acts as alleged herein;

(b) Whether the registration statements issued by WorldCom contained material misstatements or omitted to state material information;

(c) Whether WorldCom's financial results during the Class Period were materially misstated;

(d) Whether Andersen's unqualified reports issued on WorldCom's financial statements during the Class Period materially misstated that Andersen's audits thereon were

conducted in accordance with generally accepted auditing standards ("GAAS") and/or in accordance with standards established by the American Institute of Certified Public Accountants ("AICPA");

(e) Whether the analyst reports authored and disseminated by Grubman and Salomon regarding WorldCom were materially false and misleading;

(f) With respect to the claims arising under § 10(b) of the Exchange Act, whether defendants named in those claims acted with scienter;

(g) Whether the market prices of WorldCom publicly traded securities during the Class Period were artificially inflated due to the material omissions and misrepresentations complained of herein; and

(h) Whether the members of the Class have sustained damages and, if so, the appropriate measure thereof.

81. Plaintiffs know of no difficulty that will be encountered in the management of this action that would preclude its maintenance as a class action.

82. The names and addresses of the record owners of WorldCom publicly traded securities, purchased or acquired during the Class Period, are available from the Company's transfer agent(s) and/or from the Underwriter Defendants. Notice may be provided to such record owners via first class mail using techniques and a form of notice similar to those customarily used in class actions.

THE BASIS OF THE CLAIMS

83. The allegations in this Amended Complaint are made upon knowledge with respect to the actions of Lead Plaintiff NYSCRF and the Named Plaintiffs, and upon other facts obtained through an investigation conducted by the NYSCRF's undersigned counsel, which included, among other things, reviews of public filings with the SEC by WorldCom, its predecessors and

certain of the Individual Defendants; press releases; publicly available trading information; articles in the general press, the financial press, on wire services and in publications in the accounting field; analyst reports; documents identified in SEC filings and to various investigative entities; charging instruments in criminal proceedings related to WorldCom; complaints and related documents filed by the SEC, the Attorney General of the State of New York, and other regulatory agencies, including the various reports, assurances of discontinuance, and related documents released as part of the recent resolution of certain investigations into Wall Street practices ("Wall Street Settlement"); interviews of witnesses; review of documents provided by witnesses and others; documents produced by WorldCom pursuant to a subpoena issued by the NYSCRF after the Court's November 21, 2002 order partially lifting the stay imposed by the Private Securities Litigation Reform Act of 1995 ("November 2002 Order"); two interim reports issued by Bankruptcy Court Examiner Dick Thornburgh ("Examiner's First/Second Interim Report"); the report of the Special Investigative Committee of the WorldCom Board of Directors ("Special Committee Report"); and publicly available information concerning WorldCom and certain of the defendants.

84. The NYSCRF's investigation of this action is continuing. Merits discovery is just beginning. Given the Court's order that document discovery be completed by October 10, 2003, Plaintiffs anticipate that a substantial number of documents germane to this action will be produced over the next ten weeks. Efforts are underway to obtain from various regulators copies of documents that one or more defendants had submitted in connection with the recently concluded investigations into certain Wall Street practices. The Examiner will reportedly issue in or about September 2003 a third report, which will focus on the role of the Wall Street banks in the

WorldCom debacle. In addition, there are continuing investigations by various other entities that are likely to bring additional information relevant to the claims in this Amended Complaint to light.

85. In light of the foregoing, the NYSCRF reserves the right to amend its complaint further, in accordance with the Federal Rules of Civil Procedure and controlling cases, if and when further information relevant to the claims in this Amended Complaint, or potential claims against others not named in this pleading, is obtained.

SUBSTANTIVE ALLEGATIONS

The Growth of WorldCom Begins to Slow

86. For many years before the start of the Class Period, WorldCom and its CEO, Ebbers, pursued a strategy of growth by acquisition. By 1998, WorldCom had acquired more than sixty companies in transactions valued at more than $70 billion, in the process becoming the second largest telecommunications company in the nation, behind only AT&T. For example, in January 1996, WorldCom acquired MFS Communications Company, Inc. for $12.5 billion in stock. In 1998, WorldCom acquired a large local access provider, Brooks Fiber Properties, Inc., for approximately $1.2 billion in stock, and CompuServe Corp., a leading Internet service provider, for $1.3 billion in stock.

87. The biggest such deal occurred on September 14, 1998 when, with Salomon serving as its investment banker, WorldCom acquired MCI in a transaction valued at $40 billion and, in the process, became the nation's second largest telecommunications company. In the press release announcing the merger, Ebbers proclaimed that "MCI WorldCom is out in front and sets the standard by which all other communications companies will be measured."

88. These acquisitions served two purposes. First, although by 1999 the fundamentals of the telecommunications industry were beginning to deteriorate due to intense competition among providers, the acquisitions enabled WorldCom to report increasing revenues and earnings per share

and effectively disguise the problems in its business. Second, as reported in the Examiner's First Interim Report in November 2002, WorldCom's acquisition binge allowed the Company to manipulate its financial results.

89. With each acquisition, WorldCom would take charges of millions, or even billions, of dollars to account for costs supposedly incurred in connection with the merger. Such enormous charges were typical in the 1990's when companies acquired one another, and WorldCom and its senior officers knew that Wall Street would not be concerned with the size of the charges. However, in violation of GAAP, WorldCom included in the charge the cost of the acquired company's <u>future</u> expenses expected in <u>future</u> quarters. This meant that WorldCom would not have to record these expenses in the periods in which they were actually incurred, and allowed the Company to report earnings in those periods that were materially inflated.

90. In addition, WorldCom took charges, as merger reserves, that were significantly larger than the amounts for which such reserves were actually needed. WorldCom would then, in violation of GAAP, "tap" into this reserve fund whenever it needed a boost in earnings. As one former WorldCom executive said, "[t]he boost from post-acquisition accounting was like a drug. But it meant bigger deals had to come along to keep the ball rolling."

91. Turning to the MCI merger, WorldCom used that acquisition as an opportunity to raise its reported future earnings through manipulative accounting. For example, WorldCom reduced the book value of MCI's hard assets by $3.4 billion, and simultaneously increased goodwill, the value of intangible assets, by the same amount. Under GAAP, had the fair value of the hard assets WorldCom acquired been equal to the purchase price, WorldCom would have had to charge off the entire amount of the hard assets against earnings over slightly more than four years. But goodwill could be amortized over approximately forty years, far more time than hard

assets. So, with WorldCom's creative accounting, shifting the $3.4 billion into goodwill meant that the Company was able to record those amortization charge expenses over decades rather than a few years, thus reducing earnings in the near term by far smaller increments.

WorldCom Turns to Outright Fraud

92. With various reserves established by the end of 1998, the stage was set for the most astounding fraud in U.S. corporate history. As disclosed in the Special Committee's Report, the Company manipulated its earnings reports as early as 1999, when it misstated its revenue, line costs, selling, general and administrative costs ("SG&A") and other areas by $938 million. However, its 1999 manipulations were only a prelude to far greater overstatements of what the Company's senior management directed after its growth by acquisition strategy began to stall.

93. In October 1999, WorldCom announced that it had agreed to acquire Sprint in a stock-for-stock transaction valued at a staggering $129 billion. Again, Salomon was to serve as the Company's investment banker. Despite heavy lobbying by Ebbers and other WorldCom executives, in June 2000 the Justice Department refused to approve the merger, on the grounds that the combination threatened competition in the telecommunications industry.

94. Beginning in early 2000, as the Sprint deal collapsed, WorldCom's revenues began to decline, and its costs, as a percentage of revenue, began to materially increase. Anticipating huge growth in telecommunications services, WorldCom had in earlier years entered into a number of long-term lease agreements with various telecommunications carriers to gain the right to use their networks to serve customers who were not directly connected to WorldCom's own network. Many of these leases required WorldCom to make fixed monthly payments to the carrier over the full term of the lease, regardless of whether WorldCom actually used the leased facilities. These costs are referred to as "line costs," which, simply stated, are the fees that WorldCom pays local telephone companies to carry the calls of WorldCom's customers. Under GAAP, these fees must

be reported as an expense on a company's income statement. Prior to 1999, these line costs, which constituted WorldCom's single biggest operating expense, had always been accounted for as expenses, and reported as a separate line item on its income statements as part of WorldCom's operating expenses, without any improper offset.

95. However, the Examiner's Interim Reports and the Special Committee Report reveal that WorldCom's senior officers were well aware that WorldCom's revenues were falling precipitously and that this decline created a substantial risk that WorldCom's publicly reported income would fail to meet the expectations of Wall Street analysts. WorldCom's management also knew that, if the Company failed to meet expectations, it would have a disastrous impact on the price of WorldCom's stock and publicly traded debt. Thus, beginning in the first quarter of 1999, WorldCom engaged in a series of fraudulent accounting manipulations designed to artificially inflate WorldCom's publicly reported income in several ways.

96. As set forth in the Special Committee's Report and the Examiner's Interim Reports, the fraud at WorldCom occurred as detailed below:

(a) Beginning in the first quarter of 1999, WorldCom's finance employees made large improper accounting entries after the close of many quarters in order to report that the Company had achieved the unrealistic revenue growth targets set by Ebbers and Sullivan. This process was directed by Sullivan and involved the cooperation of many other finance personnel. The earliest known manipulations involved the improper release of depreciation reserves and the reclassification of SG&A expenses, both of which began in the first quarter of 1999. Combined, the manipulation of these two items amounted to improper entries of $2.86 billion over the Class Period. Additionally, beginning in the third quarter of 1999 many of the improper entries occurred in the "Corporate Unallocated" revenue account,

which was separately reported to Ebbers each month. WorldCom improperly recorded at least $958 million in this account, and the Special Committee reported that this number may double. Both Sullivan and Ebbers were aware that these non-recurring items increased revenue. Moreover, without these items, WorldCom would have failed in six of the twelve quarters between 1999 and the 2001 to achieve the double-digit growth it reported.

(b) From the second quarter of 1999 through 2000, WorldCom reduced its reported line costs by approximately $3.3 billion by improperly releasing "accruals," or reserves set aside for anticipated expenses, often entirely unrelated to the line costs the accruals were being used to offset. By reversing these reserves as needed, WorldCom was able to offset against reported line costs, thus reducing expenses and increasing reported pre-tax income. These reserves were manipulated at the direction of WorldCom's senior management, including Sullivan, Myers, Yates, Normand and Vinson. Each of these improper reversals was done after the end of the quarter, without proper documentation or support, and the reversals were known to be improper at the time.

(c) By the end of 2000, WorldCom had depleted its available reserves, but still needed to continue its manipulation of the reported line costs. Accordingly, beginning in the first quarter 2001 through the first quarter 2002, WorldCom reduced its reported line costs by $3.8 billion by improperly capitalizing $3.5 billion of those costs, again without any supporting documentation and making other fraudulent adjustments. By improperly capitalizing line costs, WorldCom avoided the immediate impact of properly expensing, or recognizing the costs, and increased pre-tax income and earnings per share. But for this scheme, WorldCom would have reported pre-tax losses in three of the five quarters in which it engaged in this element of the fraud. Instead, it reported results that made it appear

as if the Company was profitable while its competitors declined. Furthermore, this scheme allowed WorldCom to report that line costs were an acceptable 42% of revenues, when, in fact, they were over 50%. To account for line costs in this fashion was a blatant and egregious violation of GAAP. Under GAAP, line costs, which do not generate value in future years but, rather, are ongoing expenses, cannot be capitalized. Together with the improper release of accruals, through these schemes, WorldCom was able to increase its income by over $7 billion from the second quarter 1999 through the first the first quarter 2002.

(d) Also throughout much of 2001, WorldCom engaged in a process known as "Bridge the Gap." At Sullivan's direction, WorldCom's Business Operations and Revenue Accounting groups kept track of the difference between expected actual revenues and the excessive targeted revenues. They would also keep a tally of accounting "opportunities," which were accounting gimmicks that could be used to remedy the difference between WorldCom's revenue targets and reality. With both Sullivan and Ebbers aware of this process, it became institutionalized and these "opportunities" were repeatedly booked in amounts necessary for WorldCom to meet external growth projections.

(e) Additionally, throughout the Class Period, WorldCom engaged in the following accounting gimmicks, which had a smaller but still material effect on earnings: (i) the improper reduction of income taxes; (ii) the establishing of excess general accrual accounts, which were released in order to increase reported income and to meet targets; and (iii) the allocation of costs associated with the realignment of WorldCom's business and the issuing of two tracking stocks, WorldCom Group and MCI Group. The Examiner has also indicated that other improprieties may include improper accounting for inter-company

balances, impairment of goodwill, labor costs and the consolidated reporting of certain subsidiaries.

97. Documents produced to Congress in connection with its investigation also show that the fraud was intentional and deliberate. One of those documents is an e-mail dated June 26, 2002, from a WorldCom executive named Steven Brabbs ("Brabbs") to WorldCom's internal auditors that recounted certain events that took place in 2000. In that e-mail Brabbs explained that:

(a) In March 2000, Brabbs notified WorldCom executives and Andersen that the Company was fraudulently accounting for line cost expenses, but the transactions remained on the Company's books until the restatement. Brabbs was WorldCom's Director - International Finance & Control in March 2000, and his responsibilities included providing the consolidated accounting numbers for Europe and Asia to WorldCom management in the United States. According to the e-mail, after WorldCom's International Division had closed its books and reported its results for the first quarter of 2000, a journal entry was made which reduced the International Division's line cost expenses by $33.6 million. Brabbs was disturbed by the change and did not know why it had occurred. After making a series of phone calls and e-mails to the United States from his London office, "we were told that the entry had been made on the basis of a directive from Scott Sullivan. Despite repeated requests, we were given no support or explanation for the entry."

(b) During April 2000, Brabbs reviewed at a "high level" the International Division's first quarter results with Andersen's audit partner in the United Kingdom, as well as the senior manager. Brabbs noted that the increase in the margin trend was "obvious" and told the auditors that they should "request follow through in the United States to ensure appropriate accounting treatment was in place at the global consolidated level." A relevant

paragraph about this transfer was included in the report that Andersen U.K. sent to both Andersen and WorldCom executives.

(c) Shortly afterwards, Brabbs received an e-mail from Myers, who expressed anger at him for raising this issue with Andersen. Brabbs responded by saying that "we had no support for it in International, and that it was appropriate therefore to request justification (or alternatively a corresponding and reversing entry) from the U.S."

(d) The next quarter (that is, the second quarter of 2000), senior finance executives in the United States told Brabbs they wanted to "push down" the fraudulent entry so that it would appear in International's accounting records and not in the records of the accounting department of the Company's headquarters in the United States. Brabbs refused, noting that he had no supporting documentation, and thus no basis, to make the adjustment. However, Brabbs was instructed by Sullivan to make the entry. Still uncomfortable, Brabbs tried to keep the International Division's books clean by establishing a fictitious entity with no legal existence, and placing the costs on the books of that sham company. Once again, these facts were known to WorldCom senior management, including Sullivan. According to Brabbs:

> However, pressure was exerted and we were instructed to make the entry (the pressure we understood was from Scott's office specifically). Still uncomfortable, I said that I would not under any circumstances book the journal into one of our legal accounting company books and records. What we agreed to do was create a "management company" (NOT a legal entity) and post it there. This had the effect of maintaining the management accounting reported figures, but I was making it clear that I did not see it as a journal that I could support from a legal or US or local accounting perspective. This entry was made on 10 July 2000. The narrative reads "late adj as instructed by Scott Sullivan." It remains there today.

(e) Brabbs continued to raise the subject by phone and e-mail during the latter half of 2000. However, each time he did, WorldCom's senior finance management refused to discuss it, and simply continued to refer back to the fact that the entry had been made at Sullivan's instruction.

98. Other documents show that WorldCom's senior finance and accounting employees knew that capitalizing line costs was improper. In a series of e-mails that began on July 19, 2000, Tony Minert ("Minert"), the telecommunications reporting manager, wrote to Myers and Yates, noting that increasing amounts of line capacity often went unused, although that capacity had already been paid for. Minert asked Myers and Yates if the costs of that "prepaid capacity" could be capitalized as an asset. "The impact," Minert wrote, "could be huge." Minert's suggestion was initially rejected. On July 25, 2000, Yates wrote Minert that "David [Myers] and I have reviewed and discussed your logic of capitalizing excess capacity and can find no support within the current accounting guidelines that would allow for this accounting treatment."

99. When it came time to report results for the third quarter of 2000, however, WorldCom's senior executives changed their tune. They realized that, because of declining revenues, the Company would not be able to meet analysts' earnings expectations. Accordingly, as recounted above, they proceeded to "cook the books" by improperly capitalizing line cost expenses, thereby simply eliminating billions of dollars in expenses. At the end of the third quarter of 2000, Normand went to Sullivan to express his concerns about the improper capitalization of line cost expenses. Sullivan told him that there were "business reasons" for the entries, explained that "some things were occurring to him to bring the cost structure down," and assured him that "everything would be ok."

100. Other documents, as well as facts uncovered by Congress and by WorldCom's internal investigation, demonstrate that Ebbers was directly implicated in the fraud:

a) The House Committee on Financial Services has stated that its staff was told by WorldCom's general counsel that Sullivan had told Ebbers about "hundreds of millions of dollars" that were transferred into capital expenditures accounts.

b) On March 5, 2001, Myers sent an e-mail to a WorldCom employee, Tom Bosley ("Bosley"), and Sullivan, which "reminded" Bosley that, at a dinner with Sullivan and Ebbers before the Company announced its results for the fourth quarter of 2000, Bosley had "volunteered to do whatever necessary" to get margins back in line. According to the e-mail:

> Scott relayed a conversation you had with him at dinner when your [sic] volunteered to do whatever necessary to get Telco/Margins back in line. This was a dinner with Scott, Ron [Beaumont, WorldCom's Chief Operating Officer] and Bernie [Ebbers] prior to the announcement of our last quarter.
>
> As you can see, margins have declined significantly and your immediate attention is appreciated. We need to address this during the quarter and not at the end of the quarter. Just so you know, I fully realize the impact that decling [sic, declining] pricing to our customers has had on margins but I hope you feel like me that it is impossible to accept declining margins . . . .

c) On March 6, 2001, Bosley replied to Myers in an e-mail as follows:

> Actually I asked Scott [Sullivan] what numbers he wanted and I would see what could be done to get them. But . . . obviously gross margin is very important and we will put several projects in place to get this moving back where it was. The first quarter is pretty well cast at this point but we will define what we can do to reverse the trend.

Myers forwarded the e-mail to Sullivan, and later that day, Sullivan e-mailed Myers that "the numbers are in your attached spreadsheet and he needs to get to work now."

101. Through the fraudulent conduct described in ¶¶ 93 - 99 above, WorldCom fraudulently transferred more than $3.883 billion in line cost expenses to its capital asset accounts: $3.065 billion in 2001, and $818 million in the first quarter of 2002. Had the Company properly accounted for these expenses, earnings would have been far lower than reported and far below Wall Street expectations.

102. Together, these two prongs of the scheme – the drawdowns from reserves (¶¶ 92-96) and the capitalization of operating expenses (¶¶ 97-100) – had immense impact on the financial figures disseminated to the investing public. For example, in 2001, WorldCom reported line costs of $14.7 billion and pretax earnings of $2.4 billion, when in reality line costs were $17.8 billion, and the Company should have reported a loss of $662 million for the year. Similarly, in the first quarter of 2002, the Company reported pretax income of $240 million when the Company actually suffered a loss of at least $557 million. Quite simply, through this fraud, WorldCom turned what were massive losses into what appeared to be profits sufficient to meet or exceed Wall Street's expectations.

An Internal Audit Sounds the Whistle

103. According to numerous press reports and internal WorldCom documents that were produced to Congress during May 2002, Cynthia Cooper ("Cooper"), WorldCom Vice President - Internal Audit, began an investigation of certain of the Company's capital expenditures and capital asset accounts. The audit had been scheduled for third quarter of 2002, but Cooper advanced it. Cooper quickly determined that a number of large, questionable transfers had been made from operating expenses into the Company's capital asset accounts during 2001 and the first quarter of 2002. Cooper discussed her investigation with Sullivan on June 11, 2002, and Sullivan asked her to delay her review until the third quarter. Sullivan also sought to minimize the problem, falsely telling Cooper that the capitalizing of line costs started in the third quarter of 2001, and that these

issues would be “corrected” in the 2002 second quarter. Cooper, however, continued her investigation.

104. On June 17, 2002, Cooper met with, among others, a number of WorldCom employees involved in the fraud, including Myers, Yates and Vinson. Cooper asked Vinson, who was WorldCom’s Director of Management Reporting, for support for the transfers. Vinson stated that she “posted the prepaid capacity entries but did not know what prepaid capacity was and did not have support for the entries.” Vinson also indicated that Myers and Yates provided the amounts for the entries and told Cooper she should ask them for the support. Accordingly, Cooper asked Yates for support for the entries. Yates told her that “he was not familiar with the entries and that we should talk to David Myers.” Yates also indicated that he, too, had never heard of prepaid capacity. Thus, according to a memo that Coopers wrote which recounted the conversation:

> Next we went to David Myers’ office and requested support for the entries. David stated that he did not have support for the entries and that the amounts were booked based on what they thought the margins should be. David said that there were no accounting pronouncements to support these entries. David acknowledged that line costs should probably not have been capitalized and stated that it was difficult to stop once started.

105. As previously noted, WorldCom issued a press release on June 25, 2002 announcing that an internal audit had uncovered approximately $3.8 billion in improperly reported earnings and that the Company would restate its financial statements for 2001 and the first quarter of 2002. The Company admitted that “certain transfers from line cost expenses to capital asset accounts during the period were not made in accordance with generally accepted accounting principles.” The release indicated that the fraudulent transfers totaled $3.055 billion for 2001 and $797 million for the first quarter of 2002. In that same announcement, the Company announced that it had fired Sullivan and had accepted the resignation of Myers, and that Andersen had advised WorldCom that

its audit report on the Company's 2001 financial statements and its review of the Company's first quarter 2002 financial statements could not be relied upon.

Post-June 25, 2002 Events

106. The reaction to this stunning announcement – the largest restatement in history – was swift. On the very next day, June 26, 2002, the SEC filed a complaint against WorldCom accusing it of fraud. On June 27, 2002, the House Committee on Financial Services announced that it would hold hearings relating to the WorldCom fiasco beginning on July 8. Almost immediately, that Committee and the House Committee on Energy and Commerce issued subpoenas to WorldCom executives, Andersen and Salomon.

107. On July 8, 2002, Ebbers and Sullivan both refused to answer questions posed by the House Committee on Financial Services, invoking the Fifth Amendment. Melvin Dick ("Dick"), the engagement partner at Andersen responsible for the WorldCom audit for the year 2001, claimed that, prior to June 2002, neither he nor any member of the Andersen team "had any inkling that these transfers had been made." (Less than one week later, Congress released the e-mail that had been sent by Brabbs (see ¶ 97 above), which noted that Andersen had been informed in April 2000 that WorldCom was fraudulently transferring line costs. As noted by The Wall Street Journal and others, the Brabbs e-mail directly contradicted Dick's testimony.)

108. On July 8, 2002, WorldCom filed with the SEC its Revised Statement Pursuant to Section 21(a)(1) of the Securities Exchange of 1934 (the "Revised Statement"). In the Revised Statement, WorldCom admitted that certain line cost expenses were transferred to capital asset accounts in violation of GAAP. The Revised Statement provided a quarterly breakdown of the improper capitalization of line costs: $771 million for the first quarter of 2001; $610 million for the second quarter of 2001; $743 million for the third quarter of 2001; $931 million for the fourth quarter of 2001; and $797 million for the first quarter of 2002. The Company revealed $217

million of improper earnings in 1999, an additional $2.864 billion of improper earnings in 2000, an additional $161 million of improper earnings in 2001, and an additional $88 million of improper earnings in 2002.

109. On July 31, 2002, in this District, Magistrate Judge James C. Francis IV was presented with a criminal complaint setting forth many of the facts uncovered to that point regarding the WorldCom fraud. Upon reviewing that complaint, Magistrate Judge Francis determined that there was probable cause to conclude that a criminal conspiracy to commit securities fraud had existed at WorldCom; accordingly, he signed warrants for the arrest of two of the alleged co-conspirators, Sullivan and Myers. Both men were arrested and arraigned the following day.

110. On August 28, 2002, Sullivan was indicted on conspiracy, securities fraud, and false filing charges. Yates was also charged as a defendant and co-conspirator in that indictment. Myers, Vinson and Normand were named as unindicted co-conspirators.

111. On September 26, 2002, Myers pled guilty to a three-count criminal information charging conspiracy, securities fraud and making false filings with the SEC. On October 7, 2002, Yates became the second WorldCom executive to plead guilty to conspiracy and securities fraud, admitting that he followed Sullivan's instructions to falsify expenses and that these accounting manipulations had "no justification" other than to inflate WorldCom's earnings and deceive investors. And on October 10, 2000, two additional WorldCom employees – Vinson and Normand – entered guilty pleas to charges of securities fraud and conspiracy to commit securities fraud.

WORLDCOM'S FALSE AND MISLEADING STATEMENTS

112. The Company's financial results for 1999, 2000, 2001, and the first quarter of 2002 were artificially inflated by a host of improper accounting practices including, among other things, improper capitalization of expenses, excessive acquisition write-offs, improper revenue

recognition, and improper accounting for goodwill. As described below, WorldCom's financial results for each quarter during the Class Period falsely reported, among other things, revenues, earnings, pretax income, expenses, assets, and net worth.

False and Misleading Statements Relating to the 1999 First Quarter

113. On April 29, 1999, World Com issued a press release reporting its financial results for the quarter ended March 31, 1999 (the "1Q 1999 Press Release"). Net income for the first quarter of 1999 was $709 million, or $0.37 per common share. Operating income for the quarter was $1.45 billion, up 241% (on a reported basis) and 140% (on a pro forma basis) from the first quarter of 1998. Commenting on these "impressive" results, Ebbers stated:

> This is an excellent start to the year and is indicative of how well the merger with MCI has progressed . . . Our margin improvement and earnings performance are particularly impressive this early in the year. The divestiture of virtually all of our non-core assets has provided us with financial flexibility to further increase our capital investment in certain high growth areas – particularly for Internet, local and international services.
>
> We believe this incremental capital spending combined with more aggressive selling and marketing efforts will continue to propel strong top-line sales growth in our core communications services for the foreseeable future.

114. Influential Wall Street analysts commented favorably on the statements regarding WorldCom's first quarter 1999 results, and, in particular, the Company's growth levels. On April 29, 1999, Grubman trumpeted the fact that the Company's quarterly "EPS results were $0.02 above Street consensus and $0.03 above our estimate" and stated that the quarter was distinguished by "very strong top-line growth."

115. On May 17, 1999, WorldCom filed its Form 10-Q for the quarter ending March 31, 1999 (the "1Q 1999 Form 10-Q") with the SEC, which was signed by Sullivan. The 1Q 1999 Form 10-Q reiterated the consolidated financial results reported in the 1Q 1999 Press Release and

represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

116. The statements referenced in ¶¶ 113 and 115 above relating to WorldCom's first quarter 1999 results were each false and materially misleading because, as described above, the Company's financial results reported materially overstated revenues, earnings, pretax income, assets and net worth, and materially understated expenses, in violation of GAAP.

False and Misleading Statements Relating to the 1999 Second Quarter

117. On July 29, 1999, WorldCom issued a press release announcing its financial results for the quarter ended June 30, 1999 (the "2Q 1999 Press Release"), including net income of $863 million, or $0.45 per common share. Commenting on the results, Ebbers stated:

> The Company continues to execute on or ahead of plan with respect to merger synergies and the diversification of revenues . . . Our communications services revenue growth is being driven by continued strong top line performance in data, Internet and international – three of the fastest growing and most profitable areas within communications services.
>
> More impressive though, was the strong pace of improvement in our earnings, margins and cash flow. Our rapidly improving profitability, combined with recent divestitures of non-core assets, has provided the financial flexibility to pursue other high growth communications services opportunities . . . .

118. Analysts highlighted the statements regarding WorldCom's "impressive" results and, in particular, the representations regarding earnings and margins. For example, Grubman wrote on July 30, 1999 that "the quality of WCOM earnings was very high . . . [t]he quarter was highlighted by double-digit revenue growth and impressive margin expansion. . . ."

119. On August 16, 1999, WorldCom filed its Form 10-Q for the quarter ending June 30, 1999 (the "2Q 1999 Form 10-Q") with the SEC, which was signed by Sullivan. The 2Q 1999 Form

10-Q reiterated the consolidated financial results reported in the 2Q 1999 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

120. The statements referenced in ¶¶ 117 and 119 above relating to WorldCom's second quarter 1999 results were each false and materially misleading because, as described above, the Company's financial results reported materially overstated revenues, earnings, pretax income, assets and net worth, and materially understated expenses, in violation of GAAP.

False and Misleading Statements Relating to the 1999 Third Quarter

121. On October 28, 1999, WorldCom issued a press release announcing its financial results for the quarter ended September 30, 1999 (the "3Q 1999 Press Release"), including net income, after goodwill amortization, of $1.1 billion, or $0.56 per common share. Commenting on these results, Ebbers stated:

> We continue to anticipate and respond to rapid change in our industry – technology advances, regulatory change and most significantly customer expectations . . . Through innovative marketing and an unwavering focus on quality and cost controls we continue to deliver products and services to our growing customer base, which are both feature-rich and competitively priced. This winning formula, once again, drove impressive gains in revenues and earnings.

122. On November 15, 1999, WorldCom filed its Form 10-Q for the quarter ending September 30, 1999 (the "3Q 1999 Form 10-Q") with the SEC, which was signed by Sullivan. The 3Q 1999 Form 10-Q reiterated the consolidated financial results reported in the 3Q 1999 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

123. The statements referenced in the above paragraphs relating to WorldCom's third quarter 1999 results were each false and materially misleading because, as described above, the Company's financial results reported materially overstated revenues, earnings, pretax income, assets and net worth, and materially understated expenses, in violation of GAAP.

False and Misleading Statements Relating to the 1999 Fourth Quarter and Year

124. On February 10, 2000, WorldCom issued a press release announcing its financial results for the quarter and full year ended December 31, 1999 (the "Full Year 1999 Press Release"). The Full Year 1999 Press Release reported WorldCom's earnings as follows:

> [E]arnings before goodwill amortization ("cash earnings") [were] $1.6 billion, or $0.54 per common share. Reported net income, after goodwill amortization, was $1.3 billion, or $0.44 per share. Reported net income, excluding net gain items of $112 million before tax, $64 million after tax or $0.02 per share, was $1.2 billion, or $0.42 per common share.
>
> On a full year basis, cash earnings were $5.1 billion or $1.75 per common share. Reported net income, after goodwill amortization, was $3.9 billion, or $1.35 per common share. Reported net income, excluding net gain items of $87 million after tax, or $0.03 per share, was $3.9 billion, or $1.32 per common share.

125. In the Full Year 1999 Press Release, Ebbers called the financial results "outstanding" and noted that WorldCom's "industry leading incremental revenue gains" and "industry leading earnings growth" set the Company apart from its competitors:

> Our achievements in the quarter and full year 1999 were outstanding given the dramatic changes impacting communications services . . . . On an annualized basis, data, Internet and international services represent $14 billion of revenues growing at 36 percent year-over-year. Our proven ability to deliver this type of revenue growth, along with industry leading earnings growth is our mark of distinction.

126. The Company's Full Year 1999 Press Release further discussed the supposed financial improvement in WorldCom's business as a result of the WorldCom/MCI merger, stating:

> The improvement in operating income is due to the realization of merger synergies, a focus on – and improving mix of – higher margin revenues. Gross margin dollars continued to expand, growing faster than revenue growth, up 22 percent for the quarter – underscoring the quality of the earnings improvement.

127. Later in the Full Year 1999 Press Release, Ebbers touted the Company's "impressive" 1999 financial results and predicted "further revenue growth":

> Our accomplishments in 1999 are impressive. In addition to leading our sector in incremental revenue gains and expanding profitability on those revenues, we substantially strengthened our business through acquisitions and divestitures.
>
> The investments in 1999 will provide revenue growth and wireless data capabilities that will become increasingly more important as the Internet goes mobile. The early successes we have achieved in Internet and data services, coupled with the corresponding capital investments have positioned us to lead the industry in the transition to an "all-distance" advanced communications services platform. With more than $12 billion of annualized revenues and approximately $3 billion of incremental revenues coming from data and Internet today, we have confidence in our ability to lead the industry in this transition, and a track record of accomplishing it profitably.

128. Also on February 10, 2000, WorldCom hosted a conference call for the investing community and analysts. Ebbers opened the call by announcing that 1999 was an "outstanding performance year." Ebbers attributed the Company's reported success in large measure to the MCI merger, stating:

> Our most important success in 1999 has been the MCI integration. For five quarters we've delivered the synergies ahead of schedule. EBITDA margins improved by 52% to 35.5% of revenues and added $2.6 billion of net income in 1999. Cash earnings grew to $5.1 billion or $1.73 per share, and we accomplished that exceptional growth in profitability while adding nearly $4.7 billion of incremental revenue. I'm proud of how former MCI and WorldCom employees have worked together to accomplish so much, it hasn't always been easy. Our success with the MCI integration should give you comfort with the Sprint transaction. We know how to put companies together and get the most out of them.

129. Sullivan also spoke on the February 10, 2000 conference call, remarking on the Company's 1999 performance and highlighting the fact that the Company had met analysts' earnings targets for the year:

> I have three quick points to make and one message to deliver. First, we earned a solid 42 cents from operations in the fourth quarter. Second, we produced solid double-digit revenue growth in the fourth quarter. Third, we delivered $2.7 billion in first year synergies with the combination of MCI and WorldCom. And that leads up to my one message. Based upon where we exited 1999 we feel every bit of confidence for 2000 analysts' expectations, top to bottom. This was another solid quarter for MCI WorldCom. The Company posted another quarter of increased profitability resulting from effective merger synergy execution as well as strong double-digit revenue gains.
>
> As Bernie [Ebbers] said, we had a busy year in 1999. It was a year of significant accomplishments. We integrated MCI and WorldCom. We delivered on our synergy plan. We delivered on our operating plan . . . . <u>On top of all the accomplishments, we delivered on the day-to-day business and our earnings targets</u>. (Emphasis added).
>
> . . . The fundamentals of our business remain strong. Fourth quarter net income nearly tripled compared to fourth quarter of 1998, while operating income more than doubled. EBITDA margins expressed as a percentage of revenues jumped over 11 percentage points during the period to over 37%. Clearly the synergy and growth opportunities presented in our business combinations are driving these improvements. Our results highlight the importance of having an industry-leading cost structure, especially in a rapidly changing marketplace. Given the competitive pricing environment in both the consumer and business markets, we not only competed effectively, we posted $1.2 billion of incremental quarterly revenues . . . and we significantly increased our profitability and the quality of our earnings.

130. Ebbers ended the February 10, 2000 conference call by stating: "I hope you can sense the energy and the confidence we enter the year 2000 with. With the best employee base in the industry, we will achieve the results expected of us."

131. The statements referenced in the above paragraphs relating to WorldCom's fourth quarter 1999 results were each false and materially misleading because, as described above, the Company's financial results reported materially overstated revenues, earnings, pretax income, assets and net worth, and materially understated expenses, in violation of GAAP.

132. Financial analysts noted immediately that WorldCom's reported quarterly results were in line with consensus expectations. On February 15, 2000, Grubman reported that WorldCom's revenues were "exactly in line with our . . . estimate" and called the Company's margin profile "extraordinary." Grubman attributed WorldCom's success to "several acquisitions that have helped the company to [attain] its predominant position in the telecom world."

133. On March 30, 2000, WorldCom filed its Form 10-K for the year-ended December 31, 1999 (the "1999 Form 10-K"), which was signed by defendants Alexander, Allen, Areen, Aycock, Bobbitt, Ebbers, Galesi, Kellett, Macklin, Roberts, Sidgmore, Sullivan and Tucker, and which reiterated the materially false and misleading financial information initially disclosed in the Full Year 1999 Press Release and the February 10, 2000 conference call.

134. The 1999 Form 10-K also contained a clean audit opinion by Andersen, addressed to the shareholders of WorldCom, which represented that:

> We have audited the accompanying consolidated balance sheets of MCI WORLDCOM, Inc. (a Georgia corporation) and subsidiaries as of December 31, 1999 and 1998, and the related consolidated statements of operations, shareholders' investment and cash flows for each of the years in the three-year period ended December 31, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Brooks Fiber Properties, Inc., a company acquired during 1998 in a transaction accounted for as a pooling-of-interests, as discussed in Note 2, as of and for the year ended December 31, 1997. Such statements are included in the consolidated financial statements of MCI WORLDCOM, Inc. and reflect total revenues of two percent of the related consolidated totals

> in 1997. These statements were audited by other auditors whose report has been furnished to us and our opinion, insofar as it relates to amounts included for Brooks Fiber Properties, Inc. is based solely upon the report of the other auditors.
>
> We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.
>
> In our opinion, based on our audit and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of MCI WORLDCOM, Inc. and subsidiaries as of December 31, 1999 and 1998, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

135. Andersen's statements in the above paragraph relating to the 1999 audit were false and materially misleading because Andersen had not conducted its audit in accordance with GAAS and, further, because WorldCom's financial statements were not prepared in conformity with GAAP.

False and Misleading Statements Relating to the 2000 First Quarter

136. On April 27, 2000, WorldCom issued a press release announcing its financial results for the quarter ended March 31, 2000 (the "1Q 2000 Press Release"). The 1Q 2000 Press Release reported "strong profitability gains in first quarter 2000 driven by robust data, Internet and international revenues and declining access and technology costs," including net income of $1.3 billion, or $0.44 per common share, for the quarter – an 80% year-over-year increase. Commenting on these results, Ebbers stated:

> WorldCom continues to enjoy success in its focus markets. On an annualized basis, data, Internet and international services represent more than $18 billion of annualized revenues growing at 32 percent . . . We are clearly leading the communications industry into a new era . . . .

137. Once again, the Street reacted favorably to the statements regarding the Company's financial results for first quarter 2000. On April 27, 2000, Grubman noted in a report published by Salomon that WorldCom's quarterly earnings per share were "exactly in line with our estimates."

138. On May 15, 2000, WorldCom filed its Form 10-Q for the first quarter ended March 31, 2000 (the "1Q 2000 Form 10-Q"), which was signed by Sullivan. The 1Q 2000 Form 10-Q reiterated the consolidated financial results reported in the 1Q 2000 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

139. The statements referenced in ¶¶ 136 and 138 above relating to WorldCom's first quarter 2000 results were each false and materially misleading because, as described above, the Company's revenues, earnings, pretax income, assets and net worth for the quarter were materially overstated, and expenses were materially understated, in violation of GAAP.

False and Misleading Statements Relating to the 2000 Second Quarter

140. On July 13, 2000, WorldCom issued a press release announcing the termination of its merger agreement with Sprint, following indications that the Department of Justice would not approve the merger. In the press release, Ebbers stated:

> Moving forward, WorldCom remains the best-positioned global carrier with a clear focus on the highest-growth sectors of the domestic and global telecommunications marketplace.
>
> WorldCom has continued to expand on its core strengths since the merger was proposed last year. We have consistently produced significant quarter-to-quarter revenue growth in the data, Internet and

> international communications services – businesses that represent $18 billion of our annual revenue, growing 32 percent annually. Without a doubt, these high-growth areas represent the future of the industry and our company.

141. On July 27, 2000, WorldCom issued a press release announcing its financial results for the second quarter ended June 30, 2000 (the "2Q 2000 Press Release"). The 2Q 2000 Press Release reported "solid profitability gains" for the second quarter of 2000, including net income of $1.3 billion for the quarter, or $0.46 per common share. Commenting on these results, Ebbers stated:

> We will continue to expand the reach of our industry-leading global network as we sharpen our focus on higher-margin, value-added services in the commercial data, Internet and international markets. Furthermore, our continued capital investments in these high-growth areas of our business bolster our confidence in our ability to grow revenues and profitability in an extremely competitive business environment.

142. The 2Q 2000 Press Release further represented that WorldCom's operating income was $2.5 billion, a 41% increase over the same period of the prior year, and that these results were "driven by revenue increases in data, Internet and international services, combined with declining access and technology costs."

143. Also on July 27, 2000, WorldCom sponsored a conference call for financial analysts and investors to report on the second quarter 2000 results. During the call, Ebbers represented that "WorldCom posted a strong quarter with record revenue and record profit." Sullivan further stated that, despite "current softness in the voice wholesale markets," it was "realistic" to expect that the Company would post revenue growth "at or near the low end of our guidance" for the following two quarters.

144. On August 14, 2000, WorldCom filed its Form 10-Q for the second quarter ended June 30, 2000 (the "2Q 2000 Form 10-Q"), which was signed by Sullivan. The 2Q 2000 Form 10-

Q reiterated the consolidated financial results reported in the 2Q 2000 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

145. The statements referenced in the above paragraphs relating to WorldCom's second quarter 2000 results were each false and materially misleading because, as described above, revenues, earnings, pretax income, assets and net worth for the quarter were materially overstated, and expenses materially understated, in violation of GAAP.

False and Misleading Statements Relating to the 2000 Third Quarter

146. On October 26, 2000, WorldCom issued a press release announcing its financial results for the quarter ended September 30, 2000 (the "3Q 2000 Press Release"). The 3Q 2000 Press Release reported "unmatched" revenue growth, including net income of $1.4 billion, or $0.47 per common share, for the quarter:

> Consolidated revenues for the third quarter increased 12 percent over last year's comparable quarter, reflecting continued growth from global broadband services. Operating income increased by $360 million or 16 percent from the third quarter of 1999 to $2.6 billion. WorldCom's commercial services achieved revenue growth of 19 percent over third quarter 1999. Cash earnings (earnings before goodwill amortization) per share increased 21 percent year-over-year to $0.57 per common share. Net income applicable to common shareholders increased 26 percent to $1.4 billion, or $0.47 per common share, up from $0.37 per share in the third quarter of 1999.

147. On October 26, 2000, Grubman stated that the Company's quarterly earnings per share "came in below our expectations in revenues but were a penny ahead of our earnings expectations." Marc Crossman ("Crossman"), an analyst at J.P. Morgan Securities Inc., stated on October 27, 2000 that "[d]espite lower than expected revenues for the quarter . . . WorldCom reported third quarter EPS (excluding non-recurring charges) of $0.47, in line with our

expectations." In reality, however, WorldCom was only able to meet analysts' earnings expectations because it fraudulently reduced line cost expenses, through improper reversals of merger reserves.

148. On November 14, 2000, WorldCom filed its form 10-Q for the third quarter ended September 30, 2000 (the "3Q 2000 Form 10-Q"), which was signed by Sullivan. The 3Q 2000 Form 10-Q reiterated the consolidated financial results reported in the 3Q 2000 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

149. The statements referenced in ¶¶ 146 and 148 above relating to WorldCom's third quarter 2000 results were each false and materially misleading because, as described above, revenues, earnings, pretax income, assets and net worth for the quarter were materially overstated, in violation of GAAP. Specifically, WorldCom's third quarter 2000 financials improperly reduced line costs by $828 million – accomplished by drawing down from certain reserve accounts – thereby increasing WorldCom's publicly reported pretax income by that amount for the third quarter of 2000.

False and Misleading Statements Relating to the 2000 Fourth Quarter and Year

150. On February 8, 2001, WorldCom issued a press release reporting "solid" financial results for the quarter and full year ended December 31, 2000 (the "Full Year 2000 Press Release"). The Full Year 2000 Press Release reported WorldCom's earnings as follows:

> The solid results posted by WorldCom meet the performance expectations the Company announced on November 1 when it declared its intention to separate the Company's financial structure into two distinct groups: a high-growth unit focused on data, Internet and international operations and a high cash flow unit focused on mature businesses.

> Fourth quarter 2000 consolidated revenues were $9.6 billion, up from $9.3 billion in the same period of 1999. Consolidated EBITDA was $2.8 billion representing an EBITDA margin of 29 percent.
>
> Fourth quarter 2000 cash earnings were $1.0 billion, or 35 cents per share, versus $1.6 billion, or 54 cents per share in the year-ago period. Consolidated net income, after goodwill amortization, was $710 million or 25 cents per share in the quarter versus $1.3 billion or 44 cents per share in the same period a year ago.
>
> Full year consolidated WorldCom, Inc. revenues were $39.1 billion, up from $35.9 billion in 1999. Full-year consolidated EBITDA was $13.8 billion before charges, up from 1999 EBITDA of $12.2 billion.
>
> Full-year 2000 cash earnings were $5.8 billion or $2.00 per share, versus $5.1 billion or $1.74 per share in 1999. Consolidated net income before charges, was $4.6 billion or $1.59 per share.

151. Commenting on these results, Ebbers stated:

> WorldCom has made excellent progress . . . in Internet, data and international services, we have completed our operations and sales realignment to further solidify WorldCom's leadership in e-business communications for today's businesses . . . In the more mature areas of our businesses represented by the MCI Group, our focus on cash generation is expected to yield positive future results.

152. The Full Year 2000 Press Release further represented that the Company would meet its 2001 earnings projections:

> The Company expects full-year 2001 WorldCom Group revenue growth of between 12 and 15 percent with quarterly growth increasing through the year. The Company expects WorldCom Group cash earnings of between $1.25 and $1.35 per share for the year.
>
> …WorldCom, Inc. currently expects that full-year 2001 consolidated cash earnings will be in the Company's previous $1.55 to $1.65 per share guidance range.

153. Analysts immediately emphasized that, once again, WorldCom had met the Street's expectations. Grubman noted on February 8, 2001 that "cash EPS was a penny beater for WCOM Group ($0.28 actual vs. $0.27 est.), and hence for WCOM Inc. ($0.35 actual vs. $0.34 est.)." On

February 9, 2001, Marc Crossman of J.P. Morgan Securities Inc. stated that the Company's consolidated earnings "met consensus expectations."

154. The statements referenced in ¶¶ 150 and 152 above relating to WorldCom's fourth quarter 2000 were each false and materially misleading because, as described above, revenues, earnings, pretax income, assets and net worth for the quarter were materially overstated and expenses were materially understated, in violation of GAAP. Specifically, WorldCom's fourth quarter 2000 financials improperly reduced line costs by $407 million – largely accomplished by drawing down from certain reserve accounts – thereby increasing WorldCom's publicly reported pretax income by that amount for the fourth quarter of 2000.

155. On March 30, 2001, WorldCom filed its Form 10-K for the quarter and year ended December 31, 2000 (the "2000 Form 10-K"), which was signed by Defendants Alexander, Allen, Areen, Aycock, Bobbitt, Ebbers, Galesi, Kellett, Macklin, Roberts, Sidgmore, and Sullivan. The 2000 Form 10-K reiterated the financial results reported in the Full Year 2000 Press Release and represented that the financial results contained in the Form 10-K had been prepared in accordance with GAAP.

156. The 2000 Form 10-K also touted the fact that line costs as a percentage of revenues had declined in 2000 and attributed this improvement to increased traffic on WorldCom's facilities:

> Line costs as a percentage of revenues for 2000 decreased to 38.4% as compared to 40.1% reported for the prior year. The overall improvement is a result of increased data and dedicated Internet traffic over WorldCom-owned facilities, which positively affected line costs as a percentage of revenues by approximately one and one half percentage points.

157. The 2000 Form 10-K also contained a clean audit opinion by Andersen, addressed to the shareholders of WorldCom, which represented that:

> We have audited the accompanying consolidated balance sheets of WorldCom, Inc. (a Georgia corporation) and subsidiaries as of December 31, 1999 and 2000, and the related consolidated statements of operations, shareholders' investment and cash flows for each of the years in the three-year period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of WorldCom, Inc. and subsidiaries as of December 31, 1999 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

158. Andersen's statements in the above paragraph relating to the 2000 audit were false and materially misleading because Andersen had not conducted its audit in accordance with GAAS and, further, because WorldCom's financial statements were not prepared in conformity with GAAP.

False and Misleading Statements Relating to the 2001 First Quarter

159. On April 26, 2001, WorldCom issued a press release announcing its financial results for the quarter ended March 31, 2001 (the "1Q 2001 Press Release"), which reported WorldCom's consolidated earnings as follows:

> First quarter 2001 consolidated revenues were $9.7 billion, up from $9.6 billion in the same period of 2000. Consolidated EBITDA was $2.9 billion, representing an EBITDA margin of 30 percent.

> First quarter 2001 cash earnings were $1.0 billion, or 35 cents per share. Consolidated net income, after goodwill amortization, was $729 million or 25 cents per share in the quarter.

160. Commenting on these results, Ebbers stated:

> This quarter was an excellent start to what will be a pivotal year for WorldCom. These results show that WorldCom is on track to deliver strong growth and solid performance throughout the year.

161. The 1Q 2001 Press Release further represented that WorldCom "continue[d] to expect full-year 2001 WorldCom Group revenue growth of between 12 and 15 percent and expect[ed] WorldCom Group cash earnings of between $1.25 and $1.35 per share for the year."

162. Financial analysts noted that WorldCom's quarterly results were due, in part, to expense reductions in the WorldCom Group. Grubman noted on April 26, 2001 that "[a]ll of the EBITDA margin improvement came at the gross margin line . . . [t]echnology is driving down . . . ongoing operating costs." Marc Crossman of J.P. Morgan Securities Inc. stated on April 27, 2001 that "[r]eported EBITDA for the WorldCom Group beat our estimates slightly, reflecting better than expected expense reductions. . . ."

163. On May 15, 2001, WorldCom filed its Form 10-Q for the first quarter ended March 31, 2001 (the "1Q 2001 Form 10-Q") with the SEC. The 1Q 2001 Form 10-Q reiterated the consolidated financial results reported in the 1Q 2001 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods." The 1Q 2001 Form 10-Q was signed by Sullivan and reiterated the materially false and misleading financial information initially disclosed in the 1Q 2001 Press Release.

164. The statements referenced in ¶¶ 159-161 and 163 relating to WorldCom's first quarter 2001 results were each false and materially misleading because revenues, earnings, pretax

income, assets, and net worth for the quarter were materially overstated, and expenses were materially understated, in violation of GAAP. Specifically, WorldCom's first quarter 2001 financials improperly reduced quarterly line costs by $771 million – largely accomplished by accounting for the line costs as capital expenses in a blatant violation of GAAP – thereby increasing WorldCom's publicly reported pretax income by that amount for the first quarter of 2001.

False and Misleading Statements Relating to the 2001 Second Quarter

165. On July 26, 2001, WorldCom issued a press release announcing WorldCom's financial results for the quarter ended June 30, 2001 (the "2Q 2001 Press Release"):

> Second quarter 2001 consolidated revenues were $8.9 billion. Consolidated EBITDA was $2.7 billion, representing an EBITDA margin of 30 percent.
>
> Second quarter 2001 cash earnings were $917 million. Consolidated net income, after goodwill amortization, was $623 million.

166. In the 2Q 2001 Press Release, Ebbers commented:

> The growth in our data and Internet revenues this quarter again demonstrates the value of enterprise customers as we continue to see our customers' requirements for more bandwidth. . . .
>
> I'm also extremely pleased with the results of our heightened focus on cash flow. The $600 million sequential improvement in internally generated cash flow this quarter is a result of good business fundamentals: solid growth, more stable pricing, efficient cost control and effective balance sheet management.

167. The market picked up on the statements regarding WorldCom's performance, especially their assurances regarding cash flow. On July 26, 2001, Grubman called the quarterly results "exceedingly good" and stated "[t]he other major highlight of the quarter was a dramatic improvement in operating cash flow . . . ."

168. On August 14, 2001, WorldCom filed with the SEC its Form 10-Q for the quarter ending June 30, 2001 (the "2Q 2001 Form 10-Q"), which was signed by Sullivan. The 2Q 2001 Form 10-Q reiterated the consolidated financial results reported in the 2Q 2001 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

169. The statements referenced in ¶¶ 166-166 and 168 above relating to WorldCom's second quarter 2001 results were each false and materially misleading because revenues, earnings, pretax income, assets, and net worth for the quarter were materially overstated, and expenses were materially understated, in violation of GAAP. Specifically, the second quarter 2001 financials improperly reduced quarterly line costs by $560 million – largely accomplished by accounting for the line costs as capital expenses – thereby increasing WorldCom's publicly reported pretax income by that amount for the second quarter of 2001. WorldCom has admitted to improperly reducing $560 of $606 million.

False and Misleading Statements Relating to the 2001 Third Quarter

170. On October 25, 2001, WorldCom issued a press release announcing WorldCom's financial results for the quarter ended September 30, 2001 (the "3Q 2001 Press Release"), which reported WorldCom's earnings as follows:

> Third quarter 2001 consolidated revenues were $9.0 billion. Consolidated EBITDA was $2.7 billion, representing an EBITDA margin of 30 percent.
>
> Consolidated WorldCom, Inc. third quarter cash earnings were $797 million. Consolidated net income, after goodwill amortization, was $493 million.

171. Commenting on the Company's earnings, Ebbers stated:

> WorldCom delivered excellent growth this quarter, while substantially improving the free cash flow of our businesses . . . Our data, Internet and international businesses continue to perform well in spite of the very difficult economic environment. We still expect our growth businesses to gain market share profitably during this period of global economic uncertainty.

172. On July 26, 2001, during the third quarter 2001 earnings conference call, Ebbers commented on the Company's ability to grow revenues even while improving margins and increasing cash flow:

> From a revenue perspective, we achieved 12% revenue growth for the quarter and 12.5% growth for the first half of 2001 . . . We accomplished this while improving EBITDA margins and dramatically improving cash flow with improved cash from operations, excellent working capital management, and prudent capital spending . . . [W]e continue to deliver growth that will allow us to achieve our revenue growth target . . . .

173. During Sullivan's presentation on the conference call, he specifically attributed WorldCom's improved EBITDA margins to decreases in line costs:

> [A]ll in all, this was a solid quarter from a revenue standpoint. EBITDA [at the] WorldCom Group was $2 billion or 38% of revenues which was slightly ahead of 37% in the first quarter. Improvements in both line costs and SG&A contributed to the modest improvement in EBITDA percentage.

174. Sullivan further assured investors that new methods for accounting for goodwill would not affect WorldCom's balance sheet because, among other things, the Company had tremendous expertise in valuing its acquisitions:

> I think WorldCom has been very diligent over the years. In a lot of cases we have used two to three appraisers in each one of the acquisitions, and we have done a good job of identifying specific intangible assets that we amortized today and do not develop from the cash earnings number.

175. During the third quarter 2001 investor conference call held on October 25, 2001, Sullivan cited decreases in line costs as a primary reason for WorldCom's improved EBITDA margins:

> EBITDA for the WorldCom Group was $2.1 billion, or 38 percent of revenues, slightly ahead of second quarter's percentages. [The] improvement in EBITDA was the result of continued line-cost containment and workforce efficiency.

176. On November 14, 2001, the Company filed with the SEC its Form 10-Q for the third quarter ended September 30, 2001 (the "3Q 2001 Form 10-Q"), which was signed by Sullivan. The 3Q 2001 Form 10-Q reiterated the consolidated financial results reported in the 3Q 2001 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

177. The statements referenced in the above paragraphs relating to WorldCom's third quarter 2001 results were each false and materially misleading because revenues, earnings, pretax income, assets, and net worth for the quarter were materially overstated, and expenses were materially understated, in violation of GAAP. Specifically, WorldCom's third quarter 2001 financials improperly reduced quarterly line costs by $743 million – substantially accomplished by accounting for the line costs as capital expenses – thereby increasing WorldCom's publicly reported pretax income by that amount for the third quarter of 2001.

<u>False and Misleading Statements Relating to the 2001 Fourth Quarter and Year</u>

178. On February 7, 2002, WorldCom issued a press release announcing its financial results for quarter and full year ended December 31, 2001 (the "Full Year 2001 Press Release"), which reported WorldCom's consolidated earnings:

> Fourth quarter 2001 consolidated revenues were $8.5 billion. Fourth quarter 2001 WorldCom, Inc. cash earnings were $570 million.

> Consolidated net income applicable to common shareholders was $295 million.
>
> … Full-year consolidated WorldCom, Inc. revenues were $35.2 billion, a decrease of one percent from $35.6 billion in 2000. Full-year 2001 cash earnings were $3.3 billion. Consolidated net income applicable to common shareholders was $2.1 billion.

179. Commenting on the fourth quarter and full year 2001 results, Ebbers spoke positively about WorldCom's future:

> Moving into 2002 WorldCom is a company with a strong balance sheet, positive free cash flow, a fully integrated local to global network leveraged by a sales force aligned to deliver the products and services our customers are demanding today and prepared for where demand will take customers in the future. I am more confident than ever that WorldCom is well positioned in today's environment, as well as when economic growth returns.

180. These statements were materially false and misleading because revenues, earnings, pretax income, assets and net worth for 2001 were materially overstated, and expenses were materially understated, in violation of GAAP. Specifically, WorldCom's 2001 financials improperly reduced line cost expenses by $3.063 billion, thereby increasing pretax income by that same amount.

181. During the fourth quarter 2001 earnings conference call, held on February 7, 2002, Ebbers announced that WorldCom "will likely write-down goodwill by between $15 to $20 billion. . . ." When analysts raised questions about the Company's accounting practices, Ebbers assured investors that WorldCom's accounting practices were sound and reliable: "I highly recommend everyone take a step back and focus on reality rather than the fear factor." Ebbers dismissed rumors circulating about WorldCom's viability as "unfounded nonsense," and further falsely stated that "we stand by our accounting." And, Ebbers falsely informed investors that WorldCom's financials were healthy, stating: "We have a solid bill-paying customer base, $10.5

billion in current assets, $39 billion of property, plant and equipment, and we have solid investment grade debt ratings, and we are free cash flow positive ahead of time . . . Bankruptcy or a credit default is not a concern." As described in ¶¶ 319-326 below, many of the foregoing false statements were spoken at the direction of Grubman, who – notwithstanding his understanding about the deteriorating state of WorldCom's financial condition – sent Ebbers and/or Sullivan at least a half dozen e-mails over the preceding week instructing them to vouch for WorldCom's liquidity, accounting and business model on this call. As part and parcel of this scheme to mislead the investing public, Grubman published a corresponding research note that same day assuring investors that "WCOM [had] addressed all issues surrounding its liquidity, etc. of which there are none."

182. In response to this integrated message from Grubman and Ebbers, investors bid WorldCom stock up to its closing price of $7.52 on February 7, 2002, an increase of nearly 15% over the prior day's closing price. On February 8, 2002, after yet another Grubman report emphasized that WorldCom had "addressed concerns over liquidity & accounting – stating no issues there," the stock price closed up another 9%. The price continued to rise, closing at $9.01 on March 11, 2002.

183. On March 7, 2002, the SEC requested production of documents and information from WorldCom, including: (a) information on the Company's third quarter 2000 pretax charge associated with wholesale accounts, disputed customer bills and sales commissions; (b) the Company's accounting policies for goodwill and FAS 142; (c) documents relating to reserves discussed in WorldCom's third quarter 2001 Form 10-Q, such as bankruptcies, litigation, and contractual settlements; (d) loans to Ebbers; (e) billing practices, including customer complaints; and (f) organizational charts and personnel records for former employees.

184. On March 12, 2002, one day after news of the SEC inquiry was broadcast across the Dow Jones Newswires, WorldCom's stock plunged to $7.93 per share, down $1.08 from the prior day's closing price of $9.01.

185. In a news conference held on March 12, 2002, Ebbers once again falsely assured investors that rumors regarding the Company's accounting practices were unfounded and that he was unaware of the reason for the SEC investigation. According to Dow Jones Business News, Ebbers told investors: "We are not aware of any information that would give rise to this inquiry other than newspaper articles." Ebbers further stated that the Company's accounting policies and practices were fully compliant with the SEC's rules.

186. On March 13, 2002, WorldCom filed with the SEC its Form 10-K for the fourth quarter and year end December 31, 2001 (the "2001 Form 10-K"), which was signed by defendants Allen, Areen, Aycock, Bobbitt, Ebbers, Galesi, Kellett, Macklin, Roberts, Sidgmore, and Sullivan. The 2001 Form 10-K reiterated the false financial results reported in the Full Year 2001 Press Release and falsely represented that the financial results contained in the 2001 Form 10-K had been prepared in accordance with GAAP.

187. The 2001 Form 10-K falsely reported that line costs as a percentage of revenues for 2001 were 41.9% – a slight increase over the line costs for 2000. In reality, the line costs percentage was much higher but was concealed by the fraudulent accounting.

188. The 2001 Form 10-K also contained a clean audit opinion by Andersen, addressed to the shareholders of WorldCom, which represented that:

> We have audited the accompanying consolidated balance sheets of WorldCom, Inc. (a Georgia corporation) and subsidiaries as of December 31, 2000 and 2001, and the related consolidated statements of operations, shareholders' investment and cash flows for each of the years in the three-year period ended December 31, 2001. These financial statements are the responsibility of the Company's

> management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of WorldCom, Inc. and subsidiaries as of December 31, 2000 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

189. Andersen's statements in the above paragraph relating to the 2001 audit were false and materially misleading because Andersen had not conducted its audit in accordance with GAAS and, further, because WorldCom's financial statements were not prepared in conformity with GAAP.

False and Misleading Statements Relating to the 2002 First Quarter

190. On April 25, 2002, WorldCom issued a press release announcing its financial results for the quarter ended March 31, 2002 (the "1Q 2002 Press Release"), which stated:

> WorldCom, Inc. first quarter 2002 consolidated revenues were $8.1 billion, an 8 percent decline from the year-ago period. Consolidated net income was $130 million, including a $90 million after-tax charge associated with the disposition of investments, such as News Corporation. Excluding this charge, consolidated net income would have been $220 million.
>
> First quarter 2002 consolidated free cash flow from operations was $952 million. Consolidated net debt declined by $903 million to $27.9 billion. WorldCom, Inc. 2002 capital expenditures are expected to be up to $4.9 billion.

191. Ebbers stated in the 1Q 2002 Press Release:

> Despite very difficult performance this quarter WorldCom was able to generate free cash flow from operations and reduce net debt by $903 million . . . Our data and Internet production was affected by disconnects from e-business oriented customers as well as cost driven network reductions from enterprise customers. Voice revenues are pressured by price reductions and network downsizing by existing customers that offset new billed revenue.

192. During the first quarter 2002 earnings conference call held on April 25, 2002, Ebbers rejected the notion that WorldCom would not be able to pay its debt maturities: "[W]e feel very, very confident that we will be able to meet our debt maturity requirements to pay off our debt." And, Sullivan stated that, despite WorldCom's "significant" decline in revenues during the quarter, the Company's EBITDA margins had declined only slightly:

> [In the fourth quarter of 2001,] [o]ur EBITDA at the WorldCom Group was about 38% of revenue. And let's face it, we had a pretty significant decline in the first-quarter revenue for all of the reasons that I have already laid out. And despite all of that our EBITDA percentage in the first quarter [of 2002] was still 35%.

193. On April 30, 2002, WorldCom announced that defendant Ebbers had suddenly resigned his posts as WorldCom's Chief Executive Officer, President, and Director. Within three days, WorldCom's stock dropped to $1.79.

194. On May 15, 2002, WorldCom filed with the SEC its Form 10-Q for the quarter ended March 31, 2002 (the "1Q 2002 Form 10-Q"), which was signed by defendant Sullivan. The 1Q 2002 Form 10-Q reiterated the consolidated financial results reported in the 1Q 2002 Press Release and represented that "the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods."

195. Sullivan reiterated these same statements during a conference call hosted by WorldCom on May 15, 2002 to discuss the announcement of the $2.65 billion credit facility draw down.

196. The statements referenced in the above paragraphs relating to WorldCom's first quarter 2002 results were each false and materially misleading because revenues, earnings, pretax income, assets, and net worth for the quarter were materially overstated, and expenses materially understated, in violation of GAAP. Specifically, WorldCom's first quarter 2002 financials improperly reduced quarterly line costs by $818 million – accomplished by accounting for the line costs as capital expenses – thereby increasing WorldCom's publicly reported pretax income by that amount for the first quarter of 2002.

The False and Misleading Registration Statements (Notes)

A. The May 2000 Offering

197. As revealed in the Examiner's Second Interim Report, beginning in 1999 WorldCom started to fund most of its daily operating expenses through money borrowed in the short term commercial paper market. Since the true financial condition of the Company was quickly deteriorating, WorldCom's short term commercial paper debt continued to rise rapidly to meet its operating expenses. At the end of March 2000, WorldCom's short term debt reached more than $6 billion, a level so high that WorldCom could no longer access the commercial paper market. Thus, in early 2000, WorldCom faced a serious liquidity crisis. It needed huge amounts of cash to redeem most of its short term commercial paper obligations and to continue its daily operations.

198. WorldCom could temporarily solve its liquidity problem by drawing down on one of its back up credit facilities. In early 2000, WorldCom had in place two revolving credit agreements for a total of $10.75 billion. Defendants Salomon, Citigroup, Deutsche Bank, Banc of America,

CSFB, J.P. Morgan, Chase and/or their affiliates were among the lenders who committed to make billions of dollars of credit available to WorldCom in connection with these credit facilities. However, rather than drawing down on its credit facilities to pay its mounting commercial paper debt, WorldCom, aided by certain of the Underwriter Defendants, opted to tap into the public bond market.

199. On or about May 24, 2000, WorldCom issued $5 billion worth of bonds as follows: $1,500,000,000 Floating Rate Notes due November 26, 2001; $1,000,000,000 worth of 7.875% Notes due May 15, 2003; $1,250,000,000 worth of 8.000% Notes due May 15, 2006; and $1,250,000,000 worth of 8.000% Notes due May 15, 2010. WorldCom used all of the proceeds of the May 2000 Offering to pay its short term commercial paper obligations.

200. In connection with the May 2000 Offering, WorldCom filed with the SEC a Form S-3 registration statement, dated April 12, 2000, an amended Form S-3 registration statement, dated May 11, 2000, a Form 424(B)(5) prospectus supplement, dated May 17, 2000, a Form 424(B)(5) prospectus supplement, dated May 19, 2000, and a Form 424(B)(5) prospectus supplement, dated May 22, 2000 (collectively, the "May 2000 Registration Statement").

201. The May 2000 Registration Statement was signed by defendants Alexander, Allen, Areen, Aycock, Bobbitt, Ebbers, Galesi, Kellet, Macklin, Porter, Roberts, Sidgmore, Sullivan and Tucker.

202. The following Underwriter Defendants served as underwriters of the May 2000 Offering: Salomon, J.P. Morgan, Banc of America, Chase, Lehman Brothers, Blaylock, CSFB, Deutsche Bank, Goldman Sachs and UBS Warburg (together, the "May 2000 Underwriter Defendants"). Salomon was a book running manager of this Offering. In addition, Salomon and J.P. Morgan jointly served as the lead managers of the Offering.

203. The May 2000 Registration Statement included WorldCom's materially false and misleading financial statements for 1999, and also incorporated by reference the following documents:

- WorldCom's Annual Report on Form 10-K for the year ended December 31, 1999;
- WorldCom's Form 8-K, filed on May 16, 2000, which included WorldCom's Form 10-Q for the first quarter of 2000; and
- Andersen's audit opinion included in WorldCom's Annual Report on Form 10-K for the year ended December 31, 1999.

204. Andersen gave its written consent to incorporation of its audit opinion for WorldCom's 1999 annual financial statements as part of the May 2000 Registration Statement.

205. For the reasons set forth in detail in ¶¶ 92 through 96(a) and (b) above, the financial statements for 1999 and the first quarter of 2000 and Andersen's audit opinion, which were included and/or incorporated in the May 2000 Registration Statement, were materially false and misleading.

206. In addition, the May 2000 Registration Statement incorporated WorldCom's 1999 Form 10-K, which contained materially false and misleading narrative statements favorably describing the Company's business. For example, the 1999 Form 10-K boasted that the Company continued to decrease its line costs:

> Line costs as a percentage of revenue for 1999 were 43.0% as compared to 47.0% reported for the same period in the prior year. Overall decreases are attributable to changes in the product mix and synergies and economies of scale resulting from network efficiencies achieved from the continued assimilation of MCI, CompuServe Network Services and ANS into the Company's operations.

207. Further, the 1999 Form 10-K attributed the 104% increase in WorldCom's revenue to the following factors:

> Revenues for 1999 increased 104% to $37.1 billion as compared to $18.2 billion for 1998. The increase in total revenues is attributable to the MCI Merger and Embratel Acquisition as well as internal growth.

208. The 1999 Form 10-K also reported that the Company's cash flow from operations increased to $11.0 billion and set forth the following reasons for this increase:

> The increase in cash flow from operations was primarily attributable to the MCI Merger, internal growth and synergies and economies of scale resulting from network efficiencies and selling, general and administrative cost savings achieved from the assimilation of recent acquisitions into the Company's operations.

209. Moreover, the 1999 Form 10-K predicted that the Company would have sufficient cash flow for the next twelve months:

> Absent significant capital requirements for other acquisitions, the Company believes that cash flow from operations and available liquidity, including the Company's Credit Facilities and commercial paper program and available cash will be sufficient to meet the Company's capital needs for the next twelve months.

210. The May 2000 Registration Statement also incorporated by reference the 1Q 2000 Form 10-Q. This form contained further favorable narrative about WorldCom's business and operations:

> Revenues for the three months ended March 31, 2000, increased 9.4% to $10.0 billion as compared to $9.1 billion for the three months ended March 31, 1999. The increase in total revenues is attributable to internal growth of the Company.
>
> * * *
>
> Line costs as a percentage of revenues for the first quarter of 2000 were 41.0% as compared to 45.3% reported for the same period of the prior year. This improvement is a result of more traffic and revenues that have no associated access charges declining access and settlement costs, improved interconnection terms in Europe and network efficiencies associated with the MCI merger and sale of SHL. Additionally, access charge reductions that occurred in July 1999 and January 2000 reduced total line cost expense by approximately $124 million for the first quarter of 2000. While

> access charge reductions were primarily passed through to customers, line costs as a percentage of revenues were positively affected by over half a percentage point for the first quarter of 2000.
>
> * * *
>
> Selling, general and administrative expenses for the first quarter of 2000 were $2.3 billion or 23.0% of revenues as compared to 2.4 billion or 26.0% of revenues for the first quarter of 1999. The improvement in selling, general and administrative expenses is a result of a better mix of revenues, having scale in the Company network and the Company's ability to leverage certain staff areas such as information technology and engineering groups over a large base of revenues.

211. The statements referenced in ¶¶ 206 through 208 and 210 relating to WorldCom's year end results for 1999 and first quarter results for 2000 were each materially false and misleading because, as described above, the reason for the reported increase in WorldCom's revenues and decrease in lines costs and SG&A expenses was the accounting fraud and not the "internal growth" or improved network efficiencies.

212. In addition, the statement referenced in ¶ 209 above was false, because at the time of the May 2000 Offering, less than two months after the statement was made, the Company did not have sufficient cash flow to continue its operations for ten additional months. Indeed, it was seeking to borrow $5 billion from the public through the May 2000 Offering to pay off its mounting commercial paper debt and return to the short term debt market to continue to fund its operations.

213. The May 2000 Registration Statement was also materially false and misleading because it materially misrepresented WorldCom's creditworthiness. One of the key factors in evaluating a company's creditworthiness is its ability to pay its interest payments and other fixed charges from its earnings from continuing operations, the measure of which is referred to as the "earnings to fixed charges ratio." The higher the ratio, the lesser the risk associated with the

investment in a company, and the higher the creditworthiness of the company's debt. The May 2000 Registration Statement reported that in 1999 WorldCom had a ratio of earnings to fixed charges of 5.75:1, a relatively high ratio, which enabled the Company to obtain an investment grade credit rating. This ratio, however, was artificially inflated due to WorldCom's financial fraud. Had WorldCom and the May 2000 Underwriter Defendants calculated the Company's ratio based on its actual numbers, this ratio would have been much lower and the real risk involved with purchasing of the Notes would have been revealed. Indeed, had the real numbers been revealed, WorldCom would never have been able to obtain an investment grade credit rating and sell almost $5 billion of Notes to the public.

214. Further, the May 2000 Registration Statement was materially false and misleading because it failed to disclose that, as revealed in the Examiner's Second Interim Report, WorldCom selected the underwriters for the offering not on the basis of merit or other legitimate criteria, but on (a) the amount of credit that the underwriters' commercial banking affiliates had extended or committed to WorldCom; and (b) the ratings that the underwriters' analysts had agreed to provide WorldCom.

215. In addition, the May 2000 Registration Statement was materially false and misleading because, as set forth in more detail in ¶¶ 251 through 292, it failed to disclose the inherent conflicts of interest between Salomon, the lead underwriter of this Offering, and WorldCom.

216. Finally, the May 2000 Registration Statement omitted a risk factors section. By comparison, in its registration statement issued in connection with the 1998 notes offering, WorldCom included eight pages of risk factors. Item 503(c) of Regulation S-K specifically

requires companies to disclose risk factors "where appropriate." Here, a risk factors section was appropriate because:

(a) WorldCom did not have the means, intent or ability to satisfy the staggering amount of debt it was accumulating. Indeed, as the Examiner found, the WorldCom Board spent little, if any, time discussing or analyzing the Company's ever-increasing debt, even during board meetings immediately before and after a debt offering. WorldCom had no projections or models assessing whether the Company could sustain the enormous debt it was incurring;

(b) WorldCom was funding part of its operations and capital expenses with borrowed money;

(c) WorldCom had problems placing its commercial paper;

(d) WorldCom was not cash-flow positive;

(e) WorldCom had recently acquired numerous businesses in transactions that had not been properly considered (or considered at all) by the Board, that were not integrated and that made little, if any, business sense. For example, in 1999, WorldCom acquired Skytel for $2 billion. The Examiner determined that this transaction, which was approved by the WorldCom Board after a presentation by management lasting about 15 minutes, and without a single piece of paper being provided to the Board, was of "questionable strategic benefit" to WorldCom;

(f) WorldCom's stock, along with the stock of other companies in the telecommunications sector, was under-performing;

(g) WorldCom lacked any Board oversight and the Board was a rubber-stamp, completely beholden to management, that failed to perform the most basic functions of a

true Board, such as carefully considering and approving large corporate transactions. Indeed, when it came to WorldCom's debt offerings, Ebbers and Sullivan had unfettered discretion to commit the Company to billions of dollars in debt obligations with no Board oversight;

(h) the Board was dominated by Ebbers and Sullivan;

(i) the Company lacked any strategic planning or meaningful debt planning and thus had no ability to monitor its debt, let alone the ability to pay it off;

(j) Ebbers, in addition to what was supposed to be his full-time job as WorldCom's CEO, was actively involved in buying and/or running several businesses unrelated to WorldCom, including the largest working cattle ranch in Canada, a rice farm, a luxury yacht building company, a lumber mill, a country club, a trucking company, a minor league hockey team, an operating marina and a building in Chicago. Salomon and Banc of America knew, and the other May 2000 Underwriter Defendants either knew, or should have known of these facts. Indeed, as alleged herein, the affiliates of some of the Underwriter Defendants provided hundreds of millions of dollars of loans to Ebbers and his various businesses and even became business partners in some of his ventures. The May 2000 Underwriter Defendants should have questioned whether Ebbers' involvement in all of these businesses affected Ebbers' ability to successfully lead the Company, especially in view of the general downturn in the telecommunications industry, and certainly should have ensured that Ebbers' myriad business dealings be disclosed in the May 2000 Registration Statement as one of the Risk Factors, because this information would have been material to investors;

(k) Ebbers had accumulated millions of dollars of personal debt, mostly from

affiliates of the Underwriter Defendants.

217. Each of the facts referenced above was a highly material fact which should have been disclosed in the May 2000 Registration Statement.

B. The May 2001 Offering

218. In the spring of 2001, WorldCom's liquidity crisis continued and exacerbated. Although WorldCom used $5 billion of proceeds from the May 2000 Offering to pay off its short term commercial paper debt, it was so strapped for cash that it soon had to return to the commercial paper market to continue to fund its day to day operating expenses. By the end of March 2001, WorldCom's short-term debt had ballooned to almost $9 billion, and WorldCom could no longer access the commercial paper market for funding. In December 2000, WorldCom issued approximately $2 billion in bonds pursuant to a private placement, bringing its total debt to a staggering $18 billion.

219. At the same time, WorldCom had in place credit facilities for approximately $10 billion. As noted above, the Underwriter Defendants referenced in ¶ 198 and/or their affiliates were among the lenders under these credit facilities. Instead of drawing on the credit facilities to satisfy its short term debt obligations, WorldCom once again tapped into the public bond market, this time issuing $11.8 billion in debt. At the time, the May 2001 Offering was the largest debt offering in U.S. history.

220. Specifically, in May 2001, WorldCom issued approximately $11.8 billion worth of bonds as follows: $1,500,000,000 worth of 6.50% Notes due May 15, 2004; $4,000,000,000 worth of 7.50% Notes due May 15, 2011; $4,600,000,000 worth of 8.25% Notes due May 15, 2031; €1,250,000,000 worth of 6.75% Notes due May 15, 2008; and £500,000,000 worth of 7.25% Notes due May 15, 2008.

221. In connection with the May 2001 Offering, WorldCom filed with the SEC a Form

S-3 Registration Statement dated May 9, 2001 and a Form 424(B)(5) Prospectus Supplement dated May 11, 2001 (collectively the "May 2001 Registration Statement").

222. The May 2001 Registration Statement was signed by defendants Alexander, Allen, Areen, Aycock, Bobbitt, Ebbers, Sullivan, Galesi, Kellet, Macklin, Roberts and Sidgmore.

223. The following Underwriter Defendants were identified in the May 2001 Registration Statement as the underwriters for that offering: Salomon, J.P. Morgan, Banc of America, ABN/AMRO, Mitsubishi, Westdeutsche, BNP, Fleet, Blaylock, Caboto, Mizuho and Utendahl (together, the "May 2001 Underwriter Defendants"). J.P. Morgan and Salomon served as the joint book runners of the May 2001 Offering; ABN/AMRO acted as joint lead manager; Mitsubishi and Westdeutsche acted as senior co-manager, and BNP, Fleet, Blaylock, Caboto, Mizuho and Utendahl served as co-managers.

224. The May 2001 Registration Statement included WorldCom's materially false and misleading financial statements for 2000, and also incorporated by reference the following documents:

- WorldCom's Annual Report on Form 10-K for the year ended December 31, 2000, as amended on Form 10-K/A;
- WorldCom's Current Reports on Form 8-K dated April 26, 2001, which included the press release issued by WorldCom that day announcing its results for the first quarter of 2001; and
- Andersen's audit opinion included in WorldCom's Annual Report on Form 10-K for the year ended December 31, 2000.

225. Andersen gave its written consent to incorporation of its audit report on WorldCom's 2000 annual financial statements into the May 2001 Registration Statement.

226. For the reasons set forth in detail in ¶¶ 96 (b) though (c) above, the financial statements for 2000 and the first quarter of 2001 and Andersen's audit opinion, which were

included and/or incorporated in the May 2001 Registration Statement, were materially false and misleading.

227. Moreover, the May 2001 Registration Statement emphasized the Company's purportedly strong financial condition by including the following statement:

> WorldCom group reported first quarter 2001 revenues of 6.1 billion, a 12 percent increase from the same period in 2000. This strong result was driven by 22 percent year-over year revenue growth in data and Internet services and 19 percent revenue growth in international services.

This statement was false, because as described in more detail above, the reason for WorldCom's reported revenue growth in the first quarter of 2001 was accounting fraud, and not "growth in data and Internet service" or "growth in international services."

228. In addition, the May 2001 Registration Statement incorporated by reference WorldCom's 1Q 2001 Press Release, which contained the following favorable statements about WorldCom's business and operations:

> This quarter was an excellent start to what will be a pivotal year for WorldCom. These results show that WorldCom is on track to deliver strong growth and solid performance throughout the year.
>
> * * *
>
> On the WorldCom group side we achieved our growth targets, adding $237 million in revenues since the fourth quarter—the largest sequential increase we've delivered in a year.
>
> * * *
>
> And on the MCI group side we made excellent progress adjusting our businesses to maximize and maintain profitability and cash flow as far into the future as possible.

229. The statements in the preceding paragraph were materially false and misleading because, as described in more detail above, WorldCom's purportedly strong financial results for the first quarter of 2001 were achieved through accounting manipulations and not through "strong growth," "solid performance" or maximized "profitability."

230. Moreover, the May 2001 Registration Statement incorporated by reference the 2000 Form 10-K, which contained materially false and misleading narrative statements favorably describing WorldCom's financial results for 2000. For example, as noted above, in the 2000 Form 10-K, WorldCom falsely stated that it continued to decrease its line costs:

> Line costs as a percentage of revenues for 2000 decreased to 38.4% as compared to 40.1% reported for the prior year. The overall improvement is a result of increased data and dedicated Internet traffic over WorldCom-owned facilities, which positively affected line costs as a percentage of revenues by approximately one and one half percentage point.

231. The Form 2000 10-K also attributed WorldCom's increase in revenues to its internal growth rather than accounting fraud:

> Revenues for 2000 increased 15.3% to $22.8 billion versus $19.7 billion for the same period in the prior year. The increase in total revenues is attributable to internal growth of the WorldCom group.

232. The May 2001 Registration Statement was also materially false and misleading because it misrepresented the Company's earnings to fixed charges ratio. The May 2001 Registration Statement reported that this ratio for 2000 was 5:25:1, a relatively high ratio, and one which was consistent with an investment grade credit rating. This ratio, however, was again artificially inflated due to WorldCom's financial fraud. Had WorldCom and the May 2001 Underwriter Defendants calculated the ratio based on WorldCom's actual numbers, the ratio would have been much lower and the real risk involved with purchasing the Notes would have been revealed. Indeed, had the real numbers been revealed, WorldCom would have never been able to obtain an investment grade credit rating and sell almost $12 billion of Notes to the public.

233. Finally, the May 2001 Registration Statement was also materially false and misleading because it failed to disclose that the risk factors section was appropriate, because:

(a) WorldCom did not have the means, intent or ability to satisfy the staggering

amount of debt it was accumulating. Indeed, as the Examiner found, the WorldCom Board spent little, if any, time discussing or analyzing the Company's ever-increasing debt, even during board meetings immediately before and after a debt offering. WorldCom had no projections or models assessing whether the Company could sustain the enormous debt it was incurring.

(b) WorldCom was funding part of its operations and capital expenses with borrowed money;

(c) WorldCom had problems placing its commercial paper;

(d) WorldCom was not cash-flow positive;

(e) WorldCom had to renegotiate its credit facilities;

(f) WorldCom had acquired businesses in transactions that were not approved or considered by the Board, were not successfully integrated, and made little, if any, business sense.

(g) WorldCom's stock, along with the stock of other companies in the telecommunications sector, was under-performing;

(h) WorldCom lacked any Board oversight and the Board was a rubber-stamp, completely beholden to management that failed to perform the most basic functions of a true Board, such as carefully considering and approving large corporate transactions. Indeed, when it came to WorldCom's debt offerings, Ebbers and Sullivan had unfettered discretion to commit the Company to billions of dollars in debt obligations with no Board oversight;

(i) the Board was dominated by Ebbers and Sullivan;

(j) the Company lacked any strategic planning or meaningful debt planning and

thus had no meaningful ability to monitor its debt;

(k) Ebbers, in addition to what was supposed to be his full-time job as WorldCom's CEO, was actively involved in buying and/or running several businesses unrelated to WorldCom, including the largest working cattle ranch in Canada, a plantation, a luxury yacht building company, a lumber mill, a country club, a trucking company, a minor league hockey team, an operating marina and a building in Chicago. The Underwriter Defendants knew or should have known these facts. Indeed, as alleged herein, the affiliates of some of the May 2001 Underwriter Defendants provided hundreds of millions of dollars of loans to Ebbers and his various businesses and even became business partners in some of his ventures. The May 2001 Underwriter Defendants should have questioned whether Ebbers' involvement in all of these businesses affected his ability to successfully lead the Company, especially in view of the general downturn in the telecommunications industry, and certainly should have ensured that Ebbers' myriad business dealings be disclosed in the May 2001 Registration Statement as one of the Risk Factors, because this information would have been material to investors; and

(l) Ebbers had accumulated almost a billion of dollars of personal debt, mostly from loans by affiliates of the May 2001 Underwriter Defendants; and

(m) a forward-sale of 3 million shares of WorldCom stock that Ebbers made in September 2000 violated Company policy on insider trading and, as the Examiner determined, likely constituted a violation of federal securities laws.

234. As noted by the Examiner, the failure to disclose risk factors in the May 2001 Registration Statement violated the SEC regulations.

235. Each of the facts referenced above was a highly material fact which should have been disclosed in the May 2001 Registration Statement.

236. The May 2001 Registration Statement was materially false and misleading because it failed to disclose material facts regarding WorldCom's $6 billion acquisition of Intermedia, including the material facts that WorldCom had done no due diligence prior to agreeing to the transaction, and that the transaction had not been approved by the Board. On September 5, 2000, WorldCom announced that it had agreed to pay $6 billion to acquire Intermedia, a web-hosting company, in what one WorldCom director later described as an "ego deal" for Ebbers. The deal was based on roughly 60-90 minutes of due diligence and a 35 minute telephonic Board meeting for which some directors received less than two hours notice. The Board was not provided with any written materials or analyses concerning this transaction. Notwithstanding these facts, and the fact that numerous people involved with the Board's "deliberation" of this transaction later told the Examiner that they were "disturbed" by the deal, the Board approved the transaction.

237. Subsequently, minority shareholders of Intermedia filed a lawsuit challenging the transaction. This litigation, and the declining value of Intermedia's assets, gave WorldCom an opportunity to abandon the transaction. Rather than do so, WorldCom management, without consulting the Board, entered an agreement to settle the lawsuit and signed an amended merger agreement in February 2001 – less than three months before the May 2001 Offering. Although a February 15, 2001 press release issued by WorldCom specifically stated that "[t]he proposed settlement has been approved by the Board of Directors of WorldCom," that was untrue; the Company's directors had not even been polled at the time with respect to whether they wanted to settle the lawsuit on the terms agreed to, or whether they wanted to continue with the transaction. The acquisition of Intermedia was a dismal failure for WorldCom, producing massive losses for the

Company. The Examiner determined that an informed Board would not have approved this transaction, and that there was no legitimate business purpose for it. Nevertheless, despite these highly material facts, the May 2001 Registration Statement failed to disclose a single fact about the Intermedia transaction, including the circumstances surrounding the Board's "consideration" of the transaction, the fact that the Board had not approved the amended merger agreement or the settlement of the shareholder lawsuit (despite the Company's February 15, 2001 announcement), and the fact that the transaction had no legitimate business purpose. These facts, had they been disclosed, would have put investors on notice that the most basic and fundamental internal corporate controls did not exist at WorldCom, and that the Company's Board of Directors was utterly derelict in performing its duties.

238. The May 2001 Registration Statement was also false and misleading because it failed to disclose material facts about the hundreds of millions of dollars of loans that WorldCom made to Ebbers beginning in September 2000. Again, by the time of the May 2001 Offering, WorldCom had loaned Ebbers $100 million, and had guaranteed in favor of Bank of America loans to Ebbers of $150 million, so that Ebbers would not follow through on his threat to liquidate his WorldCom stock holdings to cover margin calls. Significantly, the full Board did not initially approve these massive loans to Ebbers, and the Examiner subsequently determined that the collateral underlying these loans was insufficient to support the credit extended to Ebbers, in light of his substantial other loans and obligations, thus leaving WorldCom exposed to hundreds of millions of dollars of losses in the event of a significant decline in the price of WorldCom stock. None of these material facts was disclosed to investors.

239. In addition, the May 2001 Registration Statement was materially false and misleading because it failed to disclose that, as revealed in the Examiner's Second Interim Report,

WorldCom selected the underwriters for the offering not on basis of merit or other legitimate criteria, but on (a) the amount of credit that the underwriters' commercial banking affiliates had committed to WorldCom, and (b) the ratings that the underwriters' analysts had agreed to provide to WorldCom.

240. Finally, the May 2001 Registration Statement was materially false and misleading because, as set forth in more detail in ¶¶ 252 – 292, it failed to disclose the inherent conflicts of interest between Salomon, the lead underwriter of this Offering, and WorldCom.

The False and Misleading Registration Statements Issued in Connection with WorldCom Acquisitions

A. The SkyTel Acquisition

241. On August 26, 1999, WorldCom filed a Form S-4 registration statement with the SEC for the acquisition of SkyTel Communications, through a merger of SkyTel into a wholly owned subsidiary of WorldCom. In the transaction, each outstanding share of SkyTel common stock was converted into the right to receive 0.3849 shares of WorldCom common stock. On October 1, 1999, WorldCom filed a Form S-3 registration statement in connection with the Sky-Tel acquisition. The transaction, which was completed on October 1, 1999, issued approximately 23 million shares of WorldCom stock to Sky-Tel shareholders.

242. The Form S-4 for the SkyTel acquisition set the date for shareholder meetings to vote on the acquisition for September 29, 1999. The Form S-3 included and incorporated by reference the financial statements issued by WorldCom for the year ended December 31, 1998, and for the six months ended June 30, 1999. For the six months ended June 30, 1999, the financial statements included in that registration statement reported revenues of $17.945 billion (an increase of nearly four times the $4.901 billion for the six months ended June 30, 1998), and operating

income of $3.259 million (an increase of 7 times the $0.423 million for the six months ended June 30, 1998).

243. For the reasons stated in ¶¶ 96(a) – (c) above, the financial statements for the first and second quarters of 1999 reported and incorporated by reference in the registration statement for the SkyTel acquisition were materially false and misleading.

244. The registration statement for the SkyTel acquisition was signed by or with authorization on behalf of defendants Alexander, Allen, Areen, Aycock, Bobbitt, Ebbers, Galesi, Kellett, Macklin, Porter, Roberts, Sidgmore, Sullivan and Tucker.

B. The Intermedia Acquisition

245. On October 16, 2000, WorldCom filed a draft Form S-4 registration statement with the SEC for the acquisition of Intermedia Communications Inc., through a merger of a wholly owned subsidiary of WorldCom with and into Intermedia, with Intermedia remaining as the surviving corporation and as a WorldCom subsidiary. A final version of the Form S-4/A registration statement was filed on May 14, 2001.

246. In the transaction, in which Intermedia was acquired for approximately $5.8 billion, including assumed long-term debt, stockholders of Intermedia received one share of WorldCom stock (or 57.1 million shares of WorldCom stock in the aggregate) and 1/25 of a share of WorldCom's MCI Tracking stock (or 2.3 million MCI group shares in the aggregate) for each share of Intermedia stock they owned. The Intermedia acquisition was completed on July 1, 2001. The transaction implemented the companies' Agreement and Plan of Merger, dated September 1, 2000, as amended by first and second amendments to the Agreement and Plan of Merger, dated February 15, 2001, and May 14, 2001.

247. The registration statement for the Intermedia acquisition set the date for shareholder meetings to vote on the acquisition for June 19, 2001. The registration statement, which contained

the proxy statement/prospectus, set forth a summary of WorldCom's reported financial statements for the years 1996 through 2000 (including its now-admitted overstated earnings in 1999 and 2000), and further incorporated by reference various documents that WorldCom had previously filed with the SEC, which were described as containing "important business and financial information about WorldCom." The documents incorporated by referenced included: WorldCom's Annual Report on Forms 8-K, as amended by Amendment No. 1, dated April 25, 2001 (filed April 26, 2001); the Proxy Statement filed April 26, 2001; and Current Reports on Form 10-K, including filings dated February 8, March 14, March 28, April 26 and May 1, 2001. Thus, the registration statement incorporated by reference WorldCom's financial statements for the years ended December 31, 1999 and 2000, and for the three months ended March 31, 2001.

248. For the reasons specified in ¶¶ 96-102 above, the financial statements for the years 1999 and 2000, and for the first quarter in 2001, which were incorporated by reference in the registration statement for the Intermedia acquisition were materially false and misleading.

249. The registration statement for the Intermedia acquisition was signed by or with authorization on behalf of defendants Alexander, Allen, Areen, Aycock, Bobbitt, Ebbers, Galesi, Kellett, Macklin, Roberts, Sidgmore and Sullivan. It further included, as Exhibit 23.1, a Consent of Arthur Andersen LLP to the inclusion of its opinion statement with respect to the Company's 2000 financial statements.

250. Defendant Salomon was the initial financial advisor to WorldCom on the Intermedia acquisition, but resigned on August 31, 2000, based on a reported conflict of interest. On the same day, defendant Chase was engaged as the Company's advisor.

THE NEFARIOUS RELATIONSHIP BETWEEN SALOMON AND WORLDCOM

The Investment Banking Business According to Salomon

251. In the six years preceding the WorldCom debacle, Salomon became the preeminent investment banking firm in the telecommunications sector of the market. In that period, Salomon worked with over eighty telecommunications companies to raise approximately $190 billion in debt and equity. In return, according to Thomson Financial, Salomon collected from telecommunications companies approximately $809 million in fees relating to underwriting services and approximately $178 million in fees relating to financial advice in connection with mergers and acquisition in the period between 1997-2001. Salomon's fees for that period were well over 40% greater than those of its closest rival in the telecommunication industry, Merrill Lynch.

252. Recent events and documents disclosed to the public, however, reveal that underlying Salomon's stunning success was a complex scheme of what the New York Attorney General described as "commercial bribery." To obtain the coveted investment banking services and fees, Salomon enticed top executives of telecommunications companies with a package of Wall Street's hottest currencies: (1) a guarantee of favorable analyst reports and ratings to bolster the value of the potential client's stocks; and (2) for the decision-makers at the potential clients, lucrative shares in "hot" initial public offerings. This illicit, multi-faceted quid pro quo arrangement was never disclosed to WorldCom investors, who relied on the supposed integrity of Salomon's underwriting process and the independence of Salomon's research.

The Initial Public Offering Process

253. By way of background, an initial public offering, or "IPO," is the first public issuance of stock from a company that has never been publicly traded. Wall Street investment banks like Salomon are key players in the complex process of underwriting, that is, bringing to

market, the IPOs. In a "firm commitment" IPO, the standard form of equity offering in the United States, the issuer enters into an underwriting agreement to sell all of the offered securities to an underwriting syndicate. The syndicate members in turn sell the offered shares to the public at a set offering price (or at a discount to dealers who then resell the shares to the public).

254. The NASD defines a "hot issue" as securities from an initial public offering which trade at a premium in the secondary market whenever such secondary market begins trading (hereinafter, "Hot IPO Shares"). The perception that a particular issue is "hot" creates a very high demand for the Hot IPO Shares in the secondary market. This in turn raises the prices of such shares in the secondary markets, often to extraordinary amounts. Consequently, the ability to purchase Hot IPO Shares at the IPO price creates a tremendous opportunity for a quick profit. An investor purchasing Hot IPO Shares at the IPO price can sell the shares in the secondary market within days, or even hours, from the initial purchase for an immediate and hefty profit. Thus, Hot IPO Shares became known as one of Wall Street's hottest currencies, or so called "free money."

255. Although, in general, under the NASD regulations, underwriters may not withhold Hot IPO Shares for their own accounts, the lead underwriters in the syndicate are usually awarded between 70% to 85% of the total IPO shares and have substantial, if not exclusive, discretion to allocate the IPO shares to their favored customers. The ability to selectively allocate the highly coveted Hot IPO Shares provides the lead underwriters with a powerful tool to reward their top investment banking clients for past business and to "encourage" them (or new, would-be clients) to provide investment banking business in the future.

<u>Salomon's Allocation of Hot IPO Shares</u>

256. Documents produced by Salomon in connection with various governmental investigations reveal that Salomon's systematic and selective allocation of Hot IPO shares in exchange for investment banking services amply support the New York Attorney General's

concerns about "commercial bribery." For example, The Wall Street Journal reported that Peggy Paterson, spokeswoman for the House of Representatives Committee on Financial Services, said that documents produced by Salomon to Congress in 2002 led to "an inescapable conclusion that the [IPO] shares were offered in order to leverage investment banking business." (Emphasis added). More recently, upon the conclusion of this investigation into Salomon's conduct New York Attorney General Spitzer issued a finding that "[d]uring the period 1996 through 2000, Salomon engaged in improper spinning practices by allocating hot IPO shares to executives of current or potential investment banking clients and providing special treatment for these executives."

257. One of the key Salomon employees involved in determining which top executives got what Hot IPO shares was Rick Olson ("Olson"), who worked in Los Angeles. One of Olson's top assistants during the relevant period was David Chacon ("Chacon"), who was interviewed about IPO spinning by a correspondent for Public Broadcasting System's Frontline for a documentary that aired in May 2003. Chacon confirmed that Olson was given his own IPO share allocation, which was separate and distinct from Salomon's standard allocation policy. Documents produced to the New York State Attorney General confirm that Olson's "Private Wealth Management" office received 35% of the total IPO shares allocated for distribution for Salomon's ten largest branches and Olson's office combined. According to Chacon, "Rick Olson was the point man for Jack Grubman. He was in charge of managing the personal stock portfolios of the corporate decision makers whom [Salomon] did investment banking business with, strictly in the telecommunications sector…." Chacon also stated that, "Grubman would be very much involved in the management of these portfolios and ensuring that his top decision makers, within a corporation, who directed investment banking business to the firm, were being taken care of."

Elaborating further on Grubman's role in the spinning process, Chacon said, "Jack Grubman's role [was] calling the syndicate desk and ensuring that his guys are being taken care of. Jack Grubman's involvement is communicating with Rick Olson and ensuring that their accounts are doing well. Jack Grubman's involvement is sitting down with corporate officers on a daily basis and asking them the question: 'Are you happy with the returns that you're getting at our firm?'" Chacon also revealed that, while other Wall Street firms also engaged in spinning of upcoming Hot IPO Shares, Grubman and Salomon took the process one step further by offering coveted IPO shares after the shares had turned "hot" in the secondary market. As Chacun described:

> . . . So rather than, Goldman Sachs saying, "Bernie we've got 10,000 shares of XYZ at the IPO price," the day before the stock starts trading, Salomon would be able to take it [up] a few notches and be able to call these same officers and directors, saying, "Look I have 20,000 shares of this company. It's trading at $85 right now, and [we] wanted to give you the opportunity to invest at the IPO price.

258. Employing tactics such as those described by Chacon, Salomon had, since 1996, repeatedly allocated thousands of Hot IPO Shares to the same top executives of the same telecommunications companies. In return, these executives, who were all in the position to determine or influence the selection of their company's financial advisers or underwriters, repeatedly directed to Salomon investment banking business worth many millions of dollars.

259. According to a complaint filed by Elliot Spitzer, the New York State Attorney General, on September 30, 2002 (the "Attorney General's Complaint"), documents referred to in the Attorney General's IPO Complaint, and documents produced by Citigroup on Salomon's behalf to the House Committee on Financial Services, these executives included, but were not limited to, Philip F. Anschutz, former Chairman of Qwest Communications, who was allocated Hot IPO Shares on at least fifty-seven occasions and who derived $4.8 million in profit; Joseph Nacchio, former Chief Executive of Qwest Communications, who was allocated Hot IPO Shares on at least

forty-two occasions and who derived $1 million in profit; Stephen Garofalo, founder of Metromedia Fiber Network, Inc., who was allocated Hot IPO Shares on at least thirty-seven occasions and who derived $1.5 million in profit; Clark McLeod, founder of McLeod Telecommunications, who was allocated Hot IPO Shares on at least thirty-two occasions and who derived $9.4 million in profit; and, last but not least, Ebbers of WorldCom, who was allocated Hot IPO Shares by Salomon on at least twenty-one occasions and derived a whopping $11.5 million in profit. In addition, Sullivan, WorldCom's chief financial officer, received at least 32,300 Hot IPO Shares in nine companies, and defendant Kellett, a WorldCom director, received at least 31,550 Hot IPO Shares from Salomon. In the same period, Salomon underwrote or advised on eighteen deals for Qwest, fifteen deals for Metromedia, sixteen deals for McLeod, and twenty-three deals for WorldCom. These deals generated $240 million in fees for Salomon.

260. Indeed, some of the issues allocated to Ebbers were not just hot, but scorching. For example, according to a chart Citigroup provided to the House Committee on Financial Services in August 2002, Ebbers received approximately 10,000 shares of the IPO of Rhythms NetConnections Inc. ("Rhythms"), whose stock soared 229% on its first trading day in April 1999.

261. In addition, as the NYSCRF's investigation had previously revealed, there is evidence that Salomon may have actually materially understated the amount of shares that Ebbers received. In response to a request for the number of IPO shares allocated to each WorldCom "officer," Salomon provided documents to Congress which showed that, among other allocations, it allocated Ebbers only 10,000 shares of the IPO of Rhythms. However, in his interview with Frontline, Rick Olson's self-described "right-hand man," Chacon, said the allocation was in fact much higher. Shortly after the Rhythms IPO took place (and the price of the stock soared in the aftermarket), Olson told Chacon, "just between us girls," that "Bernie Ebbers just got 350,000

shares" of that IPO. Pending completion of discovery, it is unclear if Olson was referring to shares that might have been allocated to members of Ebbers' family or to one of his many trusts or businesses.

262. Even assuming Citigroup's submission to Congress was full and complete, Ebbers' allocations also often represented very high percentages of Salomon's total allotment. For example, Ebbers was awarded two-thirds of Salomon's entire retail allocation involving the IPO of McLeod in June 1996 – 200,000 shares valued at $20 million. Ebbers also received 200,000 shares of Nextlink Communication, or 10.52 % of Salomon's entire retail allotment, and 205,000 shares in Qwest, or 12.42% of the entire Salomon allocation. As Salomon admitted in its August 7, 2002 letter to the Committee on Financial Services, "some allocations to corporate officers and directors . . . were sufficiently large as to raise questions about the appearance of conflicts."

Salomon's "Independent" Research Department

263. In addition to selective and manipulative allocation of Hot IPO Shares, Salomon also used another covert currency – the allegedly "independent" analyst research reports and ratings – to gain additional investment banking business. This part of the scheme was further illuminated in April 2003, when the New York Attorney General's Office released findings and conclusions arising from its investigation of Salomon's investment banking and research activities. See In the Matter of Citigroup Global Markets Inc. (f/k/a Salomon Smith Barney Inc.), Assurance of Discontinuance Pursuant to Executive Law of 6B(15), dated April 21, 2003 ("Citigroup Assurance of Discontinuance"). The Attorney General found that Salomon had long assured investors that their research analysts were "providing independent objective and unbiased information, reports, ratings and recommendations upon which investors could rely in reaching investment decisions." Citigroup Assurance of Discontinuance ¶14. However, documents referred to in the Citigroup Assurance of Discontinuance, the Attorney General's IPO Complaint, and elsewhere demonstrate

that Salomon had a very different idea of the role of the research analyst in affecting investors decision making.

264. For instance, in a January 1998, presentation to senior management at Travelers Corporation (Salomon's parent before that corporation merged under Citigroup), a senior Solomon officer noted "a continuing shift in the realization that an analyst is the key element in banking success." (Emphasis added). On December 8, 2000, John Hoffmann, the head of Salomon's Global Equity Research Management, wrote to Salomon CEO Michael Carpenter that one of his goals as global director of research had been "to better integrate our research product with the business development plans of our constituencies, particularly investment banking . . . ." (Emphasis added)

265. According to the Attorney General's findings in the Citigroup Assurance of Discontinuance, Salomon's business practices "intertwined research with investment banking to exert inappropriate influence over research analysts." Moreover, the Attorney General found that Salomon "failed to manage the resulting conflicts of interest in an adequate or appropriate manner." This was because the incentives for integrating the two services and, even more so, fostering the conflicts of interest were clear: as the Attorney General found, "research was a cost center" for Salomon, whereas investment banking business generated substantial profits.

266. As the Attorney General found, to "leverage its research, Salomon required research analysts to serve, among others, investment banking." In addition to being encouraged by Salomon to develop investment banking business, analysts were expected to prepare a business plan that included what the analyst had done, and would do, for the investment banking business. Salomon analysts were expected to support investment banking by pitching prospective business to prospective clients and being involved in the underwriting process and the luring of prospective investment banking services. Meanwhile, investment bankers reviewed the performance of the

principal analysts in their sector as part of the analysts' annual reviews. The analysts were also incentivized to satisfy the investment bankers because their compensation was linked to the amount of investment banking revenue they generated. Accordingly, this tight connection between analysts and investment banking was the driving force behind the content of Salomon's reports.

267. In fact, it was well known at Salomon that the purportedly independent research process was a farce. In December 2000, Hoffman told Carpenter that there was "legitimate concern" about the objectivity of Salomon's analysts. As of early 2001, Salomon employed a five-tier stock rating system: (a) Buy; (b) Outperform; (c) Neutral; (d) Underperform; and (e) Sell. The "Buy" rating was the highest possible for a particular stock, with each successive tier indicating an increasingly lower recommendation. In a presentation addressing Salomon's research ratings at a Salomon equities management meeting in early 2001, Hoffman showed that, of the 1179 public companies that Salomon rated, there were no "sell" ratings and only one "underperform" rating. He described these ratings as the "worst" and "ridiculous on face" in handwritten notes attached to the presentation. He also observed that there was a "rising issue of research integrity" and a "basic inherent conflict" between investment banking and research. In a February 2001 memorandum, Jay Mandelbaum, the global head of Salomon's retail stock selling division, told Hoffman that Salomon's "research was basically worthless."

268. Consistent with Salomon's goal of de facto integration of the research department and the investment banking department, and as revealed in the Attorney General's IPO Complaint and confirmed in the Citigroup Assurance of Discontinuance and elsewhere, Salomon began to involve research analysts in the underwriting process -- including due diligence -- and, further, in the very process of developing the lists of potential investment banking clients and in the "beauty contest" for prospective investment banking services. Since the top Wall Street investment banks

have traditionally charged similar underwriting fees, the prospect of favorable research coverage by a well-recognized and widely-followed analyst became a key factor in a company's selection of an underwriter. Since the mid-1990's, it eventually became clear that, at least with respect to the telecommunications industry sector, Salomon could deliver the research coverage of a telecom executive's dream: glowing analyst reports written by Jack Grubman.

The Grubman Factor

269. Grubman was, until August 15, 2002, Salomon's top telecommunications analyst, and one of the most powerful men on Wall Street. As observed by Time Magazine on August 5, 2002, "every big investor knew Grubman was the 'ax,' the one man who could make or break any stock in [the telecommunications] industry with a thumbs-up or thumbs-down." The financial media referred to Grubman as the "Pied Piper" of telecom, the analyst who, like the protagonist of the fable, sang a tune of broad influence. Royce Holland, CEO-Allegiance Telecom, was quoted at a 1998 meeting of fund managers in Boston that, when Grubman spoke, "It was like the messiah had come to town." Business Week, "The Power Broker," May 15, 2000. "[Grubman] knows more about what's going on in the industry than anybody," said Rob Gensler, Portfolio Manager for T. Rowe Price Media & Telecom in that same article.

270. Grubman's success within the ranks of Salomon's analysts was unquestionably linked to his particular receptiveness to the desires of Salomon's investment bankers and their top clients. Although his research was presented to the public as independent, the facts and documents revealed in connection with various governmental investigations into Salomon's practices demonstrate that Grubman was in no way "independent" of the companies he covered.

271. For example, it has been revealed that Grubman was more of a strategic adviser or merger broker to the companies he covered, rather than an objective analyst. In its August 7, 2002 letter to the House Committee on Financial Services, Citigroup disclosed that since 1997, Grubman

had attended at least ten meetings of the board of directors of Salomon's top investment banking clients, including at least two meetings of WorldCom's Board of Directors. Most of these meetings (frequently held at the invitation of Salomon's investment bankers or top executive officers) related to these companies' key mergers and acquisitions, including WorldCom's acquisition of MCI and its proposed acquisition of Sprint, in which Salomon played the role of financial adviser. Indeed, the minutes for the two WorldCom board meetings at which those transactions were approved (September 29, 1997 for MCI and October 4, 1999 for Sprint) identified Grubman as among those in attendance as "financial advisor to the Company." Grubman also served as a proxy solicitor on WorldCom's behalf in connection with the MCI merger.

272. One compelling example of Grubman's reach and influence at WorldCom shows how firmly entrenched he was as a de facto insider and senior strategic thinker within that Company since even before the outset of the Class Period. On April 12, 1999, Grubman left a lengthy voice message for Sullivan, which was transcribed and e-mailed to Sullivan and Sidgmore, then Vice Chairman of the Board. At that time, it was widely reported that WorldCom was close to acquiring Nextel, the wireless carrier. (Indeed, the NYSCRF's investigation has confirmed that the two companies had already agreed on a price, established "collar" ranges for the stock that would fund the deal, and performed due diligence visits to each others facilities.) Describing the reactions he had heard during visits with several large institutional investors, Grubman expressed doubts about the Nextel deal and said, "we could spin this any way we want but I really think [the Nextel acquisition] will cause a really bad reaction." "I am just not convinced it is the right asset for you or the right thing to do," he said. Two days later, Sidgmore told The New York Times that WorldCom would not buy Nextel.

273. Grubman also played a role in the allocation of Hot IPO Shares at Salomon. As noted above, Grubman was the key decision maker in Salomon's allocation of Hot IPO Shares to executives in the telecom sector. Further, as reported by The New York Times on August 4, 2002, a number of other former Salomon employees stated that "the allocations have been made to executives when Salomon wanted to build relationships with the executives' companies or keep existing relationships strong." The Times noted that these executives were, in effect, "part of an exclusive, very prosperous club, and membership was controlled by Mr. Grubman." Documents provided by Citigroup to the House Committee on Financial Services further corroborated these allegations. Citigroup produced two e-mails, dated March 31, 1999 and May 21, 1999, listing the names of executives who should be allocated Hot IPO Shares. Grubman was copied on both of these e-mails. During Grubman's testimony before Congress, however, when faced with the question whether certain executives had special access to Hot IPO shares, Grubman feigned ignorance: "I don't recall. I don't say 'yes,' I don't say 'no.'"

274. Most significantly, Grubman repeatedly issued "Buy" recommendations on stocks despite what he learned through his unique access to corporate managers. The reason? Investment banking concerns. For example, as revealed by documents produced by Salomon to the New York State Attorney General, Grubman admitted in an internal e-mail that he failed to timely downgrade certain stocks solely because of the pressure from his investment banking colleagues. In a June 2001 e-mail to Kevin McCaffrey, Salomon's head of U.S. research management, Grubman observed:

> [M]ost of our banking clients are going to zero and you know I wanted to downgrade them months ago but got huge pushback from banking. I wonder of what use bankers are if all they can depend on to get business is analysts who recommend their banking clients. (Emphasis added).

275. At about that same time, Grubman e-mailed a research colleague about an upcoming dinner meeting at which he expected to hear two senior investment bankers complain about some of his recent commentary on telecom stocks. Grubman vented: "Screw [the investment bankers]. We should have put a Sell on everything a year ago. (Emphasis added.)

276. In an e-mail in May 2001 – the same month as the 2001 Offering – Grubman admitted to a member of his research team: "If anything the record shows we support our banking clients too well and for too long. (Emphasis added.)

277. As a further example, on February 21, 2001, Grubman issued a research note on Focal Communications, one of Salomon's major investment banking clients, reiterating his "Buy" rating on the company. After Grubman learned that Focal was dissatisfied with certain parts of his note, he e-mailed two of Salomon's investment bankers that evening with the following message:

> If I so much as hear one more f---ing peep out of them [Focal] we will put the proper rating (i.e. 4 not even 3) on this stock which every single smart buysider feels is going to zero. We lost credibility on MCLD and XO because we support pigs like Focal.

Earlier that day, Sherlyn McMahon ("McMahon," occasionally referred to as "Sheri" in e-mail), the senior research analyst under Grubman, received the following inquiry from an investor: "Focal and McLeod are pigs aren't they?" McMahon replied: "FCOM [Focal] definitely MCLD hold not sell."

278. Grubman's scorecard with respect to recommending "pigs like Focal" to the investing public because of investment banking pressure is startling. For example, as late as three weeks before Winstar Communications filed for bankruptcy protection, Grubman held a "Buy" recommendation on the stock. Similarly, Grubman held a "Buy" recommendation" on XO Communications until November 2, 2001, less than a month before the company filed for bankruptcy, when he downgraded it to "Neutral." In fact, Grubman had a "Buy" on Winstar from

June 2000, when it traded at $40, to April 2001, when it traded at $1. Both Winstar and XO Communications were major investment banking clients of Salomon.

279. Grubman's conflicted role as both investment banker and analyst had not gone unnoticed by Salomon's own brokers. As shown in documents referenced in the Attorney General's Complaint and the Citigroup Assurance of Discontinuance, numerous former Salomon retail brokers who worked with Grubman believed that Grubman's stock ratings – and in particular his ratings on WorldCom – were false and misleading:

> Grubman is an investment bank whore! When is the firm going to stop pimping him?
>
> * * *
>
> He put me as an advisor to clients in a very difficult position. My clients now question me if a stock we are recommending is an investment banking client. They asked me if we are recommending the stock because we want their banking business. Our blind support of banking (a la WCOM/T) is hurting our retail clients. With recent SEC company communication restrictions, analysis is more important than ever. We can not afford an overpriced cheerleader like Grubman.
>
> * * *
>
> Has cost millions of dollars for SSB clients, I am appalled that he is now in a position to profit from our clients' losses, through his WCOM [investment] banking function. This sends a strong message that retail clients and retail brokers don't matter.
>
> * * *
>
> [T]o represent himself as an analyst is an egregious act by the management of this firm. Clearly many of his Buy and table-pounding Buys were directly related to investment banking $ for him and his firm . . . Shame on him, shame on the banking division, shame on the senior management of this firm.
>
> * * *
>
> Jack Grubman is not an analyst – he is an investment banker.
>
> * * *
>
> [P]oster child for conspicuous conflicts of interest;

* * *

> I hope Smith Barney enjoyed the investment banking fees he generated, because they come at the expense of the retail clients;

* * *

> His opinions are completely tainted by 'investment banking' relationships (padding his business);

* * *

> Grubman has made a fortune for himself personally and for the investment banking division. However, his investment recommendations have impoverished the portfolio of my clients and I have had to spend endless hours with my clients discussing the losses Grubman has caused them.

* * *

> Grubman's analysis and recommendations to buy (1 Ranking) WCOM [Worldcom], GX [Global Crossing], Q [Qwest] is/was careless;

* * *

> His ridiculously bullish calls on WCOM and GX cost our clients a lot of money;

* * *

> How can an analyst be so wrong and still keep his job? RTHM [Rhythm NetConnections], WCOM, etc., etc.;

280. In its August 7, 2002 letter to the House Committee on Financial Services, Citigroup admitted that, unbeknownst to most of the investing public, Grubman's compensation was linked to the investment banking revenues he generated. Indeed, beginning in 1997, Salomon (then Smith Barney) paid "helper's fees" to analysts as a percentage of the investment banking fees generated by the transactions on which the analysts worked. In more recent years, Salomon simply told its analysts to "list in detail your involvement in Investment Banking Transactions over the past year" (or similar language) on their performance evaluation forms. Each analyst's compensation was

then determined based on this response. According to documents prepared in connection with Grubman's evaluations, Salomon earned almost $800 million in gross fees from telecom companies covered by Grubman; approximately $359 million in 1999, $331 million in 2000, and $101 million in 2001. In 2001 alone, Grubman listed ninety-seven investment banking transactions in which he was involved and (according to Grubman) total investment banking revenues of $166 million. As previously noted, between 1998 and 2002, Grubman made approximately $20 million a year.

281. Both Carpenter and Citigroup Chairman and CEO Sanford Weill approved Grubman's research and understood its true purpose. At least two sources have advised that Grubman reported directly to Weill. And both Grubman and Weill had close personal relationships with many of the top executives officers of the above-mentioned companies, including WorldCom's Ebbers.

282. The New York Times reported on August 30, 2002 that Grubman was so close to Ebbers that he attended Ebbers' 1999 wedding in Mississippi. Grubman and Salomon apparently considered this trip of benefit to Salomon's investment banking business, because Grubman submitted an expense report for the trip, which was approved by Salomon's investment banking department, not the research department. According to Robert Heim, a former assistant regional director for the SEC, this fact "shows [Grubman] completely crossed the line between an objective analyst and personal friend when it came to WorldCom." Moreover, the fact that Grubman's expenses were paid by the investment banking department indicates that, in reality, Salomon considered Grubman a de facto employee of that division and not its research department.

283. Few companies depended on Grubman's "research" more than WorldCom. As noted above, WorldCom's staggering growth was fueled by its acquisition frenzy. By 1998,

WorldCom had acquired more than sixty companies. New acquisitions allowed WorldCom to increase its revenues and earnings and manipulate financial results by, among other things, decreasing its reserves or writing off goodwill as needed. Thus, to sustain its growth and stunning reported financial performance, WorldCom needed to continue the acquisition process, and it needed to swallow larger and larger companies. To maintain this process, WorldCom desperately needed to maintain a consistently higher share price. Grubman's favorable research was clearly seen by WorldCom and Salomon executives as a way to help WorldCom achieve this goal.

284. For Salomon, WorldCom was the type of the company whose business it could not afford to lose. WorldCom was on its way to becoming the second largest telecommunications company in the nation, with a market capitalization at its peak of more than $180 billion, and an unsurpassed appetite for lucrative acquisitions. As a client, it was an investment banker's dream.

285. Thus, throughout the Class Period, Grubman issued glowing reports extolling WorldCom's virtues, even though – as discussed in ¶¶ 328-346 below – Grubman came to realize that WorldCom's business model was in peril. Further, as set forth above, Salomon gave more than twenty hot IPO allocations to Ebbers, who sold them for a personal profit of more than $11.5 million. In return, Ebbers steered WorldCom's investment banking business to Salomon, which allowed Grubman to make tens of millions of dollars each year.

286. These apparent synergies and close personal contacts between Grubman and Ebbers were key reasons that WorldCom selected Salomon as its lead investment bank in all of its major acquisitions and debt offerings between October 1997 and February 2002. According to the Attorney General's IPO Complaint, WorldCom paid Salomon over $107 million for investment banking advice during that time. Furthermore, WorldCom retained Salomon to advise it on approximately twenty-three deals in that period. Some of these deals were among the largest and

most coveted deals on Wall Street. For example, WorldCom retained Salomon as the lead underwriter in connection with each of the 2000 and 2001 Offerings. Salomon also served as WorldCom's financial advisor on its largest acquisitions, including the $40 billion merger with MCI Communications (announced October 1, 1997); the proposed merger with Sprint (announced October 5, 1999); and the sale of a WorldCom unit to Allegiance Telecom (announced January 3, 2002). Salomon's fee in connection with the MCI merger alone was approximately $33 million. WorldCom also retained Salomon to manage its corporate stock option plans for WorldCom employees and designated Salomon as the broker for WorldCom employees' stock transactions.

287. In exchange for millions of dollars in investment banking fees from WorldCom, Salomon, consistent with its practice with respect to other telecommunications companies, delivered (as expected) Grubman's favorable research coverage, and unusually large and profitable allocations of Hot IPO Shares.

288. Salomon's complex scheme to enrich itself, and its parent Citigroup, at the expense of the investing public, has been investigated by the United States Congress, the New York State Attorney General's Office, the SEC, and the NYSE, and other agencies. On September 24, 2002, Salomon agreed to settle an investigation, by the NASD, by paying $5 million to resolve charges that Salomon and Grubman had issued false and misleading analyst reports concerning a different telecommunications company.

289. On August 15, 2002, Grubman, the "star" telecommunications analyst at the center of Salomon's fraudulent scheme, resigned. Even though Grubman resigned amid public outrage and numerous governmental investigations relating to his research, Salomon awarded him the $32 million severance package described in ¶ 52 above.

290. On or about September 3, 2002, Jay Mandelbaum, head of Salomon's retail branch system, resigned. On September 8, 2002, Salomon ousted Carpenter, its Chief Executive Officer. Shortly thereafter, Salomon's parent, Citigroup, released a statement by chairman and chief executive Sanford Weill, who apologized for certain of his company's actions. In a subsequent interview, Weill stated that "certain of our activities do not reflect the way we believe business should be done. That should never be the case, and I am sorry for that."

291. On October 9, 2002, Salomon announced the retirement of its global stock research chief, John Hoffmann, and the reassignment of the U.S. stock research chief, Kevin McCaffrey.

292. On April 28, 2003, a joint press release of the SEC, New York Attorney General's Office, the NASD, the NYSE, and the North American Securities Administrators Association announced the conclusion of "joint investigations by the regulators of allegations of undue influence of investment banking interests on securities research at brokerage firms." The global settlement involves ten investment banks and two individual analysts. Six of those banks, Salomon, J.P. Morgan, CSFB, Goldman Sachs, Lehman Brothers, and UBS Warburg, are Underwriter Defendants in this action. One of the two analysts is Grubman. As to Salomon, the New York State Attorney General's found that although Salomon had held out its equity research analysts as "providing independent, objective and unbiased information, reports, ratings and recommendations upon which investors could rely in reaching investment decisions," Citigroup Assurance of Discontinuance ¶14, in reality, Salomon sought to use research to support the more lucrative investment banking business, which eventually became essentially the raison d'être of research. Citigroup agreed to pay $400 million to resolve the investigation, including $150 million in penalties and $150 million in disgorgement.

GRUBMAN'S MATERIALLY FALSE AND MISLEADING ANALYST REPORTS

293. During the Class Period, Grubman consistently rendered exceptionally positive research reports that helped to artificially inflate the price of WorldCom's stock. Set forth below are examples of false and misleading statements in those reports.

294. In a report issued on August 20, 1999, Grubman reiterated his bullish position on WorldCom:

> WorldCom has Global Scale, double digit top-line and bottom-line growth, and is trading at a market multiple on 200 EPS. Load up the truck! (Emphasis added).
>
> WCOM is likely to double earnings every two to three years for the next decade. We think that any investor who does not take advantage of current prices to buy every share of WCOM they can should seriously think about another vocation.

295. In a report issued on February 7, 2000, Grubman urged investors to take advantage of the opportunity to buy WorldCom stock at an "absurdly cheap" price:

> We are aggressively reiterating our Buy Rating on WorldCom because we think this stock is at a level that is absurdly cheap. As we see it, the market completely fails to recognize the triangulation of size, growth and valuation embedded in it and, most importantly, completely ignores the fact that WCOM has more "sexy IP/Data assets" than any other company in the world. In fact, on this last point we believe that a major reason for WorldCom's lagging performance has been the view that somehow the world is passing WorldCom by and the new breed of bandwidth companies (as well as other companies such as webhosting) are grabbing the growth opportunities away from WorldCom. Whereas in the past, we believe WorldCom was always viewed as the company with the initiative in driving growth opportunities.
>
> * * *
>
> WorldCom is as "cool a cat" as any company out there. There is no one on the planet that has the reach of IP network like WorldCom. We would argue that WCOM is competitive with any company in the world in the high-end value-added areas of IP. . . .

296. On April 27, 2000, Grubman attributed a recent decline of WorldCom's stock price to unwarranted concern over the Sprint merger and urged investors to load up on WorldCom stock at bargain prices:

> [T]he stock sells as if it is a smoke stack company. We are sure that investors are tired of hearing this from us, but we don't tend to run and hide when the market is not acting the way we would like it to act. <u>We will repeat often and loudly that this company is the singular most mis-priced company in the entire global telecom space</u>. We would argue that investors should take advantage of nervousness over the FON deal that is going to get done, or the fact that the market does not have proper perspective on just how stellar WCOM's financial performance is to buy this stock at ridiculously cheap prices. (Emphasis added).

297. On June 27, 2000, Grubman placed a "Strongly Reiterate Buy" recommendation on WorldCom stock, even as it became increasingly more likely that the Department of Justice would block the merger with Sprint:

> Likely collapse of the FON [Sprint] deal is unfortunate but, we believe, doesn't disrupt co's ability to grow at a double-digit rate for top & bottom line growth.
>
> * * *
>
> We believe investors should focus on WCOM's fundamentals and assets and not potential deals & realize that WCOM is trading significantly below 1x projected earnings growth rate.
>
> * * *
>
> Turning to WCOM, we cannot strongly emphasize enough how compelling we believe WCOM is at these levels. The overhang of the FON deal has cost WCOM's stock almost a year of what should have been much better performance. The reality is that WCOM remains the company that every major global telecom company wants to look like in terms of assets.
>
> * * *
>
> WCOM is categorically the cheapest stock by far in the world of global telecom, by our analysis. We believe it has a set of assets unmatched, and now that this deal is behind us, we believe the stock

> will show strength. We believe those who continue to worry about wireless overhang will be sorely disappointed that they downgraded the stock.

298. On October 26, 2000, Grubman again awarded WorldCom stock a "Buy" rating, stating that the shares were "dirt cheap" considering the Company's growth potential:

> We believe WCOM is aggressively focusing the company to achieve growth profitability . . . We are at a point where we believe WCOM's strategic focus has never been clearer. Namely, WCOM will optimize its asset base by becoming the preeminent provider of telecom services to corporate enterprises on a global basis.

299. By January 2001, the price of WorldCom stock had dropped to under $20, a decline of more than 50% from the price it was trading at on June 30, 2000, when it closed at $46. News reports suggested that WorldCom would need to lay-off a huge percentage of its workforce. Nevertheless, in a report issued on January 26, 2001, Grubman maintained his "Buy" rating on WorldCom, arguing that the news of massive lay-offs showed a "top mgmt team" focused on "achieving results." This was another trademark of Grubman's reports about WorldCom – whenever bad news appeared to negatively impact the stock, Grubman would issue a report which shrugged off any concerns investors might have, and assured them that WorldCom was a strong buy. To wit:

> News repts. suggest WCOM might, for restructuring, reduce workforce by as much as 10-15%. We have no specific knowledge about WCOM's plans. We would argue that if true, any downsizing indicates a top mgmt team which is very engaged, w/ a heightened focus on achieving results.
>
> * * *
>
> WCOM remains our top pick. We think it is still unrivaled . . . .

300. In a report issued on April 26, 2001, a few weeks before Salomon led WorldCom's $11.8 billion 2001 Offering, Grubman again touted the stock as "the one to own:"

> WCOM posted strong and high quality results . . . . No hiding behind the economy . . . . WCOM Group made double-digit guide. & reaffirmed full yr. Guid., in stark contrast to T, FON which had negative comm. Svc growth & lower guid. <u>Obviously, WCOM is the one to own</u>. (Emphasis added).

301. Even as WorldCom's stock price slipped, Grubman encouraged investors to buy shares in the Company on July 26, 2001, as follows:

> In our view WCOM is cheapest large cap telecom stock w/ best growth and assets w/ numbers set and visibility of fcf+ [free cash flow]. <u>Reiterate Buy</u>. (Emphasis added).
>
> * * *
>
> As we said in our note on Monday, July 23, we view WCOM as the cheapest large cap telecom stock, growing faster than anyone, with better strategic global assets. Its numbers are clearly set and it has huge visibility for fcf. <u>Obviously, we would be aggressive buyers of the stock</u>. (Emphasis added).

302. Reporting on WorldCom's third quarter 2001 earnings announcement, Grubman stated on October 25, 2001 that "WCOM has the most leverage among any telecom company" and maintained Salomon's "Buy" recommendation.

303. On September 19, 2001, mere days after the terror attacks of September 11, Grubman took the position that WorldCom was uniquely positioned to capitalize on the tragedy:

> We are strongly reiterating our Buy on WCOM because we feel investors are not fully appreciating how full a participant WCOM is in the relative stability and strength of the overall telecom industry in the aftermath of last week's tragic events.

304. On January 29, 2002 – even as WorldCom's stock achieved record lows – Grubman advised investors that the Company was a "best play" for recovery and urged them to buy the stock:

> WCOM traded down today on a laundry list of concerns, most of which don't make sense to us . . . We continue to believe that WCOM and AT&T remain the best plays in our group on a recovering economy. . . .

305. Indeed, even on March 12, 2002, after the SEC announced its inquiry into WorldCom's accounting and WorldCom shares plummeted to $7.93 per share, Grubman retained his Buy recommendation on the Company and dismissed the investigation as "boilerplate":

> As far as the SEC inquiry, we view this as a very straightforward – almost boilerplate – letter of inquiry to WCOM regarding a laundry list of items – all of which are largely general in nature. In fact, the SEC is reviewing the 10-K's of every Fortune 500 company, something which has never been done before.

306. Though his March 12, 2002 public statement dismissed the SEC inquiry as a non-event that should not concern investors, Grubman was, privately quite concerned upon hearing news of the SEC inquiry. On March 11, Grubman had immediately reached out for Sullivan by e-mail to inquire: "What do you think they are getting at wrt acct rec and reserves. Also why do they care about analyst guidance?"

307. Grubman maintained a "Buy" recommendation on WorldCom until April 21, 2002, when the Company's shares were trading at $4 per share. Even then, Grubman only reduced the rating to "Neutral," not "Sell." Notably, at that point, it was obvious that due to the drastic decline of WorldCom's share price, WorldCom would not be seeking to acquire other companies in stock-for-stock transactions or gaining funds through the kind of note offerings for which Salomon served as a lead underwriter.

308. Grubman also used his research reports with respect to WorldCom as a marketing tools for WorldCom's key acquisitions on which Salomon served as the financial advisor. For example, The Washington Post observed on July 6, 2000 that "Grubman was the most consistent and strident voice forecasting approval of the WorldCom-Sprint deal."

309. Indeed, according to Scott Cleland, an analyst at Legg Mason Precursor Group, after Cleland issued a report stating that the Department of Justice would block the Sprint merger,

Grubman personally called several of Legg Mason's institutional investors to criticize Cleland's analysis and reinforce his view that the merger would be approved.

310. Purchasers of WorldCom securities were never informed that Ebbers and other WorldCom officers received millions of dollars in profit through hot IPO allocations from Salomon, the firm that was performing investment banking services for WorldCom, or that the compensation of Salomon's star analyst, who was consistently touting the stock, was dependent on this investment banking business. Purchasers of WorldCom securities were also never informed that this was a quid pro quo relationship, and that each of the "Buy" recommendations issued by Grubman on which investors relied was an integral part of an investment banking package of services marketed to WorldCom. They also were not told the true reason for Grubman's reports: to provide favorable ratings for WorldCom as part of a concerted effort at Salomon to obtain and retain investment banking business.

311. The failure to disclose these highly material facts rendered Grubman's analyst reports false and misleading, and further made the registration statements for which Salomon served as lead underwriter false and misleading. Specifically, Grubman authored the reports although he was well aware that WorldCom was not the value he portrayed it to be. Yet, Grubman continued to push the stock to ensure that WorldCom remained Salomon's investment banking client – an arrangement which garnered hundreds of millions of dollars of business for Salomon – and to ensure that he continued to receive the lucrative "helper fees" he received as a percentage of the fees from investment banking transactions on which he worked.

312. Grubman's consistent cheerleading on behalf of WorldCom stock had the effect that he, Salomon and WorldCom intended. On the heels of Grubman's false and misleading analyst reports touting WorldCom, WorldCom's stock price often surged upwards. For example:

(a) On July 8, 1999 – the day that Grubman issued an analyst report adding WorldCom to Salomon's Top Ten List of recommended stocks – the Company's stock price rose more than 5% to close at $90.00, from the prior day's close of $85.19.

(b) On the morning of February 7, 2000, Grubman issued an analyst report "Aggressively Reiterating [the] Buy Rating on WorldCom," calling the stock "absurdly cheap." That day, the stock closed at $48.00 – an increase of more than 8% from the prior trading day's closing price of $44.31.

(c) Similarly, after the market closed on June 27, 2000, Grubman issued a research report reiterating his "Buy" rating, and downplaying the "likely collapse of the Sprint deal," citing WorldCom's "ability to grow at a double-digit rate for top + bottom line growth." The next day, WorldCom's stock price increased more than 12% on enormous volume, closing at $44.56.

(d) And, the next trading day after Grubman issued his January 26, 2001 report raising his estimate of WorldCom's growth rate, the stock price rose 7% to close at $22.75.

313. When Jack Grubman spoke, the market listened. His influence over the market for WorldCom was so pervasive that, on numerous occasions during the Class Period, financial commentators specifically attributed movements in WorldCom's stock price directly to Grubman's analyst reports. For example, on March 13, 2001, Grubman issued a research report that, among other things, increased his estimates for the Company's revenue growth both for the first quarter of 2001 and full year 2001. The following day, in direct response to Grubman's report, WorldCom stock rose as much as 12%. As Bloomberg News reported:

> [s]hares of WorldCom Inc., the No. 2 U.S. long-distance phone company, rose as much as 12 percent after an analyst boosted his 2001 sales estimate for the unit that sells data and Internet services to big companies. The stock rose $1.38 to $16.56 in midafternoon trading

> after climbing as high as $17 … More than 59 million shares were traded, making it the third-most active stock in the U.S. Sales at WorldCom Group will rise 14 percent this year, Salomon Smith Barney Inc. analyst Jack Grubman wrote in a report issued last night. He had expected a 13.2 percent increase previously.

"WorldCom Rises After Analyst Boosts Sales Forecast," Bloomberg News, Mar. 14, 2001 (2:13 p.m.).

314. Conversely, on those rare occasions when even Grubman was constrained to report less than positive news about WorldCom, the price of the stock declined. For example, on January 5, 2000, Grubman cut his earnings and revenue growth estimates for the Company. The very next morning, Bloomberg News reported that "MCI WorldCom Inc. fell as much as 6.5 percent after Salomon Smith Barney analyst Jack Grubman cut his earnings and revenue estimates to reflect a shift away from selling lower-profit services. Shares in the No. 2 U.S. long-distance company fell 3 1/8 to 48 1/8 in midmorning trading of 14.3 million shares, making it the most-active U.S. stock. See "MCI WorldCom Falls After Salomon's Grubman Cuts Estimates," Bloomberg News, Jan. 6, 2000 (10:35 a.m.).

315. Perhaps the best illustration of the impact that Grubman had on the price of WorldCom stock occurred when Grubman – only two months before the end of the Class Period – finally cut his "Buy" rating on WorldCom. On Sunday, April 21, 2002, Grubman downgraded WorldCom from "Buy" to "Neutral." On Monday, April 22, 2002, WorldCom stock lost a third of its value, in trading that was the fifth busiest ever for a U.S. stock. The financial press left no doubt as to why investors had abandoned the stock:

> Salomon Smith Barney Inc. analyst Jack Grubman has stopped recommending investors buy shares of WorldCom Inc. for the first time in more than four years. He lowered his rating after the No. 2 long-distance company on Friday said 2002 sales will be less than expected … Shares of the Clinton, Mississippi-based company fell

> $1.97 to $4.01 in trading that was the fifth-busiest ever for a U.S. [stock].

"Salomon's Grubman Cuts WorldCom After 4 Years: Call of the Day," Bloomberg News, April 22, 2002 (7:02 p.m.). The next day, the stock continued to drop, closing at $3.41, a decline of 15%. In total, in two trading days following Grubman's downgrade, WorldCom lost 43% of its value -- on record-setting volume.

316. On Friday, June 21, 2002 – after the close of the market – Grubman finally lowered his recommendation for WorldCom from "Neutral" to "Underperform," noting, among other things, that WorldCom's sales forecast had deteriorated and the Company was having difficulty closing on a $5 billion credit facility. On Monday, June 24, 2002 – the next trading day – the price of WorldCom shares fell another 25%, from Friday's closing price of $1.22 to close at $0.91. Again, financial commentators attributed the drop to Grubman:

> WorldCom Inc. shares fell as much as 29 percent to a 12-year low after Salomon Smith Barney analyst Jack Grubman cut his 2002 sales forecast for the second-largest U.S. long-distance telephone company. WorldCom dropped 24 cents to 98 cents. Earlier, the shares touched 87 cents, the lowest since May 1990.

"WorldCom Falls After Salomon's Grubman Cuts Estimates," Bloomberg News, June 24, 2002 (2:09 p.m.).

317. Further evidence of the link between Grubman's reports and the artificial inflation of the price of WorldCom stock was the market's reaction as widespread media coverage focused on allegations of the conflicts of interest between Salomon and WorldCom, and the multiple governmental investigations launched into Salomon's and Grubman's business practices beginning in February 2002. These disclosures arose four months before WorldCom announced its first restatement of $3.8 billion on June 25, 2002 and five months before WorldCom filed for bankruptcy protection on July 21, 2002.

318. On February 27, 2002, for example, The New York Times reported that two former Salomon brokers had filed a counterclaim against Grubman and Salomon in a NASD arbitration case, alleging that Grubman had issued overly bullish reports about WorldCom, and that Salomon had failed to disclose the inherent conflict of interest in Grubman's reporting. See "Salomon Analyst Is Sued by Brokers Over Bullish Ratings," N.Y. Times, Feb. 27, 2002. The next day, The Wall Street Journal reported that Grubman's dual roles at Salomon as analyst and "deal broker" created a "tremendous conflict" and that Salomon was considering "downgrading" Grubman's role at the company. See "Salomon May Downgrade Jack Grubman, As the Telecom Analyst's Dual Roles Grate," Wall St. J., Feb. 28, 2002. On April 10, 2002, The Wall Street Journal reported that New York Attorney General Spitzer had subpoenaed numerous other investment banks – including Salomon – as part of his growing investigation into rampant conflicts of interest of Wall Street analysts and cited Grubman as an example of an analyst that "remained wildly optimistic on stocks … long after those stocks crashed and saddled investors with large losses. See "NY Attorney General Expands Wall Street Probe," Wall St. J., April 10, 2002. On April 12, 2002, The Wall Street Journal reported that New York Attorney General Spitzer was expanding his investigation into Wall Street analysts to include Grubman, and that Spitzer's office had issued a subpoena to Salomon asking for documents and e-mails relating to Grubman. See "As Lawyers Target Analysts, Now It's Grubman's Turn," Wall St. J., Apr. 12, 2002. On April 25, 2002, Attorney General Spitzer formally announced that he was investigating Grubman and Salomon for failure to disclose conflicts of interest and, on April 26, 2002, the SEC announced that it had opened a "formal inquiry" into the same subject. See "Wall Street Inquiry Expanded, With Subpoena to Salomon," N.Y. Times, Apr. 25, 2002; "SEC Joins Pack, Opens Inquiry Into Analysts," Wall St. J., Apr. 26, 2002. All of these disclosures predated WorldCom's bankruptcy, and the price of

WorldCom stock fell dramatically in response, falling over 80% – from $10 in mid-February 2002 to less than $2 in early June.

319. Documents that the NYSCRF recently obtained from WorldCom after the Court's November 2002 Order show that, in addition to issuing his own false statements to the investing public concerning WorldCom, Grubman was orchestrating with remarkable specificity just how, when, and why Ebbers and Sullivan should deliver theirs.

320. One glaring example of how Grubman crafted the public statements of Ebbers and Sullivan arose in connection with a critical February 2002 analyst conference call that was described in the NYSCRF's original complaint (at ¶ 180) and specifically cited by this Court in its May 19, 2003 ruling on the motions to dismiss. Opinion and Order at 15 ("On February 7, 2002, only a month before the SEC began its investigation of WorldCom, Ebbers stated in an earnings conference call with analysts that 'we stand by our accounting.'"). In the days preceding this conference call, Grubman sent a series of e-mails to Ebbers and Sullivan coaching them on what to say during the call to allay some growing concerns about WorldCom's financial health. At 6:51 a.m. on Thursday, January 31, 2002, Grubman sent an e-mail to WorldCom CFO Sullivan with the subject "Next week." In that e-mail Grubman wrote:

> Given current atmosphere I think I think (sic) you should be prepared for questions on off-balance sheet stuff. All you guys really have is AR securitization but that should be explained. Also make sure nobody can accuse you of hiding something namely Digex revs and the issue with ICix revs should be laid out as what it is nonevent and essentially zero. Also you know people look at MCIT's SGA and think more than normal costs get strutted out of WCOM Group. So be aware of that. I would not be hero on guidance especially for Q1. I think it is legitimate to say it all depends on economy which will drive demand since internally you guys are executing better than ever and pricing is better.

321. At 7:16 p.m. on Monday, February 4, 2002, Grubman sent another e-mail concerning the upcoming earnings conference. That e-mail, with the subject "List", was sent directly to Ebbers. Grubman wrote as follows:

> Below is list of issues that should be addressed head on Thursday's call:
>
> 1) liquidity issues – should talk about how you guys have no problem meeting maturities.
>
> 2) off-balance sheet stuff-discuss how securitization of accounts receivable not new and does not impact improving period-to-period free cash flow.
>
> 3) Integrity of accounting-big issue. Investors will worry that some bombshell will come out in the 10k. People want to know that what you see is what you get. Also a lot of folks worry about cosmetics of tracking stock F&L meaning offloading costs from WCOM to MCI.
>
> 4) Your situation. Basically how your situation impacts your ability to run the business.
>
> 5) Can WCOM ever grow earnings. Talk about execution. Once economy improves and you guys "lap" certain issues like intermedia dilution and increasing depreciation what can eps grow at.
>
> 6) in a worst case scenario where revenue growth is real low (like below 5% for the year) how low can capex go.
>
> These are some issues aside from the business trends that should be dealt with. Obviously you need to touch base with Scott on many of these but I think this gives you good idea.
>
> Give me a call if you want to follow-up.
>
> Hang in there.
>
> Jack

322. Grubman continued to pepper WorldCom's senior managers with e-mail concerning the February 7, 2002 conference call. At 1:04 p.m. on Tuesday, February 5, for example, Grubman wrote an e-mail with the subject "One other thing" to Ebbers:

> If there is anyway to show you control your destiny. Like something you guys can monetize to further reduce debt. Also from a business

> perspective any commentary on how you guys can clearly grow once the economy rebounds and why other than normal competitive issues you are not vulnerable to outside forces keeping you from growing. Again <u>integrity of accounting, liquidity, and certainty of deleveraging and free cash flow key messages</u>. You want people to leave the call knowing you have staying power and can control your own destiny and can grow and generate cash flow once the cycle comes back.

(Emphasis added.)

323. On February 6, 2002, the day before the conference call, Grubman e-mailed Sullivan to advise him that the earnings call by a different company, Tyco Corporation, "went well" and that there were some lessons to keep in mind for WorldCom's call. Grubman then told Sullivan:

> If you can[,] give general metrics that basically says if growth is below our guidance due to ongoing bad economy but despite that cash flow ok since capex would be lower and presumably working capital might even be better if not funding growth[,] that would be good

324. And moments before the February 7, 2002 conference call began, Grubman e-mailed Sullivan to telegraph a question he planned to ask during the conference – but only if Sullivan confirmed that Grubman would get the "right answer." Grubman wrote:

> Also, if ask you if you can hold EBITDA margin of Q4 of 02 given 3% type growth <u>will I get right answer</u>? If so, then despite lower rev growth cash flow target can be met
>
> Sullivan responded minutes later: "Yes, fine,"

(Emphasis added).

325. As noted above in ¶ 320, Ebbers did as Grubman directed, falsely assuring investors that WorldCom's accounting practices were sound and reliable – "we stand by our accounting" - and that the Company's financial circumstances were well in hand. Later that day, Grubman issued the first of two reports in which he adopted the statements he had instructed Ebbers to make. Specifically, on February 7, 2002, Grubman issued a report on WorldCom in which he stated that

WorldCom had reported "Great FCF [free cash flow]" and that "WCOM addressed all issues surrounding its liquidity, etc of which there are none." That report further noted that Grubman would issue another, more detailed note the next morning. On the morning of February 8, Grubman issued his second report reiterating the statements Ebbers had made during the February 7 conference call. In that report, Grubman mentioned WorldCom's fourth quarter results, but emphasized that the most important news was that WorldCom had "addressed concerns over liquidity & accounting -- stating no issues there." As the report provided:

> Perhaps the most significant outcome of WCOM's earnings release was its very clear denial of the unfounded rumors surrounding its liquidity position, balance sheet and accounting. We addressed all those issues during the past week, but the company's very clear and straightforward discussion we believe removes the current overhang over the stock and, in our opinion, will allow the stock to trade up to the $12 level.
>
> * * *
>
> [W]e believe there are no liquidity issues whatsoever at WCOM. That was reiterated in the Company's conference call, where WCOM reminded investors that it had $10 billion of liquidity. Of this amount, $1.5 billion is cash, and roughly $8 billion is an untapped bank credit facility.

326. As noted above, in response to the assurances that Ebbers made at Grubman's insistence and the two companion reports Grubman himself issued that reiterated Ebbers' assurances, investors bid WorldCom stock up to its closing price of $7.52 on February 7, an increase of nearly 15% over the prior day's closing price. It continued to rise, closing at $8.18 on February 8, 2002.

327. Grubman's collaboration with Ebbers and Sullivan was not limited to scripting conference calls. Grubman was quick to alert Sullivan if lower echelon employees in WorldCom's finance department looked to discuss financial matters outside the Company. When a mid-level financial manager within WorldCom, Stephen Rubio, wrote an e-mail to Grubman in October 2001 asking how Grubman had calculated certain working capital figures in a recent report about

WorldCom, Grubman forwarded the e-mail to Sullivan within five minutes, adding the comment, “Glad to see one of your guys are (sic) checking your work.” Sullivan then sent Rubio the following e-mail:

> Steve,
>
> A few things:
>
> 1. Please seek your answers internally – pick up the phone and call accounting or investor relations if they are not responsive call me directly at any time.
>
> 2. The investor relations department is the sole communication channel with investors and analysis. The same way that public relations is the sole communication channel to the media, etc. There are a lot of different reasons for this – not looking silly and not getting silly messages are also a benefit.
>
> 3. I would like to make sure that you spend all of your time analyzing, strategizing, and collecting all of our receivable balances so that we dramatically improve our cash flow from this point forward. We need to accelerate our improving performance (thank you) – now – in the fourth quarter. To that end, it would be very beneficial to the company for you to take a break from reading analyst reports and to spend 100% of your time collecting our cash.
>
> Thank you and I look forward to even better fourth quarter results.
>
> Scott

OTHER ELEMENTS OF THE SECRET RELATIONSHIP BETWEEN SALOMON AND EBBERS

Grubman Alters His Analysis Methodology to Obscure WorldCom’s Growing Cash Flow Problems

328. One of the principal bases that Grubman cited as justification for maintaining a “Buy” rating on WorldCom and other telecom stocks through much of the Class Period was the purportedly high amount of what he termed “discounted free cash flow” – the discretionary money left over after a company’s necessary expenses are met. Unfortunately for Grubman and WorldCom, the utility of this analytical model as a basis to tout WorldCom, had by late 1999,

become seriously imperiled due to increasing capital expenditures that were cutting deeper and deeper into WorldCom's revenues. Instead of alerting investors to this development – and what it meant in the context of his chosen model for telecom companies – Grubman abandoned use of discounted free cash flow as the metric for WorldCom in late 1999, switching instead to using a "cash earnings per share" approach for the Company. When Grubman switched analytical models, he did so only for WorldCom; he did not do so for any other of the telecom stocks he covered for another two years.

329. In late 1999, Salomon's investment bankers – and Grubman, of course – were gearing up to assist WorldCom on the mega-merger with Sprint. By virtue of his vaunted telecom acumen and extraordinary access to WorldCom financial data, Grubman knew that the currency to be used to consummate that deal – WorldCom's stock– was in jeopardy if the "cash flow" model were faithfully applied. So he switched to a different metric that avoided and obscured the growing issues at WorldCom, especially those pertaining to cash flow and capital spending.

330. According to a former Salomon broker, Grubman informed the retail sales force at Salomon of his changed approach to WorldCom during one of his frequent appearances on the morning "squawk box" conferences conducted in-house at Salomon. The date that Grubman so informed the brokers was noteworthy: October 6, 1999, the date the Sprint merger was announced. The former broker recalls that Grubman alluded to the "cash flow" model during the call, but made the point that he was making a "change in methodology" (or words to that effect) for Worldcom. Later that same day, the broker spoke about the change with WorldCom CFO Sullivan. Sullivan was aware of the change in Grubman's approach, and said that he agreed that the cash earnings method was the "best way" to evaluate WorldCom's value. Sullivan knew what he was talking

about: one of the "benefits" of employing a cash earnings approach rather than a discounted free cash flow analysis is that the former omits the influence of any capital expenditures.

331. On October 4, 1999, two days before informing Salomon's brokers about his change in methodology for WorldCom, Grubman had attended the WorldCom board meeting at which the Sprint transaction was approved. The board minutes for that meeting list Grubman among the investment bankers attending on behalf of Salomon, identified as "financial advisor to the Company." The "research" report Grubman issued on October 6 – which made no mention of his role as financial advisor to WorldCom – repeatedly extolled the "cash eps" approach as showing WorldCom stock to be "a steal" at just under $68. The new model supported a stock price of $130, he said. Tellingly, the minutes of the October 4 board meeting show that when it came to valuing the target telecom company, Sprint, for the WorldCom board the Salomon team used the discounted cash flow model, not the "cash earnings" analysis as the accurate metric.

332. An e-mail recently disclosed in the course of the recent Wall Street investigation confirms that the concerns about WorldCom's financial health that led Grubman to shift his focus from cash flow to cash earnings were well known within Grubman's research team at Salomon. One notable example involved an e-mail exchange that a member of Grubman's team, Arzu Cevik, had with an acquaintance on February 28, 2001. The friend had e-mailed Cevik seeking some advice:

> I should be able to trade NASDAQ stocks next week if I can pass the series 55 on Monday. What are your favorite names in the group? <u>What names should I absolutely stay away from</u>? I am really out of touch with the earnings forecast models, revenue and EBITDA expectations, and any other catalysts or events that may move these stocks. (Emphasis added.)

333. When Cevik responded later that same morning, she noted some of her favorite stocks. When it came to the "names [to] absolutely stay away from," Cevik wrote:

> There really aren't any clear cut shorts anymore but I think you have to be careful with WCG (they need money), T is dead money until restructuring and I would keep an eye on WCOM. Also don't like Tycom or 360 (Tsix). (Emphasis added.)

334. In contrast to the caution that Cevik had provided privately to her friend on February 28, 2001, there were at least three analyst reports issued that same month by Grubman and his research team – including Cevik – which urged investors to purchase as much WCOM stock as possible. For example, on the first page of Grubman's February 8 report – in a "bullet" just to the right of Cevik's name – investors were told: "We believe [WorldCom's] stock could more than double." (Emphasis added.) Later in that same report investors were told, "We would much rather be aggressive buyers of WCOM…. We aggressively reiterate our buy." Reports issued in the weeks and months after Cevik's February 28, 2001 e-mail were also bullish; none came close to suggesting that investors should "keep an eye on WCOM" as a potential stock to short.

335. The fact that Grubman and members of his team had developed secretly held concerns about WorldCom's financial health was no surprise, given the de facto insider access that Grubman's team long enjoyed with senior WorldCom officers and financial managers. The sample of e-mails described below illuminates a relationship that provided Salomon with unparalleled access to WorldCom financial data.

336. There are myriad e-mails in which Grubman's team poses specific questions to senior members of WorldCom's financial department, eliciting information that is often material, non-public, and presumably subject to the strictures of Regulation FD. On March 21, 2001, for example, a senior member of Grubman's team, Sheri McMahon, sent the following e-mail (with carbon copy to Grubman) to Sullivan and two other senior WorldCom financial managers (Blair Bingham and Scott Hamilton):

> Hi guys

> Can you provide info on the change in working capital during 2000 showing upon the cash flow statement at $4.8 billion and why it will be $2 billion in 2001. It seems very high.
>
> Also, can you tell me what the increase in intangible assets of $938 mil. are in 2000 and the increase in other assets of $1.70 bil.
>
> The value accounts are tempted to buy but these issues are holding them back.
>
> Love from 1 of your only 2 friends on the sell-side.
> Shen

337. Requests like the foregoing from Grubman's team were given high priority at WorldCom. In an April 27, 2001 e-mail responding to a different request from McMahon, for example, it was the CFO, Sullivan, who wrote back:

> Scott Hamilton and David Myers, Controller, will call you this morning to walk through the non-deductible good will amounts and reconciliation back to state and federal statutory tax rates.

338. Often it was Grubman who picked out some part of WorldCom's financial information to pursue an issue. On November 15, 2001, Grubman e-mailed Sullivan:

> Did you get my vms? Real question is were there any ICIX revs included in WCOM Group's Q3 revs. Also the charges cited in ICIX'S Q where are they in WCOM? Thanks. I fear some folks will try to make issues out of this given language of the Q since ICix's frame and CLEC ops were not specifically cited as held for sale
> Thanks

339. On February 7, 2002, in addition to the e-mails that Grubman had sent to Ebbers and Sullivan to urge them to address accounting and liquidity issues on the conference call set for that date (<u>See</u> ¶¶ 322-324 above), he also asked:

> How could $29 million in revenue be included in 4Q00 of 4948?
> Since it was not part of company a year ago?

340. Another prong of this less than arms-length relationship was the information that Grubman and his team were conveying <u>to</u> WorldCom, in an effort to bolster the price of its

securities. In April 2001, for example, after an institutional client complained to McMahon about how another telecom company had explained its utilization rates, McMahon forwarded the e-mail to Bingham and Hamilton (carbon copy to Grubman) with this recommendation:

> Maybe Bernie could mention next week on his call, what the real utilization number is. I <u>think it would help your stock</u>.

(Emphasis added.)

341. Salomon's debt analyst, Robert Waldman, was also a prolific participant in these types of communications. In a May 2001 e-mail sent to give Sullivan the "quick color" of his meeting with an institutional investor, Waldman listed a number of areas that WorldCom needed "to bang hard" in connection with the 2001 Offering. On another occasion, in June 2001, Waldman reported to Sullivan:

> I am in Boston seeing accounts The main topic is WCOM They all are hearing that the second Q is soft and guidance will come down for the rest of the year. It is getting lonely being the only guy defending the name. Seems like a lot of my peers have thrown in the towel
>
> Bob

Sullivan promptly forwarded Waldman's e-mail to Ebbers and Hamilton.

342. In March 2001, an article in <u>Barron's</u> discussed an analyst who had issued bearish warnings about the telecom sector. Waldman wrote to Sullivan about the article:

> Scott, this is the season for only negative articles about the industry. I am sure you have seen the Barrons article about the analyst from Bluestone Cap. I and many other analysts will have to address her claims of much lower data growth. 30 to 40 percent vs the 2x to 3x plus that we hear about from industry players. The first question is what is WCOM seeing in data and capacity growth in 01 and your expectations beyond? Are you seeing a slow down in demand for data services, are the large customers cutting back on data needs? <u>I thi. [sic] it is very important that we address this issue</u> There is enough overhand about voice traffic declines, we don't need the issue to arise about data. Thanks, Bob

343. The e-mail in the preceding paragraph was sent by Salomon's leading telecom debt analyst to WorldCom's CFO two months before the 2001 Offering. Virtually none of the issues that WorldCom described as "very important that we address" were addressed in the May 2001 Registration Statement.

344. Like Grubman, Waldman was quick to advise Sullivan about how the CFO's performance in conference calls and other public settings was received by investors. On November 1, 2000 – following the Company's announcement that it was slashing earnings expectations for May 2001 and creating a separate tracker stock for MCI – Waldman congratulated Sullivan on his and Ebbers' performance, in an e-mail in which Waldman tellingly referred to himself and WorldCom as "we":

> Scott
>
> I thought given the circumstances that you guys did a good job. It took "balls" for Bernie to do the mea culpa, he is a class act. My bottom line is that it looks like maybe we have 1.2 b a year of debt pay down from mcit but it seems that there is a net increase in spending and debt from wcom of about 3 b in 01. I view the credit as a low A maybe stable but the issue of taking on more debt and ebitda at wcom being flat to a little down in 01 vs 00 could be an issue with the agencies.
>
> Bob

Later that evening, Sullivan reported back to Waldman that a call to a rating agency "went well" and that the agency would "come out stable."

345. On May 2, 2001, Waldman participated in the WorldCom "Road Show" for the 2001 Offering, opening the presentation by stating that, "[o]n behalf of JPMorgan and SSB as joint book-runners … we are excited about the WorldCom credit story and this debt offering." Later that evening, Waldman forwarded Sullivan a snapshot showing certain institutional investors' written, and generally favorable, reactions to that day's performance:

> Scott

> You did a great job today. you never fail to astound me with the grasp of every number and how it ties in to the business. I thought you would want [to] read some of the feedback we got after the calls. Hope the next two days go well, I'll see you in Boston on Monday.
>
> Regards
>
> Bob

P.S. Sounded like Bernie is fired up.

346. From time to time, Grubman and his team also alerted WorldCom that some of their competitors – who did not have the access that Salomon enjoyed – were prepared to question WorldCom's accounting. In June 2001, after McMahon learned that Morgan Stanley was planning to a piece on WorldCom, Grubman promptly forwarded her e-mail to Hamilton with this warning: "Beware apparently Morgan going after you guys next on accounting" Hamilton, in turn, forwarded Grubman's e-mail to Sullivan with the following note: "Sheri [McMahon] seems to think that Morgan Stanley is going to go after us on accounting issues next."

347. Grubman's eagerness to ingratiate himself at WorldCom went so far as spur him to tip off senior WorldCom executives about which of Salomon's clients were in the process of making large purchases of WorldCom stock. On October 31, 2001, for example, Grubman e-mailed Hamilton (carbon copy to Sullivan) with a report from Salomon's trading floor:

> We have a huge buyer (Sanford Bernstein buyside, big value shop). They bought 5 million so far and our trader thinks it could be 20 million when all doing. Obviously don't give up the name.

348. Viewed in the aggregate, this small sampling of documents illuminates a relationship between Salomon's analysts and senior WorldCom officers that was neither independent, objective, or unbiased.

The Secret Travelers Loans and Travelers' Business Partnership With Ebbers

349. As the NYSCRF first revealed in its original complaint, the nefarious relationship between Salomon and Ebbers was not limited to Grubman's cheerleading for WorldCom and Salomon's allocation of lucrative IPO shares to Ebbers and other WorldCom insiders. Instead, this "relationship" was, in fact, a business partnership between Ebbers and Salomon's corporate sibling Travelers that involved hundreds of millions of dollars in secret loans to Ebbers-controlled enterprises, a billion dollar mortgage, and Travelers' equity interest in the Ebbers timber empire it was responsible for funding.

350. These massive financing arrangements served the needs of all those involved. Not only did these unprecedented loans to Ebbers benefit Salomon's relationship with WorldCom, it also served Salomon's investment banking business with other clients, who by no coincidence were parties to transactions involving Ebbers. In turn, through Citigroup's financing, Ebbers was able to put his hands on millions in cash without selling a single share of WorldCom stock. As was widely reported, Ebbers maintained a strict policy at WorldCom prohibiting executives from selling their shares of WorldCom stock. Any news that Ebbers had sold any of his shares – millions of which secured hundreds of millions of dollars in personal financing, including loans from Citigroup – would have triggered a vicious spiral of decreasing stock prices and the need for him to sell more shares to cover unavoidable margin calls on his vast network of debt. As detailed more fully below, the Citigroup financing gave Ebbers a cash generating machine that he literally wore to the ground.

351. Many of the circumstances surrounding these monumental financing arrangements were first revealed to the NYSCRF by a former senior Salomon broker, for whom some of the facts concerning these loans were confirmed, in part, by W. Mark Lewis ("Lewis") who handled Ebbers' personal business affairs. The broker stated that WorldCom CFO Sullivan referred to Lewis as

"Bernie's personal CFO." The broker, who was handling brokerage accounts for Sullivan and other senior WorldCom executives at the time, asked Sullivan how he (the broker) could best approach Ebbers about opening a brokerage account with Salomon. Sullivan referred the broker to Lewis. When the broker called Lewis, he was told that Ebbers had already had a Salomon account for a year. When asked which Salomon broker was handling Ebbers' account, Lewis replied "one of Jack's [Grubman's] boys on the West Coast." According to Lewis, Grubman had put Ebbers in touch with Rick Olson, the Salomon broker in the Los Angeles area described in **&** 257 above as Grubman's "point man" for the IPO allocations to key telecom executives. Lewis said that he did not see any opportunity for the broker to obtain any business from Ebbers in the foreseeable future because they had "a lot going on right now" that the broker had no idea about. Lewis stated that they were in the midst of negotiating for a "major loan" to be made to Ebbers by Citigroup. According to Lewis, the loan was to be made by Travelers out of its Chicago office. Upon learning that Ebbers already had a Salomon account with Olson, the broker ceased trying to contact Ebbers on this matter. The broker later learned from a source within Salomon that Ebbers had at least one significant loan collateralized by his WorldCom stock other than the Bank of America loan described in ¶ 357 below.

352. The NYSCRF's investigation has revealed detailed facts regarding the financing Lewis had said Citigroup was putting together for Ebbers. In fact, what Lewis cryptically described to the broker related to the $499 million Travelers loaned to Ebbers over the course of the next several months. Specifically, in September 1999, Travelers loaned $290 million to an Ebbers – controlled entity, Joshua Timberlands. This particular loan was comprised of a $250 million "Primary" loan and a $40 million "Mezzanine" loan. Ebbers used these loans to purchase over 460,000 acres of timberland in Alabama, Mississippi and Tennessee from Kimberly-

Clark Corporation ("Kimberly-Clark") – the largest private acquisition of timber in the Nation's history.

353. Ebbers and Travelers were not done, however. In February 2000, Travelers loaned Ebbers an additional $209 million to purchase 88,000 acres of Louisiana timberland from Strategic Timber Trust ("Strategic Timber"). This purchase was financed by an additional loan comprised of a $180 million "Primary" loan and a $29 million "Mezzanine" loan. As part of the February 2000 transaction, the September 1999 loans were consolidated with the new loans being issued. Accordingly, Joshua Timberlands had a combined "Primary" loan of $430 million and a "Mezzanine" loan of $69 million, for a total of $499 million.

354. Travelers' lending-related services did not stop with half a billion dollars of loans to Ebbers, however. As part of the February 2000 transaction, Travelers agreed to secure up to $1 billion in debt to Joshua Timberlands. On February 15, 2000, Travelers and Joshua Timberlands entered into a mortgage in Mobile County, Alabama, "[t]o secure payment of the Obligations, up to the maximum secured limit of $1,000,000,000.00" (the "Billion Dollar Mortgage"). In turn, Joshua Timberlands "acknowledge[d], notwithstanding any other provision of [the Billion Dollar Mortgage] or any other document to the contrary, the maximum amount of Obligations Secured hereby shall be $1,000,000,000.00." The mortgage agreement covered the $430 million "Primary" loan, but Travelers expressly stated that based on the collateral already pledged by Joshua Timberlands, its debt would willingly be doubled. The Billion Dollar Mortgage was signed by Lewis, Ebbers' personal CFO.

355. In all their dealing, Travelers was the only creditor with whom Joshua Timberlands dealt. The Billion Dollar Mortgage defined Travelers as the "Mortgagee," the "Lender for the Participants," the "Collateral Agent" and "Administrative Servicer." Travelers syndicated parts of

the loans to three other lenders (John Hancock Life Insurance Company, Farm Credit Bank of Texas and Metropolitan Life Insurance Company), though documents confirm that Joshua Timberlands' sole relationship regarding these loans was with Travelers. For example, it was Travelers' agents – nearly always Travelers' First Vice President S. Peter Headley ("Headley") – who signed each of the hundreds, if not thousands, of collateral releases, modifications and amendments for the various loan documents.

356. Although these timber-related loans from Citigroup were first to be disclosed in the course of the NYSCRF's investigation, The Wall Street Journal reported on December 31, 2002 in an article entitled "Easy Money: Former WorldCom CEO Built An Empire on Mountain of Debt," that Citigroup courted Ebbers for years, and had secured over $53 million with Ebbers' shares of WorldCom stock. According to The Journal, in 1994, Citibank extended a margin loan of $10 million for Ebbers to purchase two million shares of WorldCom stock. That same year, as the stock price dropped, Citibank was forced to issue a margin call on the loan. Into the breach stepped WorldCom, which gave Ebbers a loan to repay Citibank. This pattern would unfortunately replay itself years later. Despite this unsavory experience, Citigroup only pursued Ebbers' business more aggressively. In addition to the timber-related loans, in mid-1999, Citibank stepped up to refinance Ebbers' $43.2 million loan from Toronto-Dominion Bank at a better interest rate. This loan was secured with 2.3 million of Ebbers' roughly 18 million shares of WorldCom stock.

357. Upon filing of the NYSCRF's complaint in October 2002, Citigroup acknowledged, for the first time, that it had arranged $499 million in timber-related loans for Ebbers, but asserted that, notwithstanding the press report cited in the complaint, these particular loans were not secured by Ebbers' shares of WorldCom stock. Citigroup refused to answer whether other loans it made to Ebbers had been so secured, which would of course provide motivation for Citigroup to maintain

an artificially inflated price for the shares underlying any security interest. As The Journal's December 31, 2002 article revealed, at least $53 million in Citigroup loans to Ebbers had been secured by his WorldCom stock. In addition, in a letter agreement dated April 2, 2002, between WorldCom and Ebbers regarding loans that the Company had made to him (the "April 2, 2002 Letter"), Ebbers offered to WorldCom as collateral all of his WorldCom shares, with one exception: he pledged to WorldCom all of his rights "in the shares of stock of the Company now owned by [him] (except for the stock of the Company currently the subject of pledges for the benefit of Citibank, N.A. and Bank of America N.A., respectively . . . .)" (Emphasis added.) Additional documents found by the NYSCRF show that, in the weeks leading up to the Joshua Timberlands/Kimberly-Clark transaction in the Fall of 1999, Ebbers pledged certain collateral to Citibank. On August 6, 1999, and again on August 11, 1999, Citibank caused to be filed in Mississippi two UCC Financing Statements, each of which stated that Ebbers granted to Citibank "All right, title and interest of the Debtor [Ebbers] in that certain collateral account (no. 724516) maintained by the Debtor with [Citibank]." Together with Ebbers' admission of the existence of a pledge of shares to Citibank in the April 2, 2002 Letter and the timing of these UCC filings by Citibank, the logical inference to be tested through discovery is whether Ebbers' WorldCom stock formed some part of the collateral underlying the financing of the timber-related loans.

358. Citigroup did not loan half a billion dollars to Ebbers simply for the marginal profit that might be earned from timber financing. Citigroup's true motive was instead to buy its way into investment banking loyalties, not only with Ebbers and WorldCom, but with other parties to these transactions, including Kimberly-Clark, Strategic Timber and Regions Bank.

359. Citigroup's extraordinary efforts in its dealings with Joshua Timberlands illuminate a confluence of dealings centering on its investment banking business. A brief chronology reveals the various means employed by Citigroup and the ends it sought and accomplished:

- September 14, 1998: WorldCom acquired MCI in a transaction valued at $40 billion. WorldCom's financial advisor was Salomon, which was paid $32.5 million for its role as principal investment banker.

- January 27, 1999: Strategic Timber, the owner of the Louisiana property later bought by Ebbers, filed with the SEC its preliminary IPO filings. Salomon was the lead underwriter.

- Mid-1999: Citibank refinanced Ebbers' $43.2 million loan on the Douglas Lake Ranch at a superior interest rate. This loan was backed by 2 million shares of Ebbers' WorldCom stock.

- On August 20, 1999: Kimberly-Clark filed with the SEC a preliminary prospectus for a $700 million bond offering. Salomon was to be the lead underwriter.

- September 30, 1999: Joshua Timberlands' purchase from Kimberly-Clark closed. Travelers loaned Ebbers $290 million for the purchase. The closing and one-time gain, on the last day of the final quarter before its scheduled bond offering through Salomon, enabled Kimberley-Clark to announce that it had beat the consensus estimates of Wall Street analysts.

- October 5, 1999: WorldCom announced the proposed acquisition of Sprint – its biggest deal ever. Salomon was WorldCom's financial advisor. Grubman began to tout the "cash eps" model as the basis to advise investors that WorldCom's stock was undervalued and would rise dramatically.

- February 15, 2000: Joshua Timberlands' purchase from Salomon client Strategic Timber closed. Travelers loaned Ebbers $209 million for this purchase. Joshua Timberlands signed the Billion Dollar Mortgage with Travelers.

- May 24, 2000: WorldCom issued $5 billion bond offering. Salomon was co-lead underwriter.

- May 11, 2001: WorldCom issued $11.8 billion bond offering – the largest in U.S. history. Salomon was co-lead underwriter.

360.

361. For Ebbers, the financing arrangements were also a means to a profitable end. Because of the adverse implications of selling any of his WorldCom shares to raise cash, the

purchase of this vast territory of timberland presented to Ebbers an opportunity to literally turn timber into tens of millions of dollars of cash without having to sell a single WorldCom share.

362. Travelers' parent, Citigroup, had several connections to these timber transactions. Citigroup was deeply entrenched in the business affairs of Kimberly-Clark. As noted above, at the time of the transaction Salomon was gearing up for a $700 million bond offering for Kimberly-Clark, then scheduled for the summer of 1999. Shedding these vast timberland holdings was vital to Kimberly-Clark's financial health and Salomon's ability to successfully develop its investment banking business with that company.

363. On June 10, 1999, Kimberly-Clark announced that it had agreed to sell the timberlands to Joshua Timberlands' corporate relative, Joshua Management, LLC. The NYSCRF has learned of several potential driving forces bringing the world of timber and telecom together. Citigroup's vice chairman, Paul J. Collins, was a director of Kimberly-Clark. Lourdes Perez-Berkley, a Salomon Managing Director, had a portfolio of clients that spanned both timber and telecom, and which specifically included both Kimberly-Clark and WorldCom. And Salomon and Travelers were not merely corporate siblings in 1999; Michael A. Carpenter served as Co-Chief Executive Officer, Global Consumer Business at Salomon, while simultaneously serving as director and Chairman of the Board at Travelers Insurance Company. During this time frame, Sanford Weill's son, Marc P. Weill, served as an executive officer of Citigroup Investments, a director at Citigroup Venture Capital, and a director on the board of Travelers. Carpenter and Marc Weill each played a role in approving the Travelers loans to Ebbers.

364. Notably, in each public disclosure regarding these transactions, Ebbers' involvement was concealed through use of a web of holding companies. For instance, in announcing the transaction, Kimberly-Clark described Joshua Management simply as a "privately held investment

management company," when, in fact, Ebbers controlled a 90% stake. On August 12, 1999, Ebbers especially created another personally-controlled entity, Joshua Holding LLC, ("Joshua Holdings"), of which he owned 86 percent. The balance of ownership in Joshua Holdings was split between his personal CFO, Lewis and his son-in-law, James Bourne. (On April 19, 2002, Lewis and Bourne would pledge their interest in Holdings to WorldCom for loans it made to Ebbers.) On August 26, 1999, Joshua Timberlands, LLC was formed in Mississippi as the actual purchaser of the land from Kimberly-Clark.

365. However, it was not only Ebbers' participation in these transactions that was hidden from public view. The NYSCRF's investigation discovered that, despite Citigroup's assertion that it had a typical and limited role in these loans, Citigroup was deeply entrenched in the affairs of Joshua Timberlands. Not only was Travelers an undisclosed lender to the CEO of one of Salomon's largest investment banking clients, it also became his business partner. Joshua Timberlands was, in fact, a partnership comprised of Joshua Holdings; Molpus Timberlands Management, LLC ("Molpus"), a woodlands management company whose president, Dick Molpus, had close personal ties to Ebbers; and Travelers, listed at 6750 Poplar Avenue, Suite 109, Memphis, Tennessee. The revelation of this illicit partnership between Travelers and Ebbers came to light through an obscure Tennessee corporate filing entitled Limited Liability Company Annual Report (the "Tennessee Annual Report"), dated December 19, 2000 and signed by G. Benny Petty, Molpus' Director of Accounting.

366. Once the deal was in motion, Citigroup and Ebbers structured the Kimberly-Clark transaction in such a manner as to give Ebbers a unique opportunity to generate cash immediately. The NYSCRF's investigation revealed that, as part of an orchestrated plan, and simultaneously with the closing of the deal with Kimberley-Clark, Ebbers sold parcels of land to third parties.

Although it appears that Travelers financed the entire 460,000 acre purchase in the Fall of 1999, it allowed Ebbers to sell off pieces of that land for tens of millions of dollars of cash, without reducing the financing. Thus structured by Travelers, Ebbers was able to put millions in his pocket without selling a single share of his WorldCom stock.

367. The cash generating machine did not stop with these simultaneous transactions. Immediately after Joshua Timberlands purchased from Kimberly-Clark, Travelers began releasing the mortgaged collateral (*i.e.*, the trees on the land) on a frequent and repeated basis to allow the timber to be cut – meaning that the purported collateral was being diminished although the loans were not being paid down in proportion to the amount of collateral being released. Each of these collateral releases was signed by an agent of Travelers, and nearly all of them were signed by Headley for Travelers and Lewis for Joshua Timberlands. According to timber-industry experts familiar with Joshua Timberlands' land, Ebbers monetized his asset by clear cutting the timber in order to generate as much short-term revenue as possible without any long-term interest in maintaining the viability of the timber operation for the years to come. As evidenced by the volumes of collateral releases, Travelers consented. The fact that Travelers did not require a commensurate pay-down from Joshua Timberlands when releasing the collateral is yet another gift that the Citigroup family was willing to provide Ebbers in exchange for his company's investment banking business.

368. Because of the massive timber-cutting operation needed to sustain Ebbers' demand for cash, Joshua Timberlands began to run out of harvestable land by 2001. Again, Citigroup accommodated Ebbers' need to generate cash without selling his shares of WorldCom stock. Accordingly, Citigroup facilitated Joshua Timberlands' ability to obtain harvestable land. Rather than purchase new land, Joshua Timberlands now entered into swaps of timberland. Under tax and

property laws, these transactions were deemed "like-kind-exchanges" bearing no tax consequence to Joshua Timberlands or Ebbers.

369. Additionally, like Travelers' and Ebbers' involvement in Joshua Timberlands, these swap agreements were nearly impossible to trace through the public record. This, was not by accident. According to swap agreements obtained by the NYSCRF's investigation, the agreements stated that they "shall not be recorded in any office or place of public record and any [such] action … shall be deemed to be a default."

370. Like every other facet of Joshua Timberlands' operations, consummation of these swaps required Travelers' active participation. Documents obtained by the NYSCRF show that Travelers, again mainly through Headley, executed releases of the collateral it held on the property that was being swapped to a third party.

371. Interestingly, Joshua Timberlands also entered into Statutory Warranty Deeds that created what is know as a "timber reservation," or the right to cut timber on another persons' property. In a timber reservation dated June 22, 2001, filed in Monroe County, Alabama between Joshua Timberlands and Schutt Trust, Joshua Timberlands maintained a right to cut timber on the land it had swapped to Schutt Trust for a ten month period. In other words Joshua Timberlands, (1) received valuable, harvestable timber on land given by Schutt Trust, (2) Joshua Timberlands maintained a right to cut all of the timber on the land it had given to Schutt Trust, and (3) Travelers released its right to proceeds from sale of timber from the land Joshua Timberlands had swapped away. Simply put, Travelers allowed WorldCom's CEO to have his cake and eat it too – with no recourse.

Grubman's Finder's Fees and Commissions

372. In addition, the NYSCRF's investigation to date has uncovered a potential, additional thread in the nefarious relationship among Citigroup, Grubman and Ebbers.

373. According to a former Group President of Salomon, Citigroup employees who bring business to the company in a line of business outside their assigned area are typically entitled to a "finder's fee" for doing so. According to this former Salomon officer, as a research analyst, Grubman was likely entitled to some or all of a finder's fee on the various loans that Travelers made to Ebbers. According to the former officer, the finder's fee for loans was typically 15% of the company's profit on the first loan, 10% on the second, and 5% on the third.

374. The same former Group President, who was responsible for Salomon's retail sales force on the East Coast, also stated that it was "inconceivable" that Grubman did not receive a commission on the Hot IPO Shares allocated to his clients.

Sullivan Demands Greater Shares of IPO Allocations and Salomon and Ebbers Willingly Comply

375. As stated above, Sullivan also received allocations of Hot IPO Shares from Salomon. In some instances, Sullivan expressed dissatisfaction with his allotment and demanded that Salomon increase his allocation. On at least one occasion, Sullivan increased his "take" of IPO share profits by receiving a significant cut of the profits that Ebbers had made from his allocation. One example in which all of the foregoing occurred was the Rhythms IPO on April 6, 1999.

376. In its August 30, 2002 response to the subpoena issued by the House Financial Services Committee, Citigroup stated that Sullivan and his wife were allocated 7,000 shares of the Rhythms IPO. While technically accurate, Citigroup's response to Congress obscured the fact that Salomon had in fact allocated only 2,000 shares to Sullivan prior to the opening of the IPO, and had provided Sullivan with an additional 5,000 shares after the stock had begun trading in the secondary market at a price approximately 50% higher than the IPO price of $21 per share. According to a former Salomon broker who spoke with Sullivan on the date the Rhythms IPO opened, Sullivan complained that his 2,000 share allotment was insufficient and insisted that it be

increased. The broker immediately placed a call to Salomon's IPO manager in New York, who authorized the additional 5,000 shares be placed in Sullivan's account.

377. Sullivan also received a payment from Ebbers in connection with the IPO for Juniper Networks Inc. ("Juniper"). At some point after that IPO, a former Salomon broker who handled Sullivan's brokerage account learned that a check submitted for deposit into Sullivan's account had been rejected because it was a third party check. The check at issue was drawn on a personal checking account of Ebbers, made out to Sullivan for $486,750.00, and had, with a typewritten annotation, "SALE OF JUNIPER STOCK – 5000 SHARES," on the memo line on the check. The check, which Sullivan had endorsed, was dated July 14, 1999, approximately three weeks after the Juniper IPO, in which the stock opened at $34 and almost immediately went to over $100 per share. When the broker called Sullivan to explain that Salomon did not accept third party checks, Sullivan "went ballistic," according to the broker, and asked whether the broker wanted him (Sullivan) to tell Ebbers that Salomon was not accepting Ebbers' check. The broker said he would make inquiries within Salomon about making an exception concerning this check. The broker spoke with his supervisor, received permission to accept Ebbers' check, and so informed Sullivan. At some point in the discussion regarding the check, the broker asked Sullivan about the "Juniper" annotation on the check's memo line; Sullivan stated that the check was "part of the profits Bernie is sharing with me on that IPO."

378. According to that same broker, he subsequently processed another three to six similar checks, made by Ebbers to Sullivan, for six- and seven-figure numbers. None of those checks had an annotation on the memo line. With regard to at least two of those checks, Sullivan told the broker that the checks were a "bonus" from Ebbers.

ADDITIONAL FACTS REGARDING SCIENTER OF CERTAIN DEFENDANTS

Ebbers

379. In addition to the facts alleged above, the foregoing further demonstrates Ebbers' scienter. As reported in Business Week on September 23, 2002, Ken Johnson, a spokesman for the United States House of Representatives Energy and Commerce Committee, which continues to investigate WorldCom, noted that review of evidence led the Committee to "think Bernie Ebbers is up to his eyeballs in this [WorldCom accounting fraud.]" In addition, spokespersons for the House Committee on Financial Services, which is also investigating WorldCom's accounting fraud, stated that Sullivan told WorldCom's internal investigators that "Ebbers was aware that hundreds of millions of dollars had been moved" into capital expenditures accounts that would not impact the Company's earnings. Defendant Ebbers had an opportunity to refute these allegations on July 8, 2002 when he testified before Congress. Instead, Ebbers refused to testify, invoking his Fifth Amendment right not to incriminate himself, which is further compelling evidence in this civil case of his culpability.

380. The following facts demonstrate that Ebbers actively participated in orchestrating the fraud:

(a) As described in detail in ¶ 100, before the Company announced its results for the fourth quarter of 2000, Ebbers, Sullivan and Beaumount had dinner with Bosley during which Bosley agreed to help defendants cook WorldCom's books by "do[ing] whatever [was] necessary" to get WorldCom's margins back in line.

(b) Former high level executives of WorldCom confirm that Ebbers knew exactly when and how WorldCom's accounting would be manipulated. As reported by Business Week, one of WorldCom's former executives said that at one of the senior staff meetings in 2000, Ebbers assured the staff that WorldCom could avoid financial surprises,

stating that: "We won't have to worry about earnings for years" because, if necessary, the Company would tap into cash reserves to boost the revenue.

(c) Ebbers' knowledge of WorldCom's fraudulent accounting practices and his intent to disguise the fraud can be also inferred from the fact that, according to the minutes of March 6, 2002 meeting of WorldCom's Audit Committee, Ebbers sought to slash the Internal Audit Department's budget by half.

(d) Finally, the sheer magnitude of the fraud clearly indicates that Ebbers, who news reports have stated was a "hands-on" manager who kept a very close eye on expenses, and whose office adjoined Sullivan's, had to know about the fraud that so far amounts to over $7 billion. As observed by The Wall Street Journal on July 1, 2002, it is inconceivable that a CEO with that kind of an eye for numbers and expenses would have missed improper transfers of billions of dollars on his own company's books.

381. Additional evidence of scienter can also be inferred from circumstances relating to Ebbers' various loans and forward-sale of stock. From September 2000 through February 2002, as WorldCom's stock price was declining, WorldCom's Board of Directors extended to Ebbers over $400 million to allow Ebbers to cover margin calls on his personal loans secured by WorldCom's stock. These loans were in addition to the loans Travelers made which are discussed above. As has been reported by the media, this was the largest amount loaned by a company to its officer in history. In total, during the Class Period, Ebbers owed more than $900 million in loans, and by the Summer of 2000, each of Ebbers' 19.4 million WorldCom shares were pledged as collateral for at least $440 million of these loans. By that time, Ebbers had pledged his WorldCom shares as collateral to a number of financial institutions, including to Bank of America, for loans of at least $310 million, and Citibank, for loans of at least $52 million. Bank of America was the

"Administrative Agent" for WorldCom's $7 billion 364-day revolving credit facility, and for which Banc of America Securities LLC was "Sole Lead Arranger and Book Manager."

382. Because Ebbers secured the personal loans using his holdings of WorldCom stock, he was under tremendous pressure to continue WorldCom's accounting fraud and maintain WorldCom's inflated stock price. Indeed, the entire Board and senior management of WorldCom felt enormous pressure to report strong earnings because of the potential for – and then the inevitable occurrence of – Ebbers' margin calls. On July 1, 2002, The Wall Street Journal reported that a person close to Sullivan said that "throughout 2001 and 2002, you had a horrible, miserable environment because the CEO was margined out of his mind. Pressure was there."

383. In fact, when push came to shove, WorldCom's Board and Compensation Committee stepped in with over $400 million in loans and guarantees, which WorldCom was eventually forced to pay out. These unprecedented loans to Ebbers were extended by the Board so that Ebbers would not have to sell any of his WorldCom shares. Repeatedly, WorldCom's Compensation Committee and Board justified these loans and guarantees on the basis of their fear that Ebbers' sale of the stock would have an adverse impact on the Company's share price. The following paragraphs describe in more detail the events concerning Ebbers' loans from WorldCom:

(a) In September 2000, the price of WorldCom stock dropped, and Ebbers was faced with having to sell shares to cover a margin call from Bank of America. The Compensation Committee stepped in on September 6, 2000, by initially loaning $50 million to Ebbers, and also awarded him a $10 million cash retention bonus. The promissory note for this loan was dated September 8, 2000, but was not drafted until November 2000.

(b) On September 28, 2000, Ebbers was again faced with a margin call. He again asked WorldCom for another loan, but Kellett, Chairman of the Compensation

Committee, refused. That same day Ebbers entered into a forward-sale contract with Bank of America for 3 million of his shares and received a payment of $70 million. This action had a compelling effect on the Board. As Ebbers explained to Fortune magazine, "[t]he day after I entered into a contract to sell the shares, the stock went down . . . . [T]he board said, 'Wait a minute. We don't expect our shareholders to get penalized because you got a margin call.' And so the board stepped into the gap."

(c) This forward sale of stock alone is highly probative of Ebbers' and the Board's scienter. Prior to the sale, WorldCom received legal advice from outside counsel that the proposed sale might be inappropriate, particularly since it was to occur shortly before a negative earnings announcement by the Company. Despite this, the Company permitted the sale by Ebbers without investigating the likelihood that the sale violated insider trading laws and also violated Company policy that prohibited such transactions near the time of an earnings announcement.

(d) In October 2000, Ebbers again faced margin calls from Bank of America, and WorldCom again stepped in to rescue Ebbers. On October 27, 2000, the Compensation Committee decided that it was in the "best interest of the Company and its shareholders" to provide Ebbers additional financing of $25 million on the same terms as the $50 million September loan, which had been fully exhausted by then, and to enter into a $75 million guaranty in favor of Bank of America. In return, Bank of America agreed to forebear on exercising its rights on Ebbers' margin debt, but Ebbers now pledged his shares to WorldCom in exchange for the guaranty. This pledge, however, was subordinate to the rights of his other lenders. This financing was memorialized in a letter agreement dated November 1, 2000.

(e) On November 14, 2000, an additional guaranty of $100 million is offered to Bank of America for Ebbers debt. By this time, Ebbers had used $11.5 million of this second loan. Again, the Compensation Committee justified this financing as being in the best interests of WorldCom's shareholders.

(f) On December 27, 2000, WorldCom loaned Ebbers another $25 million, bringing the total amount of his indebtedness to the Company to $100 million by the end of 2000. These loans were secured not by real property or other tangible assets, but by Ebbers' holdings in WorldCom.

(g) On January 30, 2001, Ebbers and the Compensation Committee agreed to increase the guaranty in favor of Bank of America to $150 million, along with "certain additional payments." Ebbers' obligations to Bank of America would have become due and payable upon default, "which includes, among other things, Mr. Ebbers ceasing to be [WorldCom's] President and Chief Executive Officer or any materially adverse change in his compensation package from [WorldCom]." Thus, if the Board decided to remove Ebbers for any reason, the Company would have had to immediately pay at least $150 million to Bank of America – powerful incentive for the Board to ignore WorldCom's improprieties.

(h) On January 25, 2002, WorldCom agreed to loan Ebbers an additional $65 million. According to the Examiner's Second Interim Report, this loan was apparently never approved by the full board. Also that day, the Company agreed to collateralize a letter of credit extended by Bank of America to Ebbers to support financing for Mississippi College. Ebbers pledged to WorldCom a security interest in a brokerage account maintained by Bank of America.

(i) January/February 2002: As Ebbers WorldCom shares decreased in price, WorldCom agreed to repay all of Ebbers' debt to Bank of America, which the Company had guaranteed. By February 2002, WorldCom made an aggregate payment to Bank of America of $198.7 million, and deposited an additional $36.5 million to collateralize a letter of credit used to support Mississippi College. In return, Bank of America released its security interest in Ebbers' WorldCom shares, as the shares would now serve as collateral for WorldCom. The Company, however, did not perfect its security interest in the stock until March and April 2002.

(j) On April 2, 2002, Ebbers entered into a letter agreement amending the November 1, 2000 letter agreement. In this letter agreement Ebbers pledged to WorldCom all of his rights "in the shares of stock of the Company now owned by [him] (except for the stock of the Company currently the subject of pledges for the benefit of Citibank, N.A. and Bank of America N.A., respectively.)"

(k) April 17-18, 2002, Ebbers pledged to WorldCom his ownership interest in Joshua Holdings, the Canadian ranch and his ship building business.

(l) On April 29, 2002, Ebbers resigned as CEO of WorldCom. Ebbers and WorldCom entered into a promissory note that consolidated all of his outstanding debt to the Company – a total of $408,214,930. Payment on this note was due April 29, 2003, which payment he defaulted on.

384. In addition to the monumental amount of debt that WorldCom was willing to lend Ebbers, the terms of these loans were also extremely generous. The amount borrowed from the Company by Ebbers was loaned at the same floating interest rate that WorldCom paid on its multi-billion dollar revolving credit agreements – meaning that WorldCom loaned the money to Ebbers at

cost. As of April 29, 2002, the interest rate on Ebbers' outstanding debt was 2.32%. (By way of comparison, for internal accounting purposes, the Company charged MCI an interest rate of 8.4% for internal debt owed.) Furthermore, if Ebbers were an average consumer, the publicly available interest rate available in Mississippi for a personal loan in 2002 ranged from 9.75% to 17.17%.

385. Effectively, from September 2000 onward, Ebbers became increasingly dependent on an artificially inflated WorldCom stock price necessary to maintain his empire of debt. As for the Board, it too was motivated to sustain the fraudulently inflated stock price because the Company was on the hook for what amounted to over $400 million in exposure for Ebbers' loans and guarantees.

386. Additional evidence of scienter can also be inferred from circumstances relating to Ebbers' disguised sales of his WorldCom stock through a hedging transaction. Although, as described in ¶¶ 146 through 148 above, in the Fall of 2000 the Company was publicly touting to investors that WorldCom was in excellent financial and operational condition, Ebbers' actions revealed a different story. In early fall of 2000, after government officials blocked WorldCom's merger with Sprint and Ebbers began facing a series of margin calls, he entered into a complicated securities transaction to unload some of his shares. Specifically, on September 28, 2000, Ebbers entered into a forward-sale contract with Banc of America Securities, LLC for the sale of three million WorldCom shares for a prearranged price of $70,597,974, meaning that Ebbers was selling his shares at $23.54 – a 16% discount to the market price. Ebbers was paid immediately, but he did not have to deliver the shares until on or about March 28, 2002. If Ebbers had sold his shares on the open market on September 28, 2000, however, he would have obtained an additional $13 million. Ebbers was willing to take this loss, in part, because he knew that WorldCom's share price would have dropped even more on news that the CEO directly sold so many shares in the open

market, therefore triggering more margin calls that Ebbers knew he could not pay.

387. Furthermore, in entering the contract, Ebbers was betting that the stock price would decrease below $23.54 by the time he delivered the shares, meaning that he would profit from the contract. He was willing to make this bet because as revealed by evidence gathered by the Examiner, it appears that Ebbers knew that WorldCom's share price was unsustainable both in the short-term and in the years to come. In addition to the allegation detailed above regarding Ebbers participation in the fraud at WorldCom, this evidence includes that (i) on September 18, 2000, Ebbers received the August monthly review, which indicated that actual revenues were about 10% below expectations; (ii) days before the contract, Sullivan e-mailed Ebbers to inform him that revenues were lagging; (iii) Ebbers completed the sale despite it violating WorldCom's policy by falling in a "blackout period" 30-days prior to an earning announcement (in fact, on October 26, 2000, WorldCom announced that it missed the earning consensus estimate of $0.47 per share by a whopping $0.14); (iv) by September 25, 2000, Sullivan had ordered a study analyzing the impact of a public warning that WorldCom was expecting declining growth; (v) the initial $50 million loan to Ebbers needed to pay off margin loans had not yet been disclosed – this fact was qualitatively material to investors and WorldCom's outside counsel advised that the loan should have been disclosed; and (vi) Ebbers knew that WorldCom was close to adopting a tracker stock, which would be viewed by the market as major restructuring initiative and adversely affect the share price. Accordingly, Ebbers entered this contract at the opportune time to lock in a $70 million pay out in anticipation of what he knew was an inevitable downfall due to the fraud that he perpetrated.

Sullivan

388. With respect to Sullivan, numerous documents and facts uncovered in the course of various investigations show that he not only knew about WorldCom's accounting fraud, but that he was its quarterback. Specifically:

(a) In his "white paper" attached as exhibit to the WorldCom's Revised Statement , Sullivan admitted he knew that line costs were accounted as capital expenses rather than operating expenses.

(b) As described in more detail in ¶ 97, Brabbs specifically informed WorldCom senior executives nearly $34 million of operating expenses had been fraudulently capitalized in the Company's consolidated financial statements. In response, the U.S. executives told Brabbs that the entry was made at Sullivan's request.

(c) As further described above, Yates and Myers stated that Sullivan instructed them to make fraudulent entries in WorldCom's general ledger after Sullivan determined that the expenses for the third and fourth quarter of 2000 were too high, and that as a result the Company would otherwise miss Wall Street's earnings expectations. Thus, the fraudulent entries were specifically designed by Sullivan to reduce the Company's operating expenses and boost earnings.

(d) In May 2002, Sullivan attempted to delay or even stop Cynthia Cooper's internal investigation of the fraud.

(e) Sullivan sold almost $18.1 million worth of WorldCom's shares.

389. As described in more detail in ¶ 110, on August 28, 2002, Sullivan was charged in the Indictment with seven felonies relating to WorldCom's accounting fraud. The Indictment describes a variety of the intentional and deliberate actions taken by Sullivan to orchestrate the biggest accounting fraud in history.

390. Although Sullivan had an opportunity to refute the charges of his involvement in WorldCom's accounting fraud when he testified before Congress on July 8, 2002, he refused to do so, and invoked his Fifth Amendment right not to incriminate himself.

Myers and Yates

391. With respect to defendants Myers and Yates, on September 26, 2002 and on October 8, 2002, respectively, they pleaded guilty to, among other things, intentionally and knowingly committing securities fraud at WorldCom.

Kellett

392. As recently reported by The Wall Street Journal, Kellett and Ebbers struck several of their own quid pro quo transactions. For example, in 2000, Kellett, who was the Chair of the Compensation Committee of the Board, persuaded the Board to grant Ebbers several loans that ballooned to over $400 million to cover Ebbers' personal indebtedness. In return, WorldCom leased Kellett a corporate jet for $1 per month, a cost that should have been closer to $1 million annually. The Monitor appointed in the WorldCom bankruptcy, who recently scrutinized Kellett's corporate jet lease, has called for Kellett's resignation as a result of this abuse of his position. In addition, the Monitor observed that the use of the jet may have influenced Kellett's approval of a favorable severance package for Ebbers.

393. Kellett is also being investigated for several forward sales of WorldCom's stock in November 2000. At that time, apparently realizing that WorldCom's financial prospects were dim after the collapse of the Sprint deal, Kellett, under disguise of a forward contract, sold four million shares, representing approximately 67% of his and his affiliated entities' total holdings of WorldCom stock, which guaranteed that he would receive $53,566,847 in November 2003.

394. According to a Form 4 filed on December 8, 200, Kellett's arrangement with AIG Financial Services Corp. required him to deliver four million shares at an average price of

approximately $13.39, whereas the closing trading price on the contract dates of November 3, 2000 and November 10, 2000 was $17.30 and $14.90 respectively – an average of $16.10. Accordingly, Kellett passed up approximately $10.8 million in additional payment that was available if he sold his shares in the open market rather than pursuant to the forward sales contract. This was, however, a hedge against the collapse of the share price that, since it was structured as a forward contract, avoided the negative market reaction to such a large sale by an insider.

395. In addition, on December 4, 2001, Kellett sold 50% of his holdings in WorldCom for $11.9 million.

The Audit Committee

396. WorldCom had several layers of oversight and internal controls that, had they been effectively designed and had they worked properly, should have, at a minimum, detected the fraud at an earlier point. In addition to certain basic internal controls, the Company had three separate entities charged with the responsibility of overseeing the Company's accounting practices and protecting the interests of the Company and its shareholders: (i) the Audit Committee; (ii) the Internal Audit Department and (iii) Andersen, the Company's external auditors.

397. The SEC has stated that "[a]udit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditor's participation in the financial reporting process. Audit committees can, and should, be the corporate participant best able to perform that oversight function." See Audit Committee Disclosure, Exchange Act Release No. 34-42266, 71 SEC Docket 787, 1999 WL 1244029, at *3 (Dec. 22, 1999) (emphasis added).

398. The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was sponsored by the New York Stock Exchange and the NASD, specifically stated that an audit committee's oversight function includes the responsibility for ensuring that the

corporation has internal controls in place specifically to deter management fraud. As the report issued by that Committee provides:

> [S]uch oversight includes ensuring that quality accounting policies, internal controls, and independent and objective auditors are in place to deter fraud, anticipate financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders.

(Emphasis added).

399. WorldCom's SEC filings represented that the members of the Audit Committee performed the following functions: review of periodic financial statements; communication with independent accountants; review of the Company's internal accounting controls; and recommendation to the Board of Directors as to the selection of independent accountants.

400. Notwithstanding its statutory and self-imposed obligations, the Audit Committee functioned in a way that made it highly unlikely that red flags would come to its attention. As the Special Committee determined, the Audit Committee – like the WorldCom Board and Compensation Committee – was distant and detached from the workings of the Company.

401. During most of the relevant period, the Audit Committee was made up of Bobbitt, the Committee Chair, and Allen, Galesi and Areen. Allen became a member of the Audit Committee in May 1999. Bobbitt served as Chairman of the Audit Committee from about 1994 until December 2002 when he resigned from the Board. Bobbitt, Aycock and Allen each had financial expertise, and Allen and Bobbitt had started their careers as auditors for Andersen. Additionally, Allen and Bobbitt had served as chief financial officers of various companies and developed backgrounds in the telecommunications business.

402. The Audit Committee was the Board Committee that had the greatest ability to oversee the financial statements of the Company and the effective use of its Internal Audit

Department. In order to function effectively, it was vital for the Audit Committee to have a detailed understanding of the Company, particularly its financial systems and internal controls. However, the Audit Committee was reckless by failing to become sufficiently familiar and involved with the Company's internal financial workings, to see the weaknesses in the Company's internal control structure, and to appreciate or detect the true corporate culture at WorldCom. WorldCom was a complicated company in a fast-evolving industry. It had expanded quickly, through a series of large acquisitions, each of which raised concern about WorldCom's accounting and internal controls. As the Audit Committee members should have recognized, these acquisitions were not integrated, posing serious challenges for the Company and the Audit Committee. WorldCom had accounting-related operations scattered in a variety of locations around the country. To gain the knowledge necessary to function effectively required the Audit Committee to spend a substantial amount of time learning about the Company's accounting practices. However, the Audit Committee only met for three to five hours a year, which was wholly inadequate.

403. As discussed in more detail below, the Audit Committee abdicated its responsibilities in at least two critical ways. First, it allowed a "serious failure of communication" between itself and Andersen. As stated in ¶¶ 436 - 454, Andersen – which described WorldCom as one of its "crown jewels" and the client that would make Andersen's reputation in the telecom industry – utilized a "non-traditional" approach for its auditing of WorldCom. However, the Audit Committee did not understand the non-traditional audit approach Andersen employed, which should have been a matter for great scrutiny by the Audit Committee and discussion with Andersen.

404. Second, the Audit Committee failed to establish a strong reporting mechanism between itself and the Internal Audit Department. As a result, the Internal Audit Department fell under the control of Company management and spent much of its time performing operational, not audit-related, functions. Moreover, as the Audit Committee should have known, Andersen and the Internal Audit Department rarely, if ever, coordinated efforts to audit the Company's financial statements. As a result, "Internal Audit and Arthur Andersen were two ships passing in the night," according to the Examiner's Second Interim Report.

1. The Committee's Mission

405. The Audit Committee approved a formal Charter setting forth its responsibilities. The Charter was publicly disclosed to the shareholders as part of the Company's proxy statements and required the Audit Committee to perform the following functions during the relevant period: (a) review periodic financial statements; (b) communicate with independent accountants; (c) review internal accounting controls; and (d) recommend selection of independent accountants to the Company's Board of Directors. In accordance with its Charter, the Audit Committee committed to: (a) serving as an independent and objective party to monitor the Company's financial reporting processes and internal control systems; (b) reviewing and appraising the audit efforts of the Company's independent accountants and internal auditing department; and (c) providing an "open" avenue of communication among the senior management, the Internal Audit Department and the Board of Directors.

406. Under the terms of the Charter, the Audit Committee was to be made up of three or more independent directors who would be "free from any relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment as a member of the Committee." The Charter charged all members with being familiar with basic finance and accounting practices, including the ability to read and understand fundamental financial statements,

and required at least one of the members to have accounting or related financial management expertise.

407. The Audit Committee committed to meeting at least three times per year, as well as to annual meetings with management, the Vice President of Internal Audit, and the external auditors in separate executive sessions to discuss any matters that the Committee or any of these groups believed should be discussed privately. Last, the Committee, or at least its Chair, was to meet with the independent accountants and Company management quarterly to review the Company's financial statements.

2. The Audit Committee's Failure to Fulfill its Responsibilities Allowed the Fraud to Go Undetected

408. As the Examiner determined, structural weaknesses in WorldCom's internal accounting controls fostered an environment that allowed the fraud to go undetected. First, the Internal Audit Department at WorldCom was supposed to report to both the CFO and the Audit Committee. However, evidencing the extent to which it abandoned its responsibilities, the Audit Committee did not supervise or exercise any responsibility for Internal Audit. Indeed, the Examiner determined that, in actuality, Internal Audit did not report to the Audit Committee, but solely to WorldCom's CFO. Thus, throughout the Class Period, Sullivan, and not the Audit Committee, was responsible for reviewing Internal Audit's annual and revised audit plans and assigning additional non-audit and audit-related projects to Internal Audit. Sullivan and/or Ebbers reviewed preliminary audit reports issued by Internal Audit, and made comments and recommended changes. Importantly, Sullivan, working in conjunction with Ebbers, determined and controlled Internal Audit's budgets, staffing, compensation and bonuses. Moreover, the Audit Committee members allowed Sullivan to determine whether the Internal Audit Director would have an opportunity to address the Audit Committee at meetings.

409. The Audit Committee, as part of its responsibilities, was charged with reviewing and approving, on an annual basis, the Internal Audit Department's audit plan. However, the Audit Committee again did not fulfill any of its responsibilities. For example, the Audit Committee did not have any input into changes that were made to the annual audit plan by Internal Audit as the audit year evolved, and Internal Audit presented to the Audit Committee only its final recommendations at the conclusion of its audits. Indeed, the members of the Audit Committee were content to receive only executive summaries of the final audit reports and, rarely, the final audit reports in their entirety.

410. The Audit Committee's role in the Internal Audit Department's activities was very limited. The Audit Committee reviewed the list of audits scheduled for each year, and was provided general updates and summaries of information that Internal Audit thought important. However, the Audit Committee members failed to play a meaningful role in setting priorities or in following-up on problems found in the course of its audits. For instance, the Audit Committee failed to ensure that the Company's Internal Audit Department conducted investigations of the Company's financial statements, and allowed Ebbers and Sullivan to relegate the Internal Audit Department to conducting audits only of certain Company operations.

411. The failure of the Audit Committee to establish a true reporting relationship with Internal Audit – as Company policy required – was clearly a factor in the failure to recognize the rampant fraud at WorldCom. For example, in the Fall of 2001, Internal Audit was engaged in an audit of the Company's systems and controls relating to capital expenditures. At the time, some personnel at WorldCom were concerned about a number of unexplained and large discrepancies between the amount of capital expenditures tracked internally by the Company's operational departments responsible for spending capital, and the amount of capital expenditures externally

reported. In one instance during the audit, Internal Audit personnel became aware of certain categories of "corporate accruals" amounting to about $2.3 billion, but simply incorporated, without verification, the explanations of the financial reporting personnel that the accruals were proper, as well as the descriptive language they supplied, into its final report issued in January 2002. Had the Audit Committee established a direct reporting relationship with the Internal Audit Department, such findings would have been communicated to the Audit Committee, and the Audit Committee members could have sought to verify the actual journal entries that supported the corporate accruals Internal Audit had identified – steps that would have revealed the capital expenditure fraud at least eight to nine months before it was ultimately disclosed.

412. Indeed, in late May 2002, after Ebbers' departure and the replacement of Andersen by KPMG, Internal Audit finally initiated a follow-up capital expenditure audit. The follow-up included a financial component, with Internal Audit seeking to verify the actual journal entries that supported the corporate accruals they had identified as part of their 2001 audit. Once Internal Audit reviewed the journal entries at issue, their suspicious nature was immediately apparent in light of the behavior of the accounting personnel they interviewed who were aware of such entries.

413. The members of the Audit Committee abrogated their responsibilities to WorldCom's shareholders in other ways. For example, the Audit Committee failed to ensure that the Internal Audit Department coordinated its audits with Andersen, and that Andersen was provided with copies of all final reports prepared by Internal Audit. The Audit Committee also failed to ensure that internal control weaknesses that Internal Audit identified in its final reports were not material. No member of the Audit Committee even attempted to confirm that Internal Audit and Andersen were communicating about such issues or analyzing the materiality of the weaknesses identified by Internal Audit. Further, minutes of Audit Committee meetings prepared

by the Internal Audit Department did not reflect any executive sessions with the Internal Audit Director from 1999 until March 2002. This was a severe breach of the Audit Committee members' duties to the Company and its shareholders, as the Audit Committee was specifically required under its own policy to review and appraise the auditing efforts of the Internal Audit Department.

414. The Audit Committee allowed Andersen to violate GAAS by not requiring Andersen to prepare and present annual management recommendation letters to the Committee. See AU ' 325, Communication of Internal Control Related Matters Noted in An Audit. A management recommendation letter is a reporting tool by which external auditors are required by GAAS to identify and report to a company's audit committee "matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertion of management in the financial statements." AU ' 325.02 (footnote omitted). The Audit Committee members knew that Andersen was supposed to prepare a management recommendation letter in connection with each audit; the Audit Committee knew the purpose of that letter was to describe any significant deficiencies in WorldCom's accounting systems; and also knew that they were supposed to receive and review such letter each year. However, the Audit Committee members failed to require that such management recommendation letters be provided to them. As a result, the Audit Committee members remained ignorant of any reportable conditions observed by Andersen regarding the Company's accounting and internal control systems.

415. Specifically, Andersen prepared and presented to the Audit Committee management recommendation letters in which Andersen identified its concerns and corresponding

recommendations for corrective action, through at least the 1996 audit. Thus, in a 1997 draft management recommendation letter Andersen prepared in connection with its audit of WorldCom's 1996 financial statements, Andersen advised the Audit Committee of, among other things, the need to strengthen the Company's internal controls as the Company was growing through acquisitions, including the bolstering of the Internal Audit Department, and the instituting of fraud training for the Company's senior management.

416. However, that was the <u>last management recommendation letter</u> that the Audit Committee reviewed; indeed, the Examiner determined that there was no evidence that any such letters were prepared and presented to the Audit Committee from 1998 through 2001. Nor was there any other mechanism by which Andersen reported its findings to the Audit Committee. Accordingly, the Audit Committee members were reckless by failing to compel Andersen to comply with the GAAS requirement to meaningfully report to the Committee all internal control weaknesses or deficiencies, choosing instead to be satisfied with the quarterly "canned" presentations Andersen made to the members of the Audit Committee, and the pre-earnings discussions held between Andersen, the Chairman of the Audit Committee and the CFO.

417. The Audit Committee members were further reckless in failing to ensure that the Internal Audit Department functioned properly. The viability and existence of Internal Audit depended on the whim of senior management at WorldCom, and it was well known within the Company that Ebbers believed Internal Audit did not add any value to WorldCom and was unnecessary. Accordingly, to save their jobs, employees of the Internal Audit Department focused their work on projects that would add value to WorldCom, rather than fulfilling the department's role as WorldCom's "internal control police."

418. Moreover, the Audit Committee failed to take steps to ensure that any significant issues encountered by Internal Audit in the course of its operationally focused audits were reviewed and approved by Andersen. While Internal Audit reviewed the relevant financial amounts generated in the detail subsidiary journals, it did not, for the most part, trace transactions to the general ledger. Instead, the Audit Committee assumed that Andersen would be reviewing the flow of transactions through to the general ledger and external reports. Many of the audits Internal Audit performed resulted in findings that were relevant to the Company's revenue recognition policies. Yet, the Audit Committee failed to ensure that there was any meaningful coordination or communication between Internal Audit and Andersen to ensure that Internal Audit's findings were not material to the Company's financial statements and revenue recognition policies. The Examiner ultimately determined that there was virtually no evidence of any meaningful communication between Internal Audit and Andersen during the Class Period.

419. The recklessness of the Audit Committee members also is demonstrated by a review of the minutes of Audit Committee meetings. Indeed, the Examiner determined that there were serious deficiencies in the drafting and maintenance of minutes memorializing the deliberations of the Audit Committee. Prior to February 2002, the minutes provided only brief, boilerplate summaries of the Committee's deliberations with a number of discrepancies and omissions on such important matters as: (a) whether and how often the Committee met in separate executive sessions with the external auditors and with the Director of Internal Audit; (b) the substance of any discussions by Andersen or Internal Audit regarding the specific results of their audits; and (c) whether the retention of Andersen as the Company's independent auditor was formally approved by the Committee annually, as required. There are no minutes for any of the executive sessions,

and no person interviewed by the Examiner had any specific memory of issues discussed during those sessions. Thus, even the minutes reflect the Audit Committee members' recklessness.

420. The Audit Committee members, among other Board members, were further reckless in failing to require the disclosure of the risk factors relating to WorldCom bond investments in the May 2000 and May 2001 Offerings. This omission was contrary both to WorldCom's prior disclosure practices (e.g., in its August 1998 bond offering) and to SEC disclosure requirements with respect to public offerings by companies with risk profiles like WorldCom's.

421. Moreover, Bobbitt, Chair of the Audit Committee, assisted in Ebbers' restructuring of his personal loans, and Bobbitt and the other Audit Committee members knew that disclosures in the Company's February 7, 2002 Form 8-K and 2001 Form 10-K about the use of loan proceeds and the sufficiency of Ebbers' assets to satisfy the $408 million in outstanding loans and guarantees were materially false and misleading. The Audit Committee members knew, or were reckless in not discovering, that: (a) WorldCom did not have a system in place for distribution and monitoring of corporate loan proceeds; (b) WorldCom did not conduct any type of valuation of Ebbers' non-stock assets; and (c) the financial information supplied by Ebbers was substantially incomplete and outdated, such that Ebbers' lawyers and accountants expressly disclaimed its accuracy.

422. The Audit Committee members were further reckless by failing to perform their primary function to test the "quality and integrity of [WorldCom's] accounting, auditing and financial practice," and permitting management to marginalize the Audit Committee's role (as well as the role of the internal and outside auditors). As stated above, the Audit Committee members abdicated their role with respect to the outside auditors when, from 1997 forward, the Audit Committee members did not require Andersen to provide them with GAAS – mandated annual management recommendation letters.

423. The Audit Committee failed to fulfill its duty to be actively involved with WorldCom's external auditors, Andersen. Had the Audit Committee discharged its duties by remaining actively involved in Andersen's audits, it would have learned that, in 1999, Andersen had requested from management, on a quarterly basis, a list of "significant eliminating and top-side entries." The Audit Committee would have also learned what Andersen acknowledged in its working papers: that it intended to give specific attention to adjustments to line costs. Additionally, the Audit Committee would have learned that management had refused to provide Andersen with a repeatedly requested computerized version of the Company's general ledger, the primary accounting record of the Company. Management's refusal to provide requested information to the auditors was a significant red flag, and because the Audit Committee had no meaningful discussions with Andersen, the Audit Committee failed to learn of this material fact. If the Audit Committee had fulfilled its duty and been involved with Andersen's audits, it could have established procedures for the auditors to review the general ledger, and thus could have established procedures that would have discovered the improper topside adjustments, exposing the fraud.

424. The Audit Committee also was reckless when it failed to question Andersen concerning its use of a non-traditional audit approach that focused on business risks and controls to monitor those risks, with tests conducted where risks were perceived. The Audit Committee, had it asked, would have discovered that Andersen's non-traditional audit approach did not include functions typically performed by external auditors, such as verifying financial statements and account records. Andersen's deviation from a traditional audit approach should have been a matter of great scrutiny for the Audit Committee, which was charged with determining the quality and integrity of WorldCom's financial reporting. By not raising the issue, the Audit Committee knew

or recklessly disregarded that the Company's financial statements and account records would not be audited by Andersen or anyone else.

425. The Audit Committee, as stated above, further knew that the Internal Audit Department operated under the control of Sullivan, and, therefore, its independence was compromised. Sullivan and Ebbers controlled the Internal Audit Department's budgets, staffing, compensation, and bonuses, ensuring that members of the Department depended on them for their livelihood. Although Company policy provided for the Internal Audit Department to report to both Sullivan and the Audit Committee, in practice Internal Audit reported only to Sullivan. This made it difficult, if not impossible, for the Audit Committee to challenge Sullivan on accounting issues, and deterred employees from going to the Internal Audit Department with their concerns about accounting entries.

426. Management also directed the Internal Audit Department's resources, often diverting the attention of the Internal Audit Department away from policing the Company and instead to non-audit "special projects." Ebbers was openly hostile to the Internal Audit Department and attempted on more than one occasion, including in March 2002, as the Company's financial reporting was first starting to be questioned, to cut its budget.

427. As a result, the Internal Audit Department was essentially required to justify its existence by finding ways to "add value" by conducting operational audits with a view toward maximizing revenues and reducing costs. This meant that the Internal Audit Department left financial issues solely to Sullivan and the outside auditor. The Audit Committee thus allowed the Internal Audit Department to abandon the role of examining internal controls designed to prevent or detect fraud in financial reporting.

428. Notwithstanding its affirmative duty to know otherwise, the Audit Committee recklessly assumed, without any inquiry, that the Internal Audit Department and Andersen were in communication regarding internal control weaknesses and coordinated their reporting efforts. In fact, there was no coordination with Andersen. Instead of actively investigating weaknesses in internal control identified by the Internal Audit Department, the Audit Committee recklessly assumed that those weaknesses were reported to Andersen and were not material.

429. Given that Sullivan dominated the workings of the Internal Audit Department and restricted Andersen's access to internal accounting materials, it was reckless for the Audit Committee to rely heavily on Sullivan. Nonetheless, the Audit Committee permitted Sullivan to control its meetings, which consisted mainly of presentations by management, the Internal Audit Department, and Andersen. Sullivan dictated when the Internal Audit Department made presentations, and minutes of the Audit Committee's meetings indicate that the Internal Audit members often were not in the room when Andersen made a presentation.

430. The Audit Committee further failed to conduct its business with the benefit of any advice of counsel until Spring 2002, contrary to its Charter, which required that it would seek advice of counsel.

431. The Audit Committee either intentionally or recklessly failed to meaningfully question the manner by which line costs were accounted for when there was approximately $3.5 billion of line costs capitalized with no documentation provided by management. These reported capital expenditures clearly were not within the budgets passed by the Board.

432. The Audit Committee either intentionally or recklessly failed to sufficiently monitor the Company's merger reserves when it drew down $1.6 billion in merger reserves over just two

quarters ($828 million in 3Q00 and $797 in 4Q00), without any documentation provided by management.

433. The Audit Committee failed to review Andersen's audits as required by its Charter, that is, the Audit Committee failed to ensure that Andersen obtained sufficient and competent evidential matter when conducting its audits. Had the Audit Committee ensured that Andersen obtained sufficient competent evidence, it would have verified that Andersen, instead of relying on management's representations, received documentary evidence of:

(a) WorldCom's excessive write-offs;

(b) transfers of line costs from operating expenses to "property, plant and equipment;" and

(c) WorldCom's large top-side adjustments that improperly increased WorldCom's reported earnings.

434. Other red flags that the Audit Committee either intentionally or recklessly disregarded included:

(a) A failure of WorldCom's management to display and communicate an appropriate attitude regarding internal controls and the financial reporting process, including management's setting of unduly aggressive financial targets and expectations for operating personnel, exhibiting a disregard for internal auditing (e.g., precluding WorldCom's internal auditors from reviewing financial results), and failing to implement significant controls on such items as top-side adjustments (which were changed without any documentation or support);

(b) The overwhelming motivation for management to engage in fraudulent financial reporting, which included the personal motive that Ebbers had to maintain a high stock price (which stock he used as collateral for hundreds of millions of dollars of loans), the Company's need to maintain its "investment grade" credit rating in order to sell $5 billion and $11.8 billion worth of bonds in the May 2000 and May 2001 Offerings, and the Company's need to maintain its stock price in order to continue its growth by acquisition strategy;

(c) Risk factors in the industry, in which there was a high degree of competition and market saturation, accompanied by declining margins and increasing business failures that also made WorldCom's own receivables far less likely to be paid; and

(d) Risk factors relating to operating characteristics and financial stability, including the inability to generate sufficient cash flows from operations while reporting earnings and earning growth; significant pressure to obtain additional capital necessary to finance the Company's operations and capital expenditures; assets, liabilities, revenues and expenses based on significant estimates that involved unusually subjective judgment and uncertainties, such as the valuation of goodwill; unusually rapid growth and reported profitability, especially compared with that of other companies in the same industry; unusually high dependence on debt, combined with debt covenants that were difficult to maintain; and adverse consequences on significant pending transactions (such as the Note Offerings and acquisitions), if poor financial results were reported.

435. In addition to the facts alleged above, the size of WorldCom's restatement establishes that these defendants either knew about the accounting improprieties or recklessly disregarded information which would have led them to discover the fraud. As pointedly observed

by one of the accounting specialists interviewed by The Wall Street Journal on June 16, 2002, the WorldCom debacle "shows a breakdown in the chain of responsibility . . . . From WorldCom's longtime auditor [Anderson] to top management and the audit committee, all of these guys have to be responsible." Further, on January 30, 2002, only two weeks before WorldCom announced a massive write off of goodwill, Galesi sold 2.9 million WorldCom shares, which constituted approximately 63% of his total holdings, realizing proceeds of approximately $27 million.

436. In sum, WorldCom's SEC filings represented that the members of the Audit Committee performed the following functions: review of periodic financial statements; communication with independent accountants; review of the Company's internal accounting controls; and recommendation to the Board of Directors as to the selection of independent accountants. However, as demonstrated in detail above, and as earlier reported by The Washington Post on August 29, 2002, WorldCom's internal accounting controls were virtually non-existent. Indeed, as described in detail in the NYSCRF's original Complaint at ¶ 229, the minutes of a June 6, 2001 Audit Committee meeting show that the Audit Committee became aware, at least as early as June 2001, that there were systemic and material deficiencies in WorldCom's internal controls. At that meeting the Audit Committee was informed that sales personnel were improperly moving accounts from one billing system to another to generate phony sales and hence higher commissions – stemming from the use of separate billing systems for the old MCI accounts and the old WorldCom accounts, even years after that merger was completed – resulting in the reporting of higher revenues than was appropriate. Yet the Audit Committee failed to correct these practices, and failed to take any steps to improve WorldCom's controls.

Andersen

437. As described in more detail in ¶ 97, Brabbs, a senior executive in WorldCom's UK office, specifically notified Andersen on at least two occasions in 2000 that WorldCom's

management was making fraudulent entries in WorldCom's financial records relating to expenses, more specifically, that WorldCom's European operation had reversed $33.6 million in their line cost accruals after the close of the first quarter of 2000 and, as a result, they considered themselves under-accrued. Andersen employees did not have supporting documentation for such reversals. Thus, Andersen had actual knowledge of the fraudulent acts that ultimately caused the restatement – namely, the fraudulent capitalizing of normal operating expenses. Despite this knowledge, Andersen failed to inquire into WorldCom's accounting practices relating to this particular entry, which remained improperly accounted for until after Andersen was removed and replaced as WorldCom's auditor in May 2002.

438. Andersen's scienter is further demonstrated by the fact that the accounting fraud at WorldCom was enormous – yet strikingly simple to detect by an auditor bringing appropriate professional skepticism to his or her audit engagement. As observed by one of the accounting experts interviewed by The Wall Street Journal, "[t]his is basic stuff." Indeed, during the Congressional hearings on the WorldCom debacle on the July 8, 2002, Bert Roberts, the chairman of WorldCom's Board of Directors, observed that "the failure of our outside auditors to uncover them [the accounting irregularities] is inconceivable." Melvin Dick, one of Anderson's audit partners in the relevant period, declined to respond to questions regarding how Andersen's audit activities could have failed to discover the transfers. Indeed, there are reports by persons close to WorldCom that there are additional documents suggesting that Andersen actually reviewed and approved the Company's accounting of line costs.

439. Although Andersen had stated that it was not consulted or notified about the line cost capitalization, a fundamental requirement of any auditor is to look at material expenditures and make sure they are reported properly. The growth of the Company's capitalized expenses should

have informed Andersen, had it been performing its duties properly and in conformity with auditing standards, that this item was materially overstated and, concomitantly, that the Company's expenses were materially understated. In addition, auditors for capital-intensive businesses like telecommunication companies must look for improper capitalization since capitalized accounts are subject to such simple abuses. Since a chief financial officer can potentially override the accounting system of any company, auditors look at capital expenditures and make sure there is proof of such transactions.

440. Further, as a part of the audit process, Andersen was required to determine whether management had adequate controls to prevent a material error in the financial statements as a result of failure to properly capture transactions, process data, and record data in the general ledger. It is obvious that Andersen either intentionally or recklessly failed to do it, because, as noted above and as reported by WorldCom's former employee, WorldCom had virtually "no inventory controls, no fraud controls, no nothing."

441. Finally, it has been reported that Andersen specifically audited line costs expenses and, either intentionally or recklessly, observed that as a percentage of revenue such costs remained flat on a year to date basis but based on their "knowledge and experience" in the industry, Andersen should have known that the relationship between line costs and revenue should not have remained constant.

442. In a September 2000 presentation, Andersen stressed to the Audit Committee and WorldCom's management that it did not follow the "traditional audit approach." According to this presentation, the traditional approach verified the information maintained in the records and financial statements, and would have required Andersen to focus primarily on account balances. By contrast, Andersen's approach focused heavily on identifying risks and assessing whether the

Company had adequate controls in place to mitigate those risks. In the accounting industry, this approach became known as the "control-based" or "risk-based" audit. The consequences of overlooking or misjudging a potential risk are significant. Failure to identify any risks in a particular area meant that Andersen would rely on Company controls that were inadequate or that had been circumvented. Indeed, it meant that Andersen might not perform any testing at all in a particular area.

443. In conducting its audits, Andersen needed to consider, in accordance with U.S. Audit Standards AU § 311, a number of factors including, but not limited to:

- Matters relating to WorldCom's business and the industry in which it operated;
- WorldCom's accounting policies and procedures;
- Methods used by WorldCom to process significant accounting information, including the use of service organizations, such as service centers;
- Planned assessed level of control risk;
- Preliminary judgments about materiality levels for audit purposes;
- Financial statement items likely to require adjustment;
- Conditions that may require extension or modification of audit tests, such as the risk of material error or fraud or the existence of related party transactions; and
- The nature of reports expected to be rendered.

444. Andersen conducted limited substantive testing in accordance with its audit plan. Andersen provided WorldCom's senior management with a list of the procedures it anticipated performing in the areas of revenues, line costs, accounts receivable, capital expenditures, and data integrity. In an August 11, 2000 memorandum from the engagement manager to Stephanie Scott

and Myers, Andersen made it clear to senior management that a large majority of its work was "based on processes and controls the Company had in place to identify and manage risks," as opposed to detailed auditing of the components of reported account balances. Andersen's testing of capital expenditures, line costs, and revenue did not change significantly from 1999 through 2001. Andersen performed analytical procedures of various line items on WorldCom's financial statements to determine whether there were any significant or unusual variations between consecutive quarters or the same quarter in consecutive years. After the second and third quarters of 2001, Andersen relied partially on a software program to detect these variations.

445. Although Andersen's SMART Tool rated WorldCom as a "high risk" client based on its assessment of a variety of potential risks, Andersen manually overrode this result and upgraded WorldCom to a "maximum risk." The stated reason in Andersen's work papers for this change was the volatility in the telecommunications industry, the Company's future merger and acquisition plans, and the Company's reliance on a high stock price to fund those acquisitions. When Andersen overrode the "high-risk" selection in 1999, the concurring partner at the time said: "My sole reaction to [the SMART Tool risk assessment of WorldCom], however, is that the engagement should be rated as maximum rather than high. If this job is not maximum, none are." The engagement manager concurred, stating that there were "probably few other engagements where [Andersen] ha[d] a higher risk."

446. Despite the fact that Andersen rated WorldCom as a "maximum risk" client between 1999 and 2001, Andersen did not alter its audit approach or cause the engagement team to conduct more substantive testing to prevent fraud. Nor did a few less than favorable ratings relating to management in SMART Tool cause Andersen to alter its approach or perform additional testing. Andersen's "maximum risk" rating between 1999 and 2001 failed to alter Andersen's audit

approach or cause the engagement team to conduct more substantive testing to prevent fraud.

447. Andersen's June 2001 "fraud brainstorming" meeting, the purpose of which was to identify potential fraudulent accounting schemes and to "sensitize the complete engagement team to potential financial statement fraud risks and schemes" also did not alter Andersen's audit plan.

448. Andersen, through its use of a Business Risk Model, became aware of two relevant problem areas in 1999: a potential for the Company misstating its line costs, expenses and liabilities; and a risk that its management could manipulate business processes to achieve financial targets. Andersen was also aware of past problems with the Company's methods in recording inter-company transactions. In 2000, Andersen identified two additional financial risk areas: (1) the risk of credit defaults in residential and commercial accounts; and (2) continuous fluctuation in foreign currency causing a write-down in the Company's Embratel investment and potentially exposing the Company to further financial loss, or at least to fluctuating earnings that would have to be explained to analysts.

449. Andersen utilized, during all three years, a Fraud Risk Practice Aid to assess the risk of material fraud and accordingly plan and perform the audit in order to obtain reasonable assurance that any material fraud would be detected. During the 1999 audit, Andersen noted that the following Company practices might indicate a desire by management to manipulate earnings: (i) highly aggressive accounting and disclosure practices; (ii) changes in accounting principles or accounting estimates, with questionable support; (iii) inappropriate means to reduce taxable earnings. During the 2000 audit, Andersen noted a risk for fraud created by the fact that all WorldCom employees were compensated by the issuance of stock options and that stock options were a significant portion of senior Management compensation.

450. Finally, in a 2001 audit session, the auditors identified the following key financial

statement fraud risks to be addressed in the audit:

- misstatements of revenues through top-side adjustments;
- improper capitalization of expenses as fixed assets;
- manipulation of allowances for bad debts; and
- manipulation of purchase price adjustments and subsequent adjustments within the one year period.

451. Andersen was required to design its audit plan to provide reasonable assurance of detecting errors or irregularities. Yet, Andersen failed to design procedures to address such concerns or to fully implement those procedures it planned.

452. Andersen relied too heavily on senior management's assurances, and failed to corroborate the information that management provided. The most glaring example of this reliance was Andersen's request to management on a quarterly and annual basis for a list of "significant eliminating and top-side entries." Indeed, Andersen understood the importance of examining top-side entries, requesting a list of such entries after each quarter and stating in its 1999 work papers that "[s]pecific attention will be given to significant top level adjustments" to line costs. Andersen's engagement partner testified before Congress in July 2002 that Andersen never discovered the capitalization of line costs because, in part, the Company never provided it with these top-side entries. If Andersen had taken steps beyond merely requesting the entries, it is highly likely that they would have discovered huge, top-side entries, many in even-dollar amounts, which were made without any accounting support. Any one of the following entries made with no identifiable support should have raised serious concerns:

- $334,000,000 entry reducing international line cost accruals in 2Q00
- $771,000,000 entry capitalizing line costs and releasing accruals from an account for Ocean Cable Liability in Q01

- $560,000,000 entry capitalizing line costs in 2Q01
- $797,725,000 entry capitalizing line costs in 3Q01

453. Andersen could have readily identified all top-side entries from a review of the Company's General Ledger. However, Andersen accepted WorldCom management's refusal of Andersen's repeated request for access to the computerized version of the General Ledger, which showed the inappropriate on-top adjustments.

454. Andersen's audit approach disproportionately relied on finding unexplained variations in WorldCom's financial statements as its means of determining whether there were any accounting irregularities. Andersen failed to take into account that management might have manipulated the financial statements to eliminate any variations. Given the poor state of the telecommunications industry in 2000 and 2001, management's ability to continue to meet aggressive revenue growth targets, and maintain a 42% line cost expense-to-revenue ratio, should have been a red flag to Andersen.

455. Andersen failed to conduct substantive tests in the areas where WorldCom had significant accounting irregularities:

(a) *Capital Expenditures*—Andersen's auditing procedures did not contemplate the ways in which expenses could be improperly capitalized, and therefore the tests it devised were insufficient to address this issue. This occurred despite the fact that, in June 2001, Andersen specifically identified in an internal document improper capitalization of costs as a significant, risk.

(b) *Accruals*—Andersen failed to conduct any substantive tests of the Company's international line cost accruals that were managed in the U.S., or met with any employees to discuss those accruals. Had Andersen conducted tests in this area, it could

have learned that Myers and Yates asked employees to reduce more than $1.2 billion in international line cost accruals between the third quarter of 1999 and the fourth quarter of 2000, which represented a top level reduction of 20% of the Company's international line cost accruals.

(c) *Revenue*—Andersen failed to conduct any substantive tests to verify the validity of large, round-dollar revenue items on the Corporate Unallocated schedule. Andersen limited its work to discussions about the purpose of the Corporate Unallocated schedule and a small number of revenue items. The fact that the items on this schedule were not recorded in the sales regions and were the result of on-top corporate adjustments or accounting decisions should have raised the level of Andersen's attention. The appearance of large, round-dollar revenue items was a red flag, which should have set off alarm bells.

(d) Andersen failed to speak with many of the key people to whom an external auditor would normally speak to understand WorldCom's business and how WorldCom accounted for transactions.

(e) Andersen had limited contact with Internal Audit. Andersen did not work with Internal Audit in recent years to improve internal control or resolve other problems that Internal Audit encountered and documented.

(f) Andersen did not uncover the significant deficiencies in WorldCom's procedures requiring the existence and retention of documentary support for journal entries. The General Accounting group made huge journal entries, many in round-dollar amounts, without any support other than a Post-it Note or written instructions directing that the entry be made. What support that exists was organized in a haphazard manner in both marked

and unmarked rooms, and at least one closet, in WorldCom's Clinton facility. It is inconceivable that Andersen's audit did not find this systematic and pervasive lack of support for entries.

ADDITIONAL FACTS REGARDING FAILURE OF THE UNDERWRITER DEFENDANTS TO CONDUCT ADEQUATE DUE DILIGENCE

The Underwriter Defendants

456. In connection with the registration process of the Notes, the Underwriter Defendants were obligated to perform reasonable investigations into the Company's business and operations and ensure that the statements in the May 2000 and May 2001 Registration Statements were not materially false and misleading. In the process of conducting their "due diligence" investigations, the Underwriter Defendants should have exercised a high degree of care and sought to independently verify the Company's representations. Given the conflicted relationship between Salomon and WorldCom, each Underwriter Defendant had a duty to conduct its own due diligence and to view Salomon's due diligence and investigation findings with the appropriate degree of skepticism.

457. The allegations contained herein are replete with examples of the failure of the Underwriter Defendants to fulfill their duty of reasonable investigations in connection with the May 2000 and May 2001 Offerings.

458. For example, the Underwriter Defendants failed to perform a reasonable investigation in connection with their duty to fully understand WorldCom's policies with respect to recognition of revenue. For example, as revealed in the Special Committee's report and alleged herein, from 1999 through 2001, WorldCom inflated its revenues by nearly $1 billion by making fabricated revenue entries to so called "Corporate Unallocated" revenue accounts. These entries were typically large, round-dollar entries recorded in the weeks after the quarter ended. Had the

Underwriter Defendants performed customary investigation into the sources of WorldCom's revenue, they would have discovered these massive fabricated entries.

459. Moreover, the Underwriter Defendants failed to conduct a reasonable investigation into the Company's accounting of line costs. As alleged herein, one of the key objectives of the accounting fraud at WorldCom was to hide its rapidly escalating line costs, which were its largest expenses. For example, in 1999 and 2000, the Company reported its line costs as percentage of revenue at 43% and 38.4% respectively, when the actual line costs were in excess of 50% of revenues. Importantly, Salomon's valuation model prepared by Grubman in 1998 targeted WorldCom's line costs at around 52% of revenues. Had Salomon conducted a reasonable investigation into the reasons why WorldCom's reported line costs were so materially different than what its own analyst considered reasonable, it would have discovered that WorldCom was improperly releasing billions of dollars of reserves to offset line costs and, the 2001 underwriter Defendants would have discovered that, beginning in the first quarter of 2001, WorldCom was shifting line cost expenses into capital expenditure accounts. Indeed, the sheer size of the reserves releases, amounting to a staggering $3.3 billion in less than two years, should have prompted the Underwriter Defendants to ascertain the reasons for these releases.

460. Furthermore, the Underwriter Defendants also failed to investigate WorldCom's accounting treatment of goodwill. As alleged herein, WorldCom failed to timely write-down the significant amount of goodwill it carried on its books and financial statements, even though the value of such goodwill was impaired, in large part as a result of the vast over-capacity in, and the general downturn throughout the entire telecommunications industry. Given the significance of goodwill carried as an asset on WorldCom' s balance sheets throughout the Class Period, in the course of their due diligence, the Underwriter Defendants should have required management to

record and reflect such impairment in WorldCom's financial statements.

461. The Underwriter Defendants failed to conduct any due diligence to determine whether WorldCom had the intent or ability to satisfy the staggering amount of debt it was accumulating. Indeed, as the Examiner found, the Board spent little, if any, time discussing or examining the Company's increasing accumulation of debt, even during board meetings occurring immediately before and after a debt offering. WorldCom had no projections or models assessing whether the Company could sustain the enormous amount of debt it was incurring. Moreover – incredibly – WorldCom never did any strategic debt planning, which would have enabled the Company to understand and monitor its debt. Had the Underwriter Defendants conducted proper due diligence, they would have learned that the Company was burning through its cash at a much higher rate than disclosed, had no ability to monitor its debt, and that it had no plans providing for how it intended to pay off its massive debt.

462. The Underwriter Defendants also failed to ascertain whether WorldCom had any meaningful or effective internal controls relating to debt issuance, and failed to determine whether the Board even functioned as a true Board. Indeed, the Examiner's Second Interim Report reveals that the Board was completely ineffective – a rubber stamp that abdicated its responsibilities by, among other things, failing or refusing to consider important Company transactions. For example, as set forth in the Examiner's Report, at times, WorldCom announced corporate acquisitions even prior to obtaining board approval of the transaction. The Board would then, months later and with little if any deliberation, approve the transaction after-the-fact. In the case of other large acquisitions, the Board typically deliberated for an hour or less, and failed to consider any written materials or documents discussing the impact of the transaction on WorldCom.

463. In particular, when it came to WorldCom's debt offerings, Ebbers and Sullivan had

unfettered discretion to commit the Company to billions of dollars in debt obligations with no Board oversight. With respect to the offerings, Ebbers and Sullivan comprised the Company's Pricing Committee, and the Board rubber-stamped proposals from Ebbers or Sullivan regarding additional borrowings, often via unanimous consent resolutions that were adopted by the Board after little or no discussion. Indeed, the Board approval for the May 2001 Offering, for a staggering amount of $12 billion, the largest corporate bond offering in Wall Street's history, was approved by a unanimous written consent, with no deliberation by the Board. These facts clearly demonstrated that WorldCom had no ability to monitor its debt, and those facts would have been apparent to the Underwriter Defendants had they even bothered to review WorldCom's Board minutes. The fact that the WorldCom board was utterly derelict in carrying out its most basic functions was a red flag to the Underwriter Defendants, because it demonstrated that there were no internal checks and balances on WorldCom management. Moreover, notwithstanding the fact that a public company has a board of directors which is completely beholden to management and does not function in an appropriate or legitimate manner is highly material to investors, there was no "risk disclosure" regarding this in the registration statements.

464. The Underwriter Defendants also failed to investigate whether WorldCom was able to successfully integrate multi-billion dollar acquisitions, and failed to examine evidence regarding these transactions. For example, in 1999, WorldCom acquired Skytel for $2 billion. That transaction was approved by the Board after a 15-minute long meeting, and without a single piece of paper being provided to the Board. The Examiner determined that this transaction had little, if any, strategic benefit to WorldCom. Similarly, as alleged above in February 2001, WorldCom announced a $6 billion acquisition of Intermedia. As the Examiner's report noted, the Intermedia acquisition made little business sense and was "approved" by the Board after WorldCom had

conducted a total of only 60-90 minutes of due diligence, and a half-hour long meeting by the Board. In addition, WorldCom was not even provided with a fairness opinion by any financial advisor in connection with this acquisition. Again, the Examiner determined that this transaction, which resulted in massive losses for WorldCom, would never have been approved by an informed Board. Indeed, the fact that this acquisition was going to be a disaster for WorldCom was well known to two underwriters, because both Salomon and Chase (the predecessor of JP Morgan) served as WorldCom's financial advisors on this deal.

465. With regard to the May 2001 Offering, the 2001 Underwriter Defendants failed to review any of the facts concerning what by then amounted to $250 million in loans extended by WorldCom to Ebbers. As the Examiner uncovered, the facts concerning this financing revealed that the WorldCom Board was merely a "passive rubber stamp for Management and especially Ebbers." Moreover the Board and the Company were shown to have little autonomy, but instead acted at the behest of Ebbers and senior management. As alleged herein, from September 2000 through January 2001, WorldCom extended $100 million in loans, and a $150 million guaranty in favor of Bank of America – all for Ebbers' <u>personal</u> business ventures. The Examiner found that these loans initially were approved not by the Board, but what, for all practical purposes, was a two-person Compensation Committee, which never investigated Ebbers' need for the loans or his ability to repay them.

466. In addition to uncovering the extent of this unsupported lending arrangement, had the 2001 Underwriter Defendants performed any review of the Company's loans to Ebbers, they would have found that WorldCom had placed itself in a precarious financial position regarding those loans and its ability to repay the massive bond issuance. For instance, WorldCom failed to perfect its security interest in the WorldCom shares that Ebbers had pledged as collateral for the

loans. Furthermore, the collateral pledged by Ebbers, as was the case with all his WorldCom shares, was subject to superior claims by other lenders and, in any event, was woefully insufficient to cover the loans. Thus, WorldCom had very limited recourse in connection with these loans. The 2001 Underwriter Defendants also would have found that WorldCom failed to provide a repayment plan for the loans or to monitor or limit the way Ebbers used the money. Similarly, through this process, the Underwriter Defendants also would have found that WorldCom itself had no plans to satisfy its own debt.

467. Moreover, two of the lead 2001 Underwriter Defendants had first-hand knowledge of the arrangements for Ebbers' financing, but did nothing to illuminate how those loans would affect the Company and its "fully leveraged" CEO. Salomon, through Travelers and Grubman, had intimate knowledge of Ebbers' vast personal dealings. Bank of America, whose subsidiary, Banc of America Securities was a joint lead manager of the May 2001 Offering, was sufficiently concerned about Ebbers' ability to repay the loans that it obtained a $150 million guaranty from WorldCom to insure that Bank of America got paid.

468. In addition to failing to uncover the circumstances surrounding the Board's ineptitude in connection with credit extended to Ebbers, the 2001 Underwriter Defendants also failed to exercise due diligence concerning Ebbers' forward-sale in September 2000 of three million WorldCom shares. As the Examiner discovered, a review of this highly unusual transaction would have revealed that the Compensation Committee approved this sale even though it violated Company policy, as it occurred within a "Blackout Period" 30-days prior to an earnings announcement. The 2001 Underwriter Defendants also would have uncovered that the Compensation Committee permitted this sale although the sale appeared to constitute unlawful

insider trading because Ebbers possessed material non-public information – including the fact that the Company had just loaned him $50 million.

469. The Underwriter Defendants also failed to examine and identify any risks about investing in WorldCom to potential investors. As noted above, the Registration Statements issued in connection with the May 2000 and May 2001 Offerings did not contain a risk factors section, which was clearly inappropriate and violated SEC regulations.

470. Finally, the very fact that the Company was managing to consistently report earnings which either exactly met, or just exceeded, analysts' expectations, while the Underwriter Defendants knew that the telecommunications industry was performing poorly, should have made the Underwriter Defendants skeptical about WorldCom's operating performance and anticipated future cash flow. As a result, the Underwriter Defendants should have performed due diligence on the quality of WorldCom's operating income. Had they done so, they would have learned that the only reason WorldCom was able to meet expectations was because it was manipulating its numbers.

471. In performing their due diligence procedures and investigations, the Underwriter Defendants further ignored the following "red flags" that required further investigation:

- A significant portion of management's compensation was represented by bonuses, stock options, and other incentives, including but not limited to the millions of dollars that Bank of America, Citibank, Travelers (Salomon's corporate affiliates) and the WorldCom Board loaned to Ebbers, which were backed, in large part, by Ebbers' stock in WorldCom, the value and security of which was contingent upon WorldCom achieving unduly aggressive targets for operating results, and thereby maintaining its stock price above certain levels;

- Excessive interest by management in maintaining or increasing WorldCom's stock price and earnings trend through the use of unusually aggressive accounting practices;

- Ebbers, in addition to what was supposed to be his full-time job as WorldCom's CEO was actively involved in buying and/or running several businesses unrelated to

WorldCom, including the largest working cattle ranch in Canada, over half a million acres of timberland, a rice farm, a luxury yacht building company, a lumber mill, a country club, a trucking company, a minor league hockey team, an operating marina and a building in Chicago. The Underwriter Defendants knew or should have known these facts. Indeed, as alleged herein, the affiliates of some of the Underwriter Defendants provided hundreds of millions of dollars of loans to Ebbers and his various businesses and even became business partners in some of his ventures. The Underwriter Defendants should have questioned whether Ebbers' involvement in all of these businesses affected Ebbers' ability to successfully lead the Company especially in view of the general downturn in the telecommunications industry;

- Lack of any meaningful debt planning by WorldCom, as best evidenced by the fact that the Company was paying off most of its short term debt obligations with the proceeds of the May 2000 and the May 2001 Offerings in which the Underwriter Defendants played a key role;

- Lack of any strategic planning with respect to the Company's acquisitions or outsourcing transactions;

- Domination by Ebbers, Sullivan and others in a small group without compensating controls such as effective oversight by the Board of Directors or Audit Committee, as seen, among other things, by Ebbers' and Sullivan's directive that WorldCom's internal audit division would play no role in auditing the financial statements, and by the Board's continual decisions to lend hundreds of millions of dollars to Ebbers to bail him out of his personal credit problems;

- The practice by management of committing to analysts, creditors, and other third parties to achieve unduly aggressive and clearly unrealistic forecasts, as could be seen by the Underwriter Defendants through comparisons of WorldCom's projected and reported results against the results reported by WorldCom's major competitors;

- Inadequate monitoring of significant financial controls;

- Management's failure to correct known reportable conditions on a timely basis;

- Unduly aggressive financial targets and expectations for operating personnel set by management;

- A high degree of competition or market saturation, accompanied by declining margins;

- The fact that WorldCom was operating in a declining industry with increasing business failures and significant declines in customer demand, including, for instance, the minimal growth during the Class Period of business from America Online, a key WorldCom customer.

WORLDCOM'S VIOLATIONS OF GAAP

WorldCom's Improper Reduction of Reserves

472. According to the Special Committee Report, in 1999 and 2000, WorldCom reduced its reported line costs by approximately $3.3 billion by improperly releasing "accruals," or reserves (and by one other improper adjustment that, while not an accrual release, had similar effects). These accruals were amounts that had been reserved in recognition of WorldCom's obligation to pay anticipated bills. In effect, it took amounts that had been set aside on its financial statements to cover future payments and—without regard to whether they needed to remain set aside—released them into income to offset the line costs expense that were actually incurred during those quarters. The result was to make line costs expense appear smaller (and pre-tax income larger) than they actually were in those periods.

473. The Special Committee Report summarized the improper reductions on a quarterly basis:

Reductions to Line Costs from Accrual Releases
(*millions of dollars*)

Quarter	**2Q99**	**3Q99**	**4Q99**	**1Q00**	**2Q00**	**3Q00**	**4Q00**	**TOTAL**
Line Costs	40	131	329	493	679	828	797	**3,297**

474. The improper releases of accruals were directed by senior members of the corporate finance organization in Clinton, including Sullivan, Myers, and Yates. They did not occur in the normal course of day-to-day operations, but instead retroactively in the weeks following the end of the quarter in question. The timing and amounts of the releases were not supported by contemporaneous analysis or documentation.

475. The Special Committee found that WorldCom manipulated the process of adjusting accrued reserves in three ways. First, accrued reserves were released and reversed without any

apparent analysis of whether the Company actually had excess reserves. Second, the Company often did not release them in the period in which they were identified as not being required. Instead, certain line cost accruals were kept as rainy day funds and released to improve reported results when managers deemed necessary. Third, WorldCom reduced reported line costs by releasing accrued reserves that had been established for other purposes—in violation of the GAAP requirement that reserves created and required for one expense cannot be used to offset another expense.

WorldCom's Improper Capitalization of Expenses

476. According to the Special Committee Report, from the first quarter of 2001 through the first quarter of 2002, WorldCom improperly capitalized as assets approximately $3.5 billion of operating line costs expenses in violation of well-established accounting standards and WorldCom's own capitalization policy. The capitalization entries were made in large, round-dollar amounts after the close of the quarter and only a few days before the Company announced its earnings. The capitalization entries were supplemented by an additional $377 million in improper adjustments to reduce line costs expenses during this period by a total of $3.883 billion, as follows:

Reductions to Line Costs by Capitalization and Other Adjustments
(*millions of dollars*)

	1Q01	**2Q01**	**3Q01**	**4Q01**	**1Q02**	**Total**
Capitalization	544	560	743	841	818	3,506
Other Adjustments	227	60	--	100	--	377
Total	771	610	743	941	818	3,883

477. By capitalizing line costs as assets, WorldCom avoided recognizing standard operating expenses when they were incurred, and instead postponed them into the future. The line costs expenses that WorldCom capitalized as assets were ongoing, operating expenses that accounting rules required WorldCom to recognize as expense immediately. Capitalizing line costs as assets exaggerated WorldCom's pre-tax income. By capitalizing certain of its operating

expenses as assets, WorldCom improperly shifted these expenditures from "expenses" on its income statement to "assets" on its balance sheet, increasing current income and postponing the time when these costs would offset revenue as expenses.

478. By reducing reported line costs expenses, the capitalization entries also significantly improved WorldCom's line cost E/R ratio. In its public filings, WorldCom consistently emphasized throughout 2001 that is line cost E/R ratio stayed the same — about 42% – quarter after quarter. Had it not capitalized line costs, WorldCom's line cost E/R ratio would have been much higher, typically exceeding 50%.

479. WorldCom has announced that its financial statements for 1999, 2000, 2001 and the first quarter of 2002 require restatement. This constitutes an <u>admission</u> that the financial statements issued for each these periods, as described above, were false and that the overstatements of income were material. GAAP provides that financial statements should only be restated in limited circumstances; that is, when there is a change in the reporting entity, there is a change in accounting principles used, <u>or to correct an error in previously issued financial statements</u>. Accounting Principles Board ("APB") No. 20 WorldCom's restatements were not due to a change in reporting entity or a change in accounting principles, but rather to correct errors in previously issued financial statements. Therefore, the restatements are admissions by WorldCom that its previously issued financial results and its public statements regarding those results were materially false.

480. The Financial Accounting Standards Board ("FASB") provides that expenses are recognized when benefits are used up in delivering services. FASB Statement of Financial Accounting Concepts ("SFAC") Nos. 5, 85. Assets are recorded only when there is a probable

future economic benefit anticipated from a cost. SFAC Nos. 6, 25. Here, however, WorldCom had expressly admitted that it violated these fundamental accounting and reporting concepts.

481. SEC Regulations require that financial statements filed with the SEC conform to GAAP requirements. Financial statements that are not prepared in conformity with GAAP are presumed to be misleading or inaccurate. 17 C.F.R. § 210.401(a)(1). The Company's financial statements were false and misleading for the reasons alleged herein and because they constituted an extreme departure from GAAP by violating the following GAAP precepts, among the many other principles identified above:

(a) the principle that contingencies and other uncertainties that affect the fairness of presentation of financial data at an interim date shall be disclosed in interim reports in the same manner required for annual reports (APB Opinion No. 28);

(b) the principle that disclosures of contingencies shall be repeated in interim and annual reports until the contingencies have been removed, resolved, or have become immaterial (APB Opinion No. 28); and

(c) the principle that management should provide commentary relating to the effects of significant events upon the interim financial results (APB Opinion No. 28).

482. In addition, WorldCom violated the following Financial Account Concepts:

(a) the concept that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions (SFAC No. 1);

(b) the concept that financial reporting should provide information about an enterprise's financial performance during a period (SFAC No. 1);

(c) the concept that financial reporting should be reliable in that it represents what it purports to represent (SFAC No. 2);

(d) the concept of completeness, which means that nothing material is left out of the information that may be necessary to ensure that it validly represents underlying events and conditions (SFAC No. 2);

(e) the concept that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered (SFAC No. 2);

(f) the principle that if no accrual is made for a loss contingency, then disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred (SFAC No. 5); and

(g) the concept that an expense or loss is required to be recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits (SFAC No. 5).

WorldCom's Excessive Acquisition Write-offs

483. During the time it was rapidly expanding by making acquisitions, WorldCom consistently recorded excessive "one-time" write-offs and established excessive reserves in connection therewith. Such reserves were artificially inflated and were then used to secretly increase reported operating earnings in later quarters by drawing down on and reducing/reversing those reserves. This deceptive practice was successfully hidden because users of the financial statements often expect an acquiring company to establish and record large reserves in connection with major acquisitions. Further, since such items are seen as non-recurring, they normally do not have a negative impact on the trading price of the acquirer's securities. Thus, WorldCom was able

to create and record excessive, unduly large write-offs of reserves each time it did an acquisition without any adverse impact on the price of WorldCom securities. The Company would then "draw down" on these excessive reserves (which were inflated to begin with) in later quarters, which had the effect of boosting reported operating results, without disclosing this artifice. This accounting manipulation and material omission gave a misleading impression of the strength of WorldCom's operations and its ongoing earnings power by artificially inflating its reported results.

484. WorldCom frequently characterized these excess acquisition charges as "in process research and development costs" or other merger-related costs. As noted in Business Week, "Ebbers took huge write-offs associated with acquisitions, enabling him to pump up future earnings."

485. WorldCom also inflated its earnings by improperly misclassifying assets in connection with acquisitions. For example, WorldCom acquired MCI in September 1998 in a transaction accounted for as a purchase. As is customary in purchase accounting, all of MCI's assets and liabilities were revalued at the time of the acquisition to their fair market values and then combined with WorldCom's assets and liabilities. To reflect this "fair value," WorldCom reduced the book value of MCI's property, plant and equipment ("PP&E") by $3.4 billion to $10.7 billion from the pre-acquisition balance of $14.1 billion. Goodwill was commensurately increased by the $3.4 billion reduction in PP&E. This manipulation inflated WorldCom's earnings during the period from 1999 to 2001, since goodwill is amortized over a longer period than the average of 4.3 years for PP&E. Thus, the shorter-lived PP&E assets were converted into significantly longer-lived assets, artificially inflating WorldCom's subsequently reported earnings through less annual amortization expense. This manipulation increased WorldCom's 1999, 2000, and 2001 annual pre-

tax earnings by $695 million by reducing the Company's reported annual amortization/depreciation expense by that amount.

486. WorldCom's financial statements were also false and misleading throughout the Class Period due to its failure to timely record impairment in the value of goodwill on its balance sheet. WorldCom disclosed in its 2Q 2002 Form 10-Q that, based on preliminary analysis, it planned to reduce goodwill by $15 to $20 billion. The Company's management attributed the reduction to adoption of Statement of Financial Accounting Standards ("SFAS") No. 142, which became effective in fiscal years after December 31, 1991.

487. However, the true amount of the required write-down of goodwill was $50 billion. Indeed, the excuse given by WorldCom management in the 1Q 2002 Form 10-Q – that the goodwill write-down resulted from a change in accounting standards – was itself false and misleading. In actuality, the conditions that required the write-down existed well <u>before</u> SFAS No. 142 became effective, and the full $50 billion write-down was required under the long-standing SFAS No. 121.

488. The foregoing failures violated Section 13(b)(2) of the Exchange Act which requires WorldCom management to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." In addition, by failing to periodically review and write down goodwill and intangible assets, on a timely basis and in appropriate amounts, defendants also breached a duty imposed by GAAP as set forth in FASB Statement of Standards No. 121, ¶¶ 5 and 6, which requires the reevaluation of values of assets upon the occurrence of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed, including:

(a) a significant decrease in the market value of an asset;

(b) a significant change in the extent or manner in which an asset is used or a significant physical change in an asset;

(c) a significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator;

(d) an accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset; and

(e) a current period operating or cash flow loss combined with a history of operating or cash flow losses associated with an asset used for the purpose of producing revenue.

489. Widely publicized problems in the telecommunications industry and in WorldCom's acquired businesses should have indicated to WorldCom's management – as well as Andersen, Salomon and each of the Underwriter Defendants – long before the admission that WorldCom's goodwill and other intangibles were being carried at values that were materially inflated and not supportable by any acceptable accounting practices. However, defendants failed to review the value of WorldCom's goodwill and intangibles in connection with the May 2000 and May 2001 Offerings or on any sort of periodic basis, and to adjust and write down the carrying value of the Company's goodwill and intangibles in order to: (a) inflate WorldCom's share price by reporting artificially high and materially misleading earnings; (b) allow WorldCom to complete the SkyTel and Intermedia acquisitions during the Class Period; and (c) allow WorldCom to undertake its much-needed May 2000 and May 2001 Offerings, while its debt securities were still rates as "investment grade."

WorldCom's Improper Revenue Recognition

490. The Special Committee found that WorldCom improperly inflated its revenues by the amounts set forth below:

Improper Revenue Entries
(*millions of dollars*)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
85	5	65	50	19	121	161	27	17	132	117	92	67	958

Ebbers' Reviews of Financials

491. The principal tool by which revenue performance was measured and monitored at WorldCom was the MonRev Report, a comprehensive, monthly revenue report prepared for and distributed by the Revenue Accounting group. The MonRev Report provided a revenue snapshot of the entire company for any given period. It took computer feeds from the MCI and WorldCom billing systems, and consolidated and organized them into a collection of schedules, broken down into the Company's sales channels and segments. It included dozens of spreadsheets detailing revenue data from all of those channels and segments. It also compared those actual results with budgeted numbers.

492. The MonRev Report contained an attachment, known as the Corporate Unallocated schedule, which detailed adjustments made at the corporate level, and it was regularly sent to and reviewed by Ebbers and Sullivan. According to the Special Committee's findings, most of the improper or questionable revenue entries were booked to the Corporate Unallocated revenue account. These entries often involved large, round-dollar revenue items (millions or tens of millions of dollars). They generally appeared only in the quarter-ending month, and they were not recorded during the quarter, but instead in the weeks after the quarter had ended. As a result, the total amounts reported in the Corporate Unallocated schedule usually spiked upward during quarter-ending months, and the largest spikes occurred in those quarters in which WorldCom's

operational revenue lagged furthest behind quarterly revenue targets—the second and third quarters of 2000 and the second, third and fourth quarters of 2001.

493. In 1999 and 2000, the Revenue Reporting and Accounting group attempted to track the impact of Corporate Unallocated and other accounting adjustments by generating two MonRev Reports for Ebbers – one that represented the Company's operational revenues before any adjustments (called the "Normalized MonRev") and a second (the "General Ledger" or "GL MonRev") representing the revenues as supplemented by any "extraordinary" accounting entries, such as those recorded in the Corporate Unallocated revenue account. The items that comprised the difference between the Normalized and the GL MonRev were recorded in an attachment called the "Extraordinary Revenue Items" schedule. In other words, WorldCom maintained two sets of books – one reflecting its true revenues, the other reflecting the manipulated numbers that WorldCom presented to the investing public.

494. From 1999 through 2001, senior WorldCom management was intensely focused on achieving double-digit revenue growth, and large revenue accounting entries were frequently made during the quarterly close in order to hit these growth targets. WorldCom tracked the gap between projected and target revenue –an exercise labeled "Close the Gap" – and kept a running tally of accounting "opportunities" that could be exploited to bridge that difference. The "Close the Gap" progress was described to both Ebbers and Sullivan. Many of these opportunities were purely accounting adjustments designed to boost reported revenue. Most of the accounting adjustments suggested in the "Close the Gap" presentations were ultimately recorded revenue and many of them were not appropriate under GAAP.

495. In the second, third and fourth quarters of 2001, the largest improper revenue entries were recorded in the following areas: (1) Minimum Deficiency Charges; (2) Customer Credits; (3)

Early Termination Charges; (4) Electronic Data Systems ("EDS") Penalties; and (5) the Qwest Settlement.

496. First, WorldCom improperly recorded approximately $312 million in revenue associated with minimum deficiency charges. Minimum deficiency charges arise from customer agreements that permit a telecommunications company to bill customers for usage amounts that fall below contractual minimums. There was a large unsupported entry of $100 million in the second quarter of 2000, and another in the third quarter of 2000 in the amount of $133 million.

497. Second, WorldCom also improperly inflated its revenue when it improperly accounted for over $215 million of credits that it had issued to its customers as part of the Close the Gap Process. WorldCom reclassified certain of these customer credits into miscellaneous expenses rather than offsetting them to current operating revenue as GAAP requires. Thus, reported revenues were overstated.

498. Third, during the second and third quarters of 2002, WorldCom improperly recognized revenue when it improperly recognized approximately $30 million in early termination charges. Early termination penalties are charges based on long-term customer contracts with clauses calling for payments should the customer terminate the contract before its expiration. These penalty provisions were rarely enforced by WorldCom; it was so rare to collect these charges, and WorldCom so infrequently billed customers, that the Company had virtually no collection history on such billings. These entries were improper for at least two reasons. One, the Company failed to acknowledge the low probability of collection of these charges, thereby improperly recognizing revenue. Two, a significant portion of the revenue recognized was based on billings to a customer WorldCom was set to acquire, virtually assuring that collection would never be realized.

499. Fourth, WorldCom improperly recorded revenue form its October 22, 1999 outsourcing agreement with EDS. The agreement provided that EDS would make penalty payments to WorldCom if EDS failed to meet certain cumulative minimum outsourcing requirements (the "Take or Play" penalty). The Company improperly recorded the Take or Play penalty as $58 million of revenue based on estimates that indicated that EDS would not meet its obligations under the contract. An arbitrator found that WorldCom was only entitled to recover $40.8 million from EDS, and WorldCom recorded the difference, approximately $17 million, as a miscellaneous expense. In the third quarter of 2001, pursuant to Sullivan's direction, the Company also directed a $100 million "EDS Ratable Accrual" to be improperly recorded in the third quarter of 2001.

500. Fifth, during the third quarter of 2001, WorldCom improperly recognized $50 million in revenue as a result of the Company's settlement of a billing dispute with Qwest. WorldCom received the first settlement installment amount for $57.5 million on June 29, 2001. The remaining $115 million was received the following month. Sullivan and Myers initially rejected the Qwest settlement as a revenue opportunity, but later directed the entry of $50 million in revenue without offsetting any reserves associated with the settlement accounts.

WorldCom's Other Accounting Violations

Large Accrual Accounts

501. The General Accounting group in Clinton maintained three large accrual accounts that warehoused millions of dollars in balance sheet accrual accounts for purposes of managing internal results and improving the Company's balance sheet and income statement when required. Two employees in General Accounting, Normand, Director of Legal Entity Reporting, and Vinson, Director of Management Reporting, each set up and managed one of these accounts, which they referred to as their "own" accrual accounts. Between the third quarter of 2000 and the first quarter

of 2002, these three general accrual accounts were used to reduce reported line costs by at least $120 million, SG&A expenses by at least $562 million, and miscellaneous expenses by at least $19 million, and caused WorldCom's EBITDA to be overstated by hundreds of millions of dollars.

502. These general accrual accounts were used in violation of GAAP. GAAP requires that when accruals or other balance sheet liability accounts are no longer needed, they should be reversed in that period and offset against the financial statement line item for which they were originally recorded. WorldCom accumulated general excess accrual accounts so they could later be released to offset expenses for which they may not have been established originally, to replenish under-funded accruals, and for future write down asset accounts required, resulting in an increase in reported income in those periods. GAAP (FASCON No. 1 and No.2) also requires support for accounting entries; no documentary support for any of the entries posted to these general accounts.

Reclassification of SG&A expenses to line expenses

503. From the first quarter of 1999 through the first quarter of 2002, WorldCom reclassified a total of $1.876 billion in SG&A expenses to Cost of Goods Sold ("COGS"), which were reported in the Company's public filings as line costs. SG&A expenses are the costs of running WorldCom's business, from employee costs to administrative facilities and bad debts; COGS are the specific costs that WorldCom incurs to provide services to existing customers under specific contracts. For twenty consecutive months, between April 2000 and December 2001, SG&A expenses were reclassified in round-dollar amounts of a little over $53 million each month. The quarterly totals are as follows:

Reductions to SG&A from Reclassifications
(millions of dollars)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02
93	140	156	100	139	160	160	160	160	160	160	160	128

504. By reclassifying expenses from one category to another, these adjustments did not affect the Company's pre-tax income. They reduced reported SG&A and, consequently, the SG&A expense-to-revenue ratio. They also increased WorldCom's reported line costs, which WorldCom then reduced through accrual releases in 1999 and 2000 and the capitalization of line costs and additional accrual releases in 2001 and 2002. There is no supporting documentation for these reclassification entries.

Wireless Bad Debt Accrual Reversals

Between the fourth quarter of 2000 and the first quarter of 2002, the General Accounting group reversed $168 million of accruals made (and deemed necessary) by WorldCom's Wireless finance group. The original expense entries had been made by the Wireless division (over Sullivan's objections) in order to supplement the Wireless group's bad debt accrual for uncollectible amounts, caused principally by poor billing and other operational problems. The reversals had the effect of reducing WorldCom's bad debt accrual, understating WorldCom's SG&A expenses, and overstating pre-tax income. The Wireless group believed the bad debt expense was substantially underaccrued and in fact, by the end of December 2001 the bad debt accrual had a negative balance.

EIT Accrual Releases

505. A company's Effective Income Tax ("EIT") rate is a measurement of overall tax efficiency, and is calculated by dividing the company's total annual tax expense as reported on the income statement by its pre-tax income from operations. Between 1999 and 2002, WorldCom publicly reported that it had gradually improved its EIT rate each year since the 1998 merger with MCI. In fact, however, WorldCom was managing this performance metric through manipulation of accruals. In 2000 and 2001, WorldCom released, at Sullivan and/or Myers' direction, a total of over $365 million from tax accruals in violation of GAAP in order to record an artificially low total

income tax expense amount and thereby meet target EIT rates. As a result of lowering its reported income tax expense amount, WorldCom increased its reported net income in these years by the amount of the releases (although there was no effect on the taxes WorldCom actually paid). These accrual releases were inconsistent with GAAP: they were not supported by any bona fide accounting analysis and appear to have been designed solely to hit the target EIT rate.

Depreciation Reserve Releases

506. Depreciation is the systematic allocation of the cost of an asset to expense over accounting periods making up its useful life and therefore recognizes periodically the gradual reduction in utility of a fixed asset. Such periodic allocation to expense is required under the matching concept of GAAP. (FASCON No. 5, 86c) From the first quarter of 1999 through the first quarter of 2002, WorldCom improperly released approximately $984 million in "depreciation reserves." As a result, depreciation expense was reduced, which had an overall effect of improving WorldCom's reported pre-tax income. The releases were often in large, round dollar amounts; they were done on the instruction of General Accounting (usually delivered by Normand); and they always occurred in the weeks after quarter-end). The quarterly amounts of the reserve releases were as follows:

Depreciation Reserve Releases
(*millions of dollars*)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
116	0	7	95	95	100	153	85	80	80	55	60	58	**984**

507. Failure to record depreciation expense results in understating the total expenses of the period and overstating pre-tax income.

WorldCom's Lack of Controls

508. On August 29, 2002, The Washington Post published an article entitled "Fast and Loose at WorldCom - Lack of Controls, Pressure to Grow Set Stage for Financial Deceptions."

The article was based on a review of thousands of pages of previously undisclosed documents that the Post had obtained, along with interviews with former employees and people familiar with WorldCom's operations. According to the article:

(a) In the years before WorldCom announced the restatement, WorldCom was plagued by loose business practices, inadequate financial disclosure, and "widespread internal chicanery and corruption." Among other things, WorldCom booked orders for services or equipment even if they were not provided, so that departments could meet their revenue targets. Further, employees routinely falsified sales in order to boost their commissions.

(b) In early 2002, WorldCom announced that it had fired a number of employees in its Pentagon City, Virginia office for improperly booking sales to inflate their commissions. Although the Company denied that this was a widespread problem, the minutes of a June 6, 2001 meeting of the Company's Audit Committee belie this assertion. At that meeting, Cooper (who ultimately revealed the line cost fraud) reported that numerous "accounts that moved from one billing system to another resulted in commission overpayments." In all, "292 accounts had been moved over a year's period," resulting in overpayment of commissions of $930,000. Moreover, according to one former WorldCom employee, Senior Vice President for Sales Deborah Surrette ("Surrette") the scam involved "many more employees, including a vice president, and significantly more money."

(c) In May 2001, an employee faxed an anonymous note to Surrette and Chief Operating Officer Beaumont identifying several instances of improper billing by a manager in order to inflate commissions. The employee wrote that "[t]here are a lot more instances of things like this going on. Just ask around and you will find out." Similarly, on February

20, 2002, an employee told an internal auditor that two network circuits were billed and recorded even though the customer never got access to the circuits and the order was later cancelled. According to the e-mail, which was sent to Cooper, Sullivan and Ebbers, this occurred "because Ms. Surrette needed MonRev [monthly revenue] credit."

509. The documents obtained by The Washington Post also showed that, in October 2000 – only days before the Company was set to announce its results for the 2000 third quarter – a small group of WorldCom executives, including then Vice-Chairman Sidgmore, was well aware that WorldCom's business was eroding rapidly and discussed various accounting maneuvers that would help prop up the Company's bottom line. Summarizing an e-mail exchange over two days that began on Oct. 21, the article stated:

> Sullivan told then-Vice Chairman Sidgmore that the company was in a "really scary" situation of escalating costs and declining revenue growth in certain key areas. Just two months earlier, Sullivan had sold stock worth $18 million.
>
> He told Sidgmore, for instance, that revenue from one of the company's biggest customers, America Online, was growing by only 1 percent, in part because its Internet traffic growth had slowed and much of the data was being carried on lines leased, not owned, by WorldCom.
>
> "Wow! I had no idea that the revenue growth had deteriorated that much," Sidgmore wrote back, adding that "it's going to take some pretty fancy explaining."
>
> Sullivan agreed, telling Sidgmore he would be making some accounting changes that would result in better margins for certain parts of the business. Sullivan said he would be taking two sources of revenue totaling about $225 million - in one case certain fees and in another case some equipment sales - and reclassifying them as cost reductions.

510. WorldCom announced its third quarter results on October 26, 2000, and touted "solid" results with a 12 percent increase in overall revenue. The adjustments, which Edward

Soule, a professor of corporate ethics at Georgetown University and a CPA, has called "baldly manipulative" enhanced the Company's operating margin, a key statistic for Wall Street. Despite what defendants knew about the true state of WorldCom's business, on the conference call following the announcement, an upbeat Ebbers told analysts that the Company was "a very good bargain out there in the market today." This was the same quarter in which Sullivan began directing WorldCom employees to use Company reserves to offset operating costs by $828 million, thereby increasing the Company's earnings by the same amount.

511. Moreover, the most basic systems to control costs were either absent or ineffective. Documents showed that the sales division was not responsible for how much it cost to bring in business – in other words, it was acceptable to sign a contract to provide a data network for $1 million, even if it cost $2 million to fulfill the order. According to a 2001 Internal Audit report, "groups purchase new equipment without verifying whether the equipment is already in inventory. The purchasing system does not require that inventory be checked . . . In December 2000, $10 million in new equipment purchases was processed without inventory review. A sample of these purchases indicated unnecessary spending of $2 million to $3 million . . . on fiber patch cords alone."

512. These problems were exacerbated by WorldCom having become, by 2000, a conglomeration of the more than 60 telecommunications companies it had acquired. Internal documents and current and former WorldCom employees confirm how poorly WorldCom had integrated these companies, doing little if anything to integrate them to eliminate overlapping costs. As Minert explained in an e-mail to Myers and Yates on July 20, 2000, "there seems to be no regard for cost. This will continue in the future until we make people accountable for their actions."

513. WorldCom has since announced that it expects to write-off all existing goodwill and other intangible assets, which had been recorded as $50.6 billion, which means that WorldCom's assets were materially overstated during the Class Period. The Company is also reevaluating the carrying value of existing property, plant and equipment as to possible impairment of historic values previously reported.

FRAUD-ON-THE-MARKET DOCTRINE

514. Plaintiffs will rely, in part, upon the presumption of reliance established by the fraud-on-the-market doctrine. The market for WorldCom stock and bonds was at all times an efficient market for the following reasons, among others:

(a) WorldCom's stock met the requirements for listing and was listed on the NASDAQ National Market System;

(b) As a regulated issuer, WorldCom filed periodic public reports with the SEC;

(c) WorldCom's securities volume was substantial during the period from 1999 through June 2002;

(d) WorldCom was followed by various analysts employed by major brokerage firms, including Salomon, UBS Warburg, Merrill Lynch and others, who wrote reports which were distributed to the sales force and certain customers of their respective brokerage firms and which were available to various automated data retrieval services; and

(e) The market price of WorldCom securities reacted efficiently to new information entering the market.

515. The foregoing facts clearly indicate the existence of an efficient market for trading of WorldCom stock and bonds and support application of the fraud-on-the-market theory. Similarly, Plaintiffs are entitled to a presumption of reliance with respect to the misstatements and omissions alleged in this Complaint.

CLAIMS FOR RELIEF

COUNT I

(Against the Individual Defendants Except Myers and Yates for Violations of § 11 of the Securities Act)

516. This claim is asserted on behalf of all Class members who purchased or acquired the Notes issued in the May 2000 Offering and May 2001 Offering. This claim does not sound in fraud, and plaintiffs do not incorporate herein any allegations of fraud in connection with this Count.

517. The Individual Defendants (other than Myers and Yates) were directors of WorldCom at the time the May 2000 Registration Statement became effective and the Individual Defendants (other than Myers, Yates, and Tucker) were directors of WorldCom at the time the May 2001 Registration Statement became effective, and with their consent were identified as such in those registration statements.

518. In addition, the Individual Defendants (other than Myers and Yates) signed the May 2000 Registration Statement or authorized it to be signed on their behalf; and Individual Defendants (other than Myers, Porter, Yates and Tucker) signed the May 2001 Registration Statement or authorized it to be signed on their behalf.

519. The May 2000 Registration Statement contained false statements of material fact and omitted to state material facts necessary to make the statements made therein not misleading, as set forth in ¶¶ 197 and 217 above.

520. The May 2001 Registration Statement contained untrue statements of material fact and omitted to state material facts necessary to make the statements made therein not misleading, as set forth in ¶¶ 218 and 240 above.

521. The Individual Defendants (other than Myers and Yates) are liable under Section 11

of the Securities Act for the material misrepresentations or omissions contained in the May 2000 Registration Statement and/or the May 2001 Registration Statement, as applicable. These defendants did not make a reasonable investigation and did not possess reasonable grounds for believing that the statements contained in the May 2000 or May 2001 Registration Statements were true, did not omit any material fact, and were not materially misleading.

522. Certain plaintiffs and other members of the Class purchased WorldCom Notes issued in, or traceable to, the May 2000 and May 2001 Offerings, which were conducted pursuant to the May 2000 and May 2001 Registration Statements.

523. The May 2000 and May 2001 Registration Statements, at the time they became effective, contained material misrepresentations of fact and omitted facts necessary to make the facts stated therein not misleading. The facts misstated and omitted would have been material to a reasonable person reviewing the registration statements.

524. Plaintiffs did not know, and in the exercise of reasonable diligence, could not have known of the misstatements and omissions of the May 2000 and May 2001 Registration Statements.

525. Plaintiffs have sustained damages as a result of the misstatements and omissions in the May 2000 and May 2001 Registration Statements, for which they are entitled to compensation.

526. Plaintiffs brought this action within one year after the discovery of the untrue statements and omissions, and within three years after the May 2000 Offering and the May 2001 Offering.

527. None of the misrepresentations or omissions alleged here were forward looking statements but, rather, concerned existing facts. Moreover, defendants did not properly identify any of these statements as forward-looking statements and did not disclose information, known to

them, that undermined the validity of those statements.

528. In addition, the Individual Defendants who signed the Intermedia Registration Statement and the Skytel Registration Statement are liable of the false and misleading statements or omissions contained therein as alleged herein.

COUNT II

(Against the Individual Defendants for Violations of § 15 of the Securities Act)

529. This claim is asserted on behalf of all Class members who purchased or acquired the Notes issued in the May 2000 Offering and May 2001 Offering. This claim does not sound in fraud, and plaintiffs do not incorporate herein any allegations of fraud in connection with this Count.

530. The Individual Defendants at all relevant times participated in the operation and management of the Company, and conducted and participated, directly and indirectly, in the conduct of WorldCom's business affairs.

531. As officers and directors of a publicly owned company, the Individual Defendants had a duty to disseminate accurate and truthful information with respect to WorldCom's financial condition and results of operations.

532. WorldCom has admitted that its financial statements included and incorporated in the May 2000 and May 2001 Registration Statements were materially false and misleading. This admission by itself proves WorldCom's primary violation of Section 11 of the Securities Act with respect to the May 2000 and May 2001 Offerings.

533. Because of their positions of control and authority as senior officers and directors of WorldCom, the Individual Defendants were able to, and did, control the contents of the May 2000 and May 2001 Registration Statements which contained materially false financial information. The

Individual Defendants therefore were "controlling persons" of WorldCom within the meaning of Section 15 of the Securities Act.

534. Certain plaintiffs and other members of the Class purchased WorldCom Notes issued in, or traceable to, the May 2000 and May 2001 Offerings. The May 2000 and May 2001 Offerings were conducted pursuant to the May 2000 and May 2001 Registration Statements.

535. The May 2000 and May 2001 Registration Statements, at the time they became effective, contained material misrepresentations of fact and omitted facts necessary to make the facts stated therein not misleading. The facts misstated and omitted would have been material to a reasonable person reviewing the May 2000 and May 2001 Registration Statements.

536. Plaintiffs did not know, and in the exercise of reasonable diligence, could not have known of the misstatements and omissions of the May 2000 and May 2001 Registration Statements.

537. Plaintiffs have sustained damages as a result of the misstatements and omissions of the May 2000 and May 2001 Registration Statements, for which they are entitled to compensation.

538. Plaintiffs brought this action within one year after the discovery of the untrue statements and omissions, and within three years after the May 2000 Offering and the May 2001 Offering.

539. None of the misrepresentations or omissions alleged here were forward looking statements but, rather, concerned existing facts. Moreover, defendants did not properly identify any of these statements as forward-looking statements and did not disclose information, known to them, that undermined the validity of those statements.

COUNT III

(Against Andersen for Violations of § 11 of the Securities Act)

540. This claim is asserted on behalf of all Class members who purchased or acquired the

Notes issued in the May 2000 Offering and May 2001 Offering. This claim does not sound in fraud, and plaintiffs do not incorporate herein any allegations of fraud in connection with this Count.

541. Andersen was an independent accountant retained by WorldCom since 1989 to audit WorldCom's fiscal 1989 through 2002 financial statements. Andersen issued unqualified opinions for WorldCom's financial statements for fiscal years 1999, 2000, and 2001.

542. Andersen expressly consented to having its unqualified audit opinions for WorldCom's 1999 and 2000 financial statements incorporated by reference into the May 2000 and May 2001 Registration Statements. As such, Andersen expressly consented to serve as an accounting "expert" with respect to the offering of the Notes.

543. Andersen's unqualified opinions on WorldCom's 1999 and 2000 financial statements, incorporated by reference into the May 2000 and May 2001 Registration Statements, were materially false and misleading. Contrary to its representations, Andersen's audit of those financial statements had not been conducted in accordance with GAAS, and WorldCom's financial condition and results of operations had not been presented in conformity with GAAP. Instead, WorldCom's audited financial statements for the years 1999 and 2000 contained untrue statements of material fact and failed to state other facts necessary to make the statements not misleading.

544. As an accounting expert which consented to the use of its unqualified audit opinions in the May 2000 and May 2001 Registration Statements, Andersen is liable under Section 11 of the Securities Act for the material misrepresentations or omissions contained in its unqualified audit opinions and in WorldCom's financial statements for the years 1999 and 2000, as reported and incorporated in the May 2000 and May 2001 Registration Statements. Andersen did not perform the requisite procedures and did not possess reasonable grounds for believing that its

representations in its unqualified audit opinions with regards to WorldCom's financial statements were true, did not omit any material facts, and were not materially misleading.

545. Certain plaintiffs and other members of the Class purchased WorldCom Notes issued in, or traceable to, the May 2000 and May 2001 Offerings. The Offerings were conducted pursuant to the May 2000 and May 2001 Registration Statements.

546. The May 2000 and May 2001 Registration Statements, at the time they became effective, contained material misrepresentations of fact and omitted facts necessary to make the facts stated therein not misleading. The facts misstated and omitted would have been material to a reasonable person reviewing the May 2000 and May 2001 Registration Statements.

547. Plaintiffs did not know, and in the exercise of reasonable diligence, could not have known of the misstatements and omissions the May 2000 and May 2001 Registration Statements.

548. Plaintiffs have sustained damages as a result of the misstatements and omissions in the May 2000 and May 2001 Registration Statements, for which they are entitled to compensation.

549. Plaintiffs brought this action within one year after the discovery of the untrue statements and omissions, and within three years after the May 2000 Offering and the May 2001 Offering.

COUNT IV

(Against the Underwriter Defendants for Violations of § 11 of the Securities Act)

550. This claim is asserted on behalf of all Class members who purchased or acquired the Notes issued in the May 2000 Offering and May 2001 Offering. This claim does not sound in fraud, and plaintiffs do not incorporate herein any allegations of fraud in connection with this Count.

551. The Underwriter Defendants served as the underwriters of the Notes and qualify as such according to the definition contained in Section 2(a)(11) of the Securities Act, 15 U.S.C.

§ 77b(a)(11). As such, they participated in the solicitation, offering, and sale of the Notes to the investing public pursuant to the May 2000 and May 2001 Registration Statements.

552. Due to their role as underwriters of the Notes, the 2000 Underwriter Defendants were responsible for the contents and dissemination of the May 2000 Registration Statement, and the 2001 Underwriter Defendants were responsible for the contents and dissemination of the May 2001 Registration Statement. As such, they are liable under Section 11 of the Securities Act for any material misrepresentations or omissions contained therein. As alleged in detail herein, the Underwriter Defendants did not make a reasonable investigation and did not possess reasonable grounds for believing that the statements contained in the registration statements were true, did not omit any material fact, and were not materially misleading.

553. Further, each of the 2000 Underwriter Defendants and 2001 Underwriter Defendatns knew of, or but for their negligence should have recognized, the conflicted position that Salomon – a co-lead underwriter on the May 2000 Offering and May 2001 Offering – had with respect to its underwriting and due diligence duties for the May 2000 and May 2001 Offerings, respectfully. As described in detail above, Salomon's relationship with WorldCom, its senior executives and certain of its Board members, was fraught with conflicts. Given the conflicts, Salomon had a duty to ensure that the other 2000 Underwriter Defendants and 2001 Underwriter Defendants conducted their own due diligence and investigations separate and apart from Salomon, and satisfied themselves that the May 2000 and May 2001 Registration Statements did not contain untrue statements or fail to include material information.

554. The other Underwriter Defendants were or should have been aware of the many deals on which Salomon served as WorldCom's financial advisor; the bullish reports that Grubman published to support WorldCom's stock price; Salomon's service as the WorldCom employee stock

option manager, as well as its service as broker to many of WorldCom's top executives and employees; and WorldCom's selection of Salomon as a co-lead underwriter for the massive May 2000 and May 2001 Offerings. As a result, each of the other Underwriter Defendants had a duty to conduct its own due diligence and investigation, separate and apart from Salomon, and to view Salomon's due diligence and investigation findings with the appropriate degree of skepticism, given Salomon's hopelessly conflicted position. And each of the Underwriter Defendants, including Salomon, had a duty to disclose Salomon's conflicted position.

555. Certain plaintiffs and other members of the Class purchased the Notes issued in, or traceable to, the May 2000 and May 2001 Offerings. The May 2000 and May 2001 Offerings were conducted pursuant to the May 2000 Registration Statement and the May 2001 Registration Statement, respectively.

556. The May 2000 and May 2001 Registration Statements, at the time they became effective, each contained material misrepresentations of fact and omitted facts necessary to make the facts stated therein not misleading, as set forth above at ¶¶ 197-217 and 218-240. The facts misstated and omitted would have been material to a reasonable person reviewing the May 2000 and May 2001 Registration Statements.

557. Plaintiffs did not know, and in the exercise of reasonable diligence, could not have known of the misstatements and omissions in the May 2000 and May 2001 Registration Statements.

558. Plaintiffs have sustained damages as a result of the misstatements and omissions in the May 2000 and May 2001 Registration Statements, for which they are entitled to compensation.

559. Plaintiffs brought this action within one year after the discovery of the untrue statements and omissions, and within three years after the May 2000 Offering and the May 2001

Offering.

COUNT V

(Against the Underwriter Defendants for Violations of Section 12(a)(2) of the Securities Act)

560. This claim is asserted on behalf of all class members who purchased or acquired the Notes issued in the May 2000 Offering and May 2001 Offering. This claim does not sound in fraud, and plaintiffs do not incorporate herein any allegations of fraud in connection with this Count.

561. By means of the May 2000 and May 2001 Registration Statements, and by using means and instruments of transportation and communication in interstate commerce and of the mails, the 2000 Underwriter Defendants and 2001 Underwriter Defendants as applicable, through public offerings, offered and sold the Notes to certain plaintiffs and other members of the Class. As previously set forth herein, the 2000 Underwriter Defendants and the 2001 Underwriter Defendants, as applicable negligently included in the May 2000 and/or May 2001 Registration Statements false statements of material facts and negligently omitted to state therein material facts necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.

562. In connection with and in furtherance of the prospectuses issued in connection with the May 2000 and May 2001 Offerings, the May 2000 and May 2001 Registration Statements were widely distributed to approximately several hundred or more individuals and/or entities, and thus the May 2000 and May 2001 Offerings were public offerings. The May 2000 and May 2001 Registration Statements also were prospectuses for purposes of the Securities Act.

563. The Underwriter Defendants are sellers within the meaning of the Securities Act because they: (a) transferred title to plaintiffs and other purchasers of the Notes; (b) transferred

title to the Notes to other underwriters and/or broker-dealers that sold the Notes as agents for the Underwriter Defendants; and (c) solicited the purchase of the Notes by plaintiffs and other members of the Class, motivated at least in part by the desire to serve the Underwriter Defendants' own financial interest and the interest of WorldCom, including but not limited to commissions on their own sales of the Notes and separate commissions on the sale of the Notes by non-underwriter broker-dealers.

564. The 2000 Underwriter Defendants and the 2001 Underwriter Defendants each actively solicited the sale of the Notes by participating in "road show" meetings in furtherance of the May 2000 Offering and May 2001 Offering, as applicable.

565. The May 2000 and May 2001 Offerings consisted of new issues of securities, the Notes.

566. Certain plaintiffs and other Class members purchased the Notes based on the May 2000 and May 2001 Registration Statements, or in the immediate wake of the May 2000 and May 2001 Offerings and traceable thereto.

567. Plaintiffs did not know of the omissions and misstatements described above when they purchased their Notes.

568. Plaintiffs brought this action within one year after the discovery of the untrue statements and omissions, and within three years after the May 2000 and May 2001 Offerings.

569. By virtue of the foregoing, the Underwriter Defendants have violated Section 12(a)(2) of the Securities Act.

570. Those Plaintiffs and the other members of the Class who acquired Notes pursuant to the May 2000 and May 2000 Registration Statements and who still hold such Notes have the right to rescind and recover the consideration exchanged for their Notes, and hereby tender their Notes to

the Company. Those Plaintiffs and class members who have sold Notes they acquired pursuant to those registration statements seek damages to the extent permitted by law.

COUNT VI

(Against Defendants Ebbers, Sullivan, Myers, Yates, Kellett, Bobbitt, Allen, Areen, and Galesi for Violations of Section 10(b) of the Exchange Act and Rule 10b-5)

571. This Count is asserted on behalf of all Class members. Plaintiffs repeat and reallege each and every allegation set forth above as if fully set forth set forth herein.

572. The defendants named in this Count, in concert with others, individually and in concert, directly and indirectly, by the use of means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct that operated as a fraud and deceit upon plaintiffs; made various untrue and/or misleading statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; made the above statements with a severely reckless disregard for the truth; and employed devices, and artifices to defraud in connection with the purchase and sale of securities, which were intended to, and, during the Class Period, did: (i) deceive the investing public, including plaintiffs and other Class members, regarding, among other things, WorldCom's improper capitalization of expenses, excessive acquisition write-offs, improper revenue recognition and improper accounting for goodwill; (ii) artificially inflate and maintain the market price of WorldCom stock and debt securities; and (iii) cause plaintiffs to purchase WorldCom stock and debt securities at artificially inflated prices.

573. As more fully described in the paragraphs relating to the fraud, and the scienter of the above-identified defendants, pursuant to the aforesaid plan and course of conduct, the defendants participated, directly and indirectly, in the preparation and/or issuance of the statements

and documents referred to above, including in WorldCom filings with the SEC, press releases, and registration statements. These statements and documents were materially false and misleading in that, among other things, they misrepresented the Company's results, and failed to disclose the fraudulent accounting practices alleged herein.

574. At all relevant times, the material misrepresentations and omissions particularized herein directly or proximately caused the damages sustained by plaintiffs.

575. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, WorldCom stock and debt securities were sold in the public market, and the market prices of such securities were artificially inflated during the Class Period. In ignorance of the materially false and misleading nature of the reports and statements described above, plaintiffs relied to their detriment on the statements described above and/or on the integrity of the market prices as reflecting the completeness and accuracy of the information disseminated by the Company in connection with their purchases of the securities.

576. At the time of said misrepresentations and omissions, plaintiffs were ignorant of their falsity, and believed them to be true. Plaintiffs could not, in the exercise of reasonable diligence, have known the actual facts. Had plaintiffs known the truth, they would not have taken such action.

577. The markets for WorldCom securities were open, well-developed and efficient at all relevant times. As a result of these materially false and misleading statements and failures to disclose the full truth about WorldCom and its financial condition, performance, and business, the securities traded at artificially inflated prices during the Class Period, reaching a high closing price of $96.75 per share for the stock and $109.25 for the Notes, until the time the adverse information referred to above was finally provided to and digested by the securities markets. Plaintiffs

purchased or otherwise acquired the securities relying upon the integrity of the market prices and market information relating to WorldCom, or in the alternative, upon defendants' false and misleading statements, and in ignorance of the adverse, undisclosed information known to defendants, and have been damaged thereby.

578. The prices of WorldCom securities declined materially upon the various partial public disclosures of the true facts about the fraudulent and improper practices which had inflated their prices, and which material facts had been misrepresented and/or concealed as alleged herein. Plaintiffs have suffered substantial damages as a result of their purchases of the WorldCom securities.

579. By virtue of the foregoing, the above-identified defendants have violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

COUNT VII

(Against the Individual Defendants for Violations of Sections 20(a) of the Exchange Act)

580. This Count is asserted on behalf of all Class members. Plaintiffs repeat and reallege each and every allegation stated above, as if fully set forth herein.

581. Plaintiffs assert this Count for violations of Section 20(a) of the Exchange Act against the Individual Defendants.

582. Through their positions of control and authority as officers and directors of the Company, the Individual Defendants were able to and did control, directly and indirectly, the content of the public statements disseminated by the Company. With knowledge of the falsity of the statements contained therein or in severely reckless disregard of the truth about the Company's financial condition and prospects, the Individual Defendants caused the false and misleading statements and omissions of material facts as alleged herein.

583. The Individual Defendants had direct involvement in the day-to-day operations of the Company, were senior officers of the Company, corporate officers with direct involvement in WorldCom's financial reporting and accounting functions, and/or were members of the Board of Directors, including certain of the Individual Defendants who served as Chairman of the Board, Vice Chairman of the Board, and on its Audit and Compensation Committees, and therefore are presumed to have had the power to control or influence the particular transactions giving rise to the securities violations alleged herein, and exercised same.

584. WorldCom has admitted that its financial statements were materially false and misleading, as described above; that the actions to materially overstate the financial statements were intentional and knowing; and that it was done to artificially inflate the prices of WorldCom securities. These admissions prove WorldCom's primary violation of Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

585. By reason of their management positions and/or control of the Board of Directors, the Individual Defendants were "controlling persons" within the meaning of Section 20(a) of the Exchange Act and had the power and influence to direct the management and activities of the Company and its employees, and to cause the Company to engage in the unlawful conduct complained of herein. Because of their executive, officer and director positions within WorldCom and control of the Board of Directors of WorldCom, the Individual Defendants had access to adverse non-public financial information about the Company and acted to conceal the same, or knowingly or recklessly authorized and approved the concealment of the same.

586. By virtue of the foregoing, the Individual Defendants have violated Section 20(a) of the Exchange Act.

587. Plaintiffs have been damaged by the violations of the Individual Defendants as

described in this Count and seek recovery of damages caused thereby.

COUNT VIII

(Against Andersen for Violations of Section 10(b) of the Exchange Act and Rule 10b-5)

588. This Count is asserted on behalf of all Class members. Plaintiffs repeat and reallege each and every allegation set forth above as if fully set forth set forth herein.

589. Andersen, in concert with others, individually and in concert, directly and indirectly, by the use of means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct that operated as a fraud and deceit upon plaintiffs; made various untrue and/or misleading statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; made the above statements with a severely reckless disregard for the truth; and employed devices, and artifices to defraud in connection with the purchase and sale of securities, which were intended to, and did: (i) deceive the investing public, including plaintiffs, regarding, among other things, WorldCom's improper reduction of reserves, improper capitalization of expenses, excessive acquisition write-offs, improper revenue recognition and improper accounting for goodwill; (ii) artificially inflate and maintain the market price of WorldCom stock and debt securities; and (iii) cause plaintiffs to purchase WorldCom securities at artificially inflated prices.

590. As alleged herein, the violations of GAAP and Andersen scienter, pursuant to the aforesaid plan and course of conduct, Andersen participated, directly and indirectly, in the issuance of the statements and documents referred to above, including in WorldCom filings with the SEC, press releases, and the May 2000 and May 2001 Registration Statements. These statements and documents were materially false and misleading and in violation of GAAP in that, among other

things, Andersen misrepresented, and failed to disclose, WorldCom's improper reduction of reserves, capitalization of expenses, excessive acquisition of write-offs, improper revenue recognition and improper accounting for goodwill, during the Class Period. Accordingly, Andersen's opinion on such financial statements was false and misleading.

591. At all relevant times, the material misrepresentations and omissions particularized herein directly or proximately caused the damages sustained by plaintiffs.

592. Andersen, among others, participated in such a scheme to misrepresent the financial condition and results of WorldCom and to consummate the acquisitions and the May 2000 and May 2001 Offerings, and maintain and/or inflate the prices of WorldCom's securities to, among other things, gain lucrative auditing and other consulting services fees from WorldCom. Specifically, Andersen knew or should have known that WorldCom's reported annual financial results for 1999, 2000 and 2001, as filed with the SEC in WorldCom's Forms 10-K and other SEC filings, and disseminated to the investing public, were materially misstated and were not presented in accordance with GAAP, that Andersen's audits were not performed in accordance with GAAS, and, therefore, that Andersen's unqualified audit reports, as included or incorporated by reference in those annual and quarterly reports and other SEC filings, were materially false and misleading.

593. The 1999, 2000 and 2001 Forms 10-K were materially false and misleading; contained untrue statements of material facts; omitted to state material facts necessary to make the statements made in those SEC filings, under the circumstances in which they were made, not misleading; and failed to adequately disclose material facts. As detailed herein, the misrepresentations contained in, or the material facts omitted from, those SEC filings included, but were not limited to, the overstatement of revenues and understatement of expenses, resulting in the overstatement of income from continuing operations, EBITDA and net earnings for 1999, 2000 and

2001, as well as the representations in Andersen's unqualified audit reports issued in connection with Andersen's audits of WorldCom's financial statements for those years. In those financial statement, Andersen certified that (i) it had audited WorldCom's financial statements in accordance with GAAS; (ii) it had planned and performed those audits "to obtain reasonable assurance about whether the financial statements are free of material misstatement"; (iii) in its opinion, WorldCom's financial statements "present fairly, in all material respects, the financial position" of WorldCom "in conformity with generally accepted accounting principles;" and (iv) Andersen's audits provided a "reasonable assurance" for its opinions. As detailed herein, Andersen's audit reports were materially false and misleading. Andersen did not possess reasonable grounds for the belief that the statements described above, which were contained in the 1999, 2000 and 2001 Forms 10-K, and incorporated by reference in other SEC filings, were true, were without omissions of any material facts, and were not misleading.

594. Andersen, with knowledge of the falsity and misleading nature of the statements contained in its unqualified audit reports, and in reckless disregard of the true nature of its audits, caused the heretofore complained of public statements to contain misstatements and omissions of material facts as alleged herein. As described herein, Andersen's audit of WorldCom's financial statements for 1999, 2000 and 2001 were not performed in accordance with GAAS, and therefore, in fact, Andersen had no basis for its unqualified opinions. Andersen's unqualified reports dated March 24, 2000, March 30, 2001 and March 7, 2002, issued in connection with those audits, as included in the Forms 10-K, in which Andersen certified, among other things, that WorldCom's financial statements were prepared in conformity with GAAP and its audits were performed in accordance with GAAS, were materially false and misleading.

595. As described above at ¶¶ 436-454, and as detailed below, Andersen acted with

scienter throughout the Class Period, in that it either had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose the true facts, even though such facts were available to them. Andersen was WorldCom's auditor, and, therefore, was directly responsible for the false and misleading statements and omissions disseminated to the public through its unqualified audit reports.

596. Andersen, as WorldCom's auditor, had unfettered access to the Company's books and records throughout the Class Period. Andersen, as a world-renowned former "Big 5" public accounting firm, had knowledge of the requirements of GAAS, and knew of the audit risks inherent of WorldCom and in its industry. In addition to the facts alleged in ¶¶ 436-454 above, the following facts, among others, indicate a strong inference that Andersen acted with scienter.

597. Andersen knew or recklessly disregarded that it had not performed its audits of WorldCom's 1999, 2000 and 2001 financial statements in accordance with GAAS, and, therefore, that its unqualified audit reports on those financial statements were materially false and misleading. Under GAAS, "[t]he auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." AICPA Professional Standards, AU § 110.02 (1998); AU § 316.05 (1997). As described herein, Andersen did not fulfill that responsibility. In fact, Andersen's audits of the financial statements were so woefully inadequate that Andersen repeatedly violated GAAS. Andersen utterly failed to perform the most fundamental of procedures to provide a basis for its unqualified reports. As described below, Andersen repeatedly and materially violated GAAS in each of those audits, failed to maintain its independence, exercise due care, plan or to perform its audits to obtain reasonable assurance that WorldCom's financial statements were free of material

misstatement and obtain sufficient audit evidence, and, therefore, had no basis on which to opine that the financial statements were presented in conformity with GAAP.

598. The general, field work, and reporting standards approved and adopted by the membership of the AICPA, as amended by the AICPA Auditing Standards Board (ASB), are as follows:

> General Standards
>
> 1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
>
> 2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
>
> 3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.
>
> Standards of Field Work
>
> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
>
> 2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
>
> 3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.
>
> Standards of Reporting
>
> 1. The report shall state whether the financial statements are presented in accordance with GAAP.
>
> 2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
>
> 3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
>
> 4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons

therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

599. Andersen violated GAAS in numerous ways, including the following:

Andersen Did Not Maintain Its Independence

600. An auditor "must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings." AU§ 220.02 "To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners." AU §220.03 Andersen violated GAAS because it was not free from interest in WorldCom. From 1999 through 2001, WorldCom paid Andersen $7.8 million in fees to audit the financial statements, $6.6 million for other audits required by law in other countries, and approximately $50 million for consulting, litigation support, and tax services. In its Year 2000 Audit Proposal, Andersen told the Audit Committee that it considered itself "a committed member of [WorldCom's] team" and that none of Andersen's clients was as important as WorldCom to its success and reputation in the telecommunications industry.

(i) Andersen Failed to Obtain Sufficient and Competent Evidential Matter.

"Most of the independent auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements." AU § 326.02. "The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly." AU § 326.21. Representations from management "are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial

statements under audit." AU § 333.02 (1998); AU § 333.02 (1997). "The books of original entry, the general and subsidiary ledgers, related accounting manuals, and records such as work sheets and spreadsheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements." "[W]ithout adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted." AU § 326.16 (1998); AU § 326.15 (1997). Andersen violated GAAS by failing to obtain sufficient competent evidential matter. For example:

(1) Andersen failed to obtain sufficient evidence in connection with WorldCom's elimination or reduction of expenses through write-offs of reserves. Instead, Andersen relied largely on management's representations. As a result, during 1999 and 2000, approximately $1.2 billion of those reserves were written off directly to income without any conceptual basis under GAAP. Andersen failed to discover that the adjustments were unsupported by documentation. In particular, Andersen failed to determine whether non-reporting-system journal entries (i.e., those entries that come from sources other than WorldCom's revenue, expense, cash receipts, cash disbursement and payroll accounting and reporting systems) were valid. Either Andersen failed to review WorldCom's general ledgers or failed to ask to see any post-closing journal entries, or recklessly disregarded such journal entries made without support. For example, while discussing management's aggressive accounting practices, Andersen documented the following note in its workpapers: "Manual Journal Entries How deep are we

going? Surprise w[ith] look [at] journal entries." Anderson failed to examine the nature of these manual journal entries.

(2) Andersen further failed to obtain sufficient documentation with respect to the transfers of line costs from operating expenses to "plant, property and equipment," thereby failing to understand that approximately $3 billion in line costs were improperly eliminated from operating expenses during the year 2001. No documentation existed for such transfers. Therefore, Andersen failed to obtain sufficient evidence for such transfers.

(3) Andersen also failed to determine whether WorldCom's general ledgers supported its financial statements. Thus, it failed to test and recognize that reversals of merger reserves were utilized, likely through "top-side" adjustments, to increase the amounts of earnings reported by WorldCom; it failed to test or determine that, as defendant Sidgmore acknowledged during 2000, WorldCom's "revenue growth had deteriorated that much" and that it would "take some pretty fancy explaining;" and it failed to review or consider the e-mails that have since been disclosed that prove WorldCom's blatant manipulation of its financial statements.

(4) Andersen outright failed to perform procedures it had planned to perform without documenting a specific reason why these procedures may no longer have been necessary, in accordance with GAAS. Examples of these procedures include: control testing of certain revenue processes, reviews of significant top level adjustments related to 1999 line costs, FAS 121 impairment reviews related to fixed assets and goodwill, confirmation of

debt, and review of computations related to deferred tax assets and certain variance analyses related to liabilities.

(ii) Andersen Over-relied on Management Representations. Management representations are part of the evidential matter the auditor obtains, "but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements." AU §333.02. "If a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified." AU § 333.04. Andersen violated GAAS, because it placed unquestioned reliance on the integrity of senior management whereas in exercising professional skepticism, the auditor does not assume management's unquestioned honestly. As a result, Andersen did not corroborate information it received from management in many areas.

(iii) Andersen Failed to Exercise Due Professional Care and Professional Skepticism. "Due professional care requires the auditor to exercise professional skepticism." This requires the auditor to "diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence." "In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest." AU §§ 230.07-09 (1998); AU § 316.16-21 (1997). Professional skepticism is an attitude that includes a

questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. AU ' 316.01. The auditor also "must be without bias with respect to the client since otherwise he would lack [the] impartiality necessary for the dependability of his findings." AU § 220.02. Notwithstanding these requirements, Andersen failed to exercise professional skepticism, failed to maintain an independent mental attitude and failed to exercise professional due care in the exercise of its audits. Specific examples of failing to exercise due professional case include:

a) Given the poor state of the telecommunications industry in 2000 and 2001, Andersen failed to use professional skepticism in evaluating WorldCom's ability to continue to meet aggressive revenue growth targets and maintain a 42% line cost expense-to-revenue ratio.

b) During 2000, WorldCom employees reported to Andersen audit team that WorldCom's European operation reversed $33.6M in line costs accruals <u>after</u> the close of the first quarter of 2000 and as a result they were underaccrued. This top-side entry was directed by WorldCom's U.S. management, and the U.K. employees did not have supporting documentation for it. Andersen failed to request and receive supporting documentation for this reduction and failed to exercise due professional care in evaluating the accrual release.

(iv) Andersen Failed to Properly Plan and Supervise. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud. AU § 16.01. The auditor must adequately plan its audit and properly supervise the work of assistants so as to establish and carry out procedures reasonably designed to search for and detect the existence of fraud that could have a material effect on the financial statements. AU § 310,320,327. The auditor must also obtain a level of knowledge of its clients' businesses sufficient to enable it to "obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements." AU § 311.06. In connection with planning its audit procedures, Andersen violated GAAS because Andersen failed to obtain sufficient knowledge:

(1) of WorldCom's accounting and reporting systems to recognize, among other things, that the nature and significance of senior management's top-side adjustments, reversals of reserves, highly questionable revenue items, and entries capitalizing line costs certainly merited special consideration;

(2) upon which to assess the conditions under which WorldCom's accounting data, particularly manual journal entries and consolidating trial balances, were produced and processed;

(3) to properly evaluate the Company's estimates and management representations concerning, among other things, the establishment and application of merger and other reserves;

(4) to properly understand and evaluate the Company's internal controls, which were in fact nonexistent;

(5) of WorldCom's business and transactions upon which to assess the propriety of management's accounting treatment of, among other things, asset write-offs; and

(6) to properly evaluate the propriety and consistency of WorldCom's application of accounting principles notwithstanding Andersen's knowledge that WorldCom's management and Board had determined that WorldCom's internal auditing division would provide only operational audits, and would not have any role in auditing the Company's reported financial results.

(v) Andersen Failed to Properly Consider Audit Risk and Materiality and to Evaluate Audit Findings. Audit risk and materiality are required to be considered in planning the audit and determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. If the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or if he believes that evaluating their effectiveness would be inefficient, he would assess control risk for that assertion at the maximum. AU § 312. The auditor can reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures on a continuous basis in performing the audit. AU § 312.39.

(vi) Andersen's SMART Tool rated WorldCom as a "high risk" client based on assessment of a variety of potential risks. Andersen overrode this result

and upgraded WorldCom to a "maximum risk". Accordingly, Andersen should have factored those results into planning and determining the nature, timing, and extent of auditing procedures yet, the workpapers indicate that as a result of WorldCom's maximum risk rating, Andersen did not alter its audit approach or cause the audit team to conduct more substantive testing.

(vii) Andersen Failed to Properly Consider Fraud. "The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed." AU § 316.12; AU § 316.05 ("The auditor should assess the risk that fraud may cause the financial statements to contain a material misstatement."). Among the conditions that should cause the auditor to consider that a client has attempted financial fraud are discrepancies in the accounting records, such as transactions not properly recorded as to amount, or unsupported or unauthorized balances or transactions; conflicting or missing evidential matter, such as significant unexplained items on reconciliations; or denied access to records. AU § 316.25, 317.09 (1998); AU § 316.21, 317.09 (1997). To limit the risk of financial statement misstatement as a result of fraud, the auditor should perform procedures, including a detailed review of the client's quarter-end and year-end adjusting journal entries and an examination of any entries that appear unusual as to nature or amount and of significant and unusual transactions, particularly those occurring at or near quarter- or year-end. AU § 316.29 (1998). Andersen violated GAAS because it failed to properly consider the risk that WorldCom's financial statements would be materially misstated as a result of fraud.

(viii) Andersen Failed to Properly Consider WorldCom's Lack of Internal Control. "In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit." AU § 319.02. "The auditor should obtain sufficient knowledge of the information system relevant to financial reporting to understand," among other things, the classes of significant transactions, "the accounting records, supporting information and specific accounts in the financial statements involved in the processing and reporting of transactions," the accounting processing involved in recording, processing, accumulating and reporting transactions, and the financial reporting process used to prepare financial statements. AU § 319.36. Andersen violated GAAS because it failed to learn or to modify its audit procedures because that WorldCom had grossly deficient internal controls and procedures.

601. Many of the factors that AU316 indicates may increase the risk of fraudulent financial reporting were present at WorldCom throughout the Class Period. Such red flags, which Andersen either intentionally ignored or recklessly disregarded, included:

(a) A failure of WorldCom's management to display and communicate an appropriate attitude regarding internal control and the financial reporting process, including domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee, management's setting unduly aggressive financial targets and expectations for operating personnel, exhibiting a disregard for internal auditing (e.g., precluding WorldCom's internal auditors from reviewing financial results), and failing to implement significant controls over such items as top-side adjustments (which were changed without any documentation or

support);

(b) The overwhelming motivation for management to engage in fraudulent financial reporting, which included the personal motive that Ebbers had to maintain a high stock price (which stock he used as collateral for hundreds of millions of dollars of loans), and the Company's need to maintain its "investment grade" credit rating in order to sell the $5 billion and $11.8 billion May 2000 and May 2001 Offerings.

(c) The strained relationship between management and the current auditor including restrictions on the auditor that inappropriately limit his or her access to people or information. As an indication of this occurring, management denied Andersen's requests to speak with WorldCom employees, refused and parried Andersen's requests for information, and rejected Andersen's requests for access to the computerized general ledger and other ledgers and journals. Had Andersen pursued obtaining the general ledger it would have been able to identify most top-side entries including capitalization of line costs. Again, in violation of GAAS, Andersen failed to exercise due professional care and failed to properly access the risk associated with limitations placed on its audit and failed to inform the audit committee of such limitations.

(d) Risk factors in the industry, in which there was a high degree of competition and market saturation, accompanied by declining margins, and increasing business failures, which also made WorldCom's own receivables far less likely to be paid; and

(e) Risk factors relating to operating characteristics and financial stability, including the inability to generate sufficient cash flows from operations while reporting earnings and earning growth; significant pressure to obtain additional capital necessary to finance the Company's operations and capital expenditures; assets, liabilities, revenues and

expenses based on significant estimates that involved unusually subjective judgment and uncertainties, such as the ultimate collectability of receivables, timing of revenue recognition, or significant deferral of costs; significant or unusual transactions especially those close of year [period] end; unusually rapid growth and reported profitability, especially compared with that of other companies in the same industry; unusually high dependence on debt, combined with debt covenants that were difficult to maintain; unrealistically aggressive sales or profitability incentive programs; and adverse consequences on significant pending transactions (such as the May 2000 and May 2001 Offerings and acquisitions), if poor financial results were reported.

602. Andersen knew or should have known that the above-identified fraud risk factors were present at WorldCom at the time it performed the audits during the Class Period. As a consequence, and taken collectively, Andersen also knew that these risk factors present at WorldCom meant that the risk of fraudulent financial reporting was increased.

603. WorldCom was the single most valuable client of Andersen's Jackson, Mississippi office. According to WorldCom's April 22, 2002 Proxy Statement, Andersen was paid a total of $16.8 million for its services to WorldCom during 2001. It received $4.4 million for services rendered "for the audit and quarterly reviews of WorldCom's financial statements;" $7.6 million for tax services; $1.6 million for "non-financial statement audit services;" and $3.2 million for "all other services."

Andersen Failed to Consider the Internal Audit Function

604. [T]he auditor should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. AU § 322.04. The internal auditors' work may affect the nature, timing, and extent of the audit, including, 1)

procedures the auditor performs when obtaining an understanding of the entity's internal control, 2) procedures the auditor performs when assessing risk, and 3) substantive procedures the auditor performs. AU § 322.12. The auditor ordinarily should make inquiries of appropriate internal audit personnel about, among other things, the internal auditors' audit plan, including the nature, timing, and extent of audit work and access to records and whether there are limitations on the scope of their activities. AU § 322.05. The auditor may find that 1) reviewing how the internal auditors allocate their audit resources to financial or operating areas in response to their risk-assessment process and 2) reading internal audit reports to obtain detailed information about the scope of internal audit activities, are helpful in assessing the relevancy of internal audit activities. AU § 322.07. Yet, there was not any meaningful coordination, especially during the Class Period, between Internal Audit and Andersen to ensure that Internal Audit findings were not material to the Company's financial statements and revenue recognition policies and in fact, there was little meaningful communication between Internal Audit and Andersen during the relevant time period. This lack of coordination with Internal Audit is evident by Andersen's annual statements to the Audit Committee that it noted no material internal control weaknesses as part of its annual audits whereas Internal Audit had identified numerous internal control weaknesses in its reports.

<u>Andersen Failed to Properly Communicate with the Audit Committee</u>

605. GAAS requires the auditor is required "to ensure that the audit committee receives additional information regarding scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible." AU § 380.02. More specifically, the auditor is required to communicate to the Audit Committee items such as 1) any changes in significant accounting policies, 2) disagreements with management, 3) difficulties encountered during the audit, for example, not providing requested

information, and 4) any conditions which, in the auditor's judgment, represent significant deficiencies in the design or operation of internal controls which could adversely affect the organizations' ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements. AU § 380.

606. Andersen violated GAAS, because it failed to report to the Audit Committee the following:

1. Certain critical risk assessments. For instance Andersen's concerns that caused them to conclude WorldCom was a maximum risk client.

2. Certain significant issues. For example that WorldCom Management had made unsupported journal entries to the ledgers of its United Kingdom subsidiary.

3. It was restricted by WorldCom management from accessing the Company's general ledger with respect to the information it sought in connection with its audits.

4. Comments Andersen had identified in its 1999 and 2000 workpapers including for instance that the Company should improve its controls in a number of areas. For example, Andersen stopped providing the Audit Committee with management comment letters by 1998. No other reporting mechanism to the Audit Committee was substituted in place of the management comment letter.

607. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, WorldCom stock and debt securities were sold in the public market, and the market prices of such securities were artificially inflated during the Class Period. In ignorance of the materially false and misleading nature of the reports and statements described above, plaintiffs relied to their detriment on the statements described above and/or on the integrity of the market prices as reflecting the completeness and accuracy of the

information disseminated in connection with their purchases of the securities.

608. The prices of WorldCom securities declined materially upon the various partial public disclosures of the true facts about the fraudulent and improper practices which had inflated their prices and which material facts had been misrepresented and/or concealed as alleged herein. Plaintiffs have suffered substantial damages as a result of their purchases of the securities.

609. By virtue of the foregoing, the Andersen violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

COUNT IX

(Against Defendants Salomon and Grubman for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 (Registration Statements))

610. Plaintiffs repeat and reallege each and every allegation above, as if fully set forth herein.

611. This Count is brought on behalf of all Class members, and is based on WorldCom's SEC filings, including the May 2000 and May 2001 Registration Statements for the May 2000 and May 2001 Offerings which Salomon served as a lead underwriter.

612. Salomon and Grubman, in concert with others, individually and in concert, directly and indirectly, by the use of means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct that operated as a fraud and deceit upon plaintiffs; made various untrue and/or misleading statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; made the above statements with a severely reckless disregard for the truth; and employed devices, and artifices to defraud in connection with the purchase and sale of securities, which were intended to, and did: (i) deceive the investing public, including plaintiffs, regarding, among other things, WorldCom's financial condition and business

prospects; (ii) artificially inflate and maintain the market price of WorldCom stock and debt securities; and (iii) cause plaintiffs to purchase WorldCom stock and debt securities at artificially inflated prices.

613. Salomon and Grubman, as more fully described above in ¶¶ 251-371, entered into numerous, conflicting relationships that had the effect of forming a conspiracy between and among WorldCom, Ebbers, Sullivan, Salomon and Grubman. Pursuant to the plan and course of conduct, Salomon and Grubman participated, directly and indirectly, in the preparation and/or issuance of the statements and documents referred to above, including in WorldCom filings with the SEC, press releases, and registration statements. These statements and documents were materially false and misleading in that, among other things, they misrepresented, and failed to disclose, WorldCom's true financial condition, operation, results and business prospects during the Class Period.

614. At all relevant times, the material misrepresentations and omissions particularized herein directly or proximately caused the damages sustained by plaintiffs.

615. Salomon and Grubman, among others, engaged in such a scheme to misrepresent the financial condition and results of WorldCom and to consummate the acquisitions and the May 2000 and May 2001 Offerings, and maintain and/or inflate the prices of WorldCom's stock and debt securities, to obtain extremely lucrative work from WorldCom. As more fully described above, WorldCom retained Salomon for extremely lucrative investment banking and brokerage services, including: (a) WorldCom's retention of Salomon as a Lead Underwriter and/or Book Manager for each of the May 2000 and May 2001 Offerings during the Class Period; (b) WorldCom's retention of Salomon as its "financial advisor" on the major acquisitions made or sought to be made by WorldCom; (c) WorldCom's retention of Salomon to manage its corporate stock option plans for

WorldCom employees; and (d) WorldCom's designating Salomon as the broker for WorldCom employees' stock transactions.

616. For its part, Salomon and Grubman made sure that: (a) defendants Ebbers, Sullivan and Kellett were allocated Hot IPO shares that allowed Ebbers and the others to reap substantial profits from those IPOs; (b) Salomon's primary telecommunications analyst, defendant Grubman, issued glowing reports during the Class Period concerning WorldCom, which reports continued until April 2002, when Grubman was forced by market conditions to finally lower his rating of WorldCom; (c) sending Grubman to attend meetings of WorldCom's Board and a subcommittee meeting called to discuss WorldCom's merger with MCI, and its later attempt to merge with Sprint; (d) providing "fairness opinions" and underwriting services to facilitate the many acquisitions made by WorldCom using its inflated stock, and the massive debt offerings - totaling approximately $25 billion from 1997 to May 2001 - undertaken by WorldCom; and (e) compensating Grubman based on the investment banking work that Grubman helped Salomon obtain from WorldCom through the issuance of his bullish, and materially misleading, analyst reports. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, WorldCom stock and debt securities were sold in the public market, and the market prices of such securities were artificially inflated during the Class Period. In ignorance of the materially false and misleading nature of the reports and statements described above, plaintiffs relied to their detriment on the statements described above and/or on the integrity of the market prices as reflecting the completeness and accuracy of the information disseminated by the Company in connection with their purchases of the securities.

617. At the time of said misrepresentations and omissions, plaintiffs were ignorant of their falsity, and believed them to be true. Plaintiffs could not, in the exercise of reasonable

diligence, have known the actual facts. Had plaintiffs known the truth, they would not have purchased said securities.

618. The markets for WorldCom securities were open, well-developed and efficient at all relevant times. As a result of these materially false and misleading statements and failures to disclose the full truth about WorldCom and its financial condition, performance, and business, the securities traded at artificially inflated prices during the Class Period, reaching a high closing price of approximately $96.75 per share for the stock and $109.25 for the Notes, until the time the adverse information referred to above was finally provided to and digested by the securities markets. Plaintiffs purchased or otherwise acquired the securities relying upon the integrity of the market prices and market information relating to WorldCom, or in the alternative, upon defendants' false and misleading statements, and in ignorance of the adverse, undisclosed information known to defendants, and have been damaged thereby.

619. The prices of WorldCom securities declined materially upon the various partial public disclosures of the true facts about the fraudulent and improper practices which had inflated their prices and which material facts had been misrepresented and/or concealed as alleged herein. Plaintiffs have suffered substantial damages as a result of their purchases of the securities.

620. By virtue of the foregoing, Salomon and Grubman violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

COUNT X

(Against Defendant Salomon and Grubman for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 (Analyst Reports and Adoption of Ebbers' Statements))

621. Plaintiffs repeat and reallege each and every allegation contained above, as if fully set forth herein.

622. Salomon and Grubman, in concert with others, individually and in concert, directly

and indirectly, by the use of means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct that operated as a fraud and deceit upon plaintiffs; made various untrue and/or misleading statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; made the above statements with a severely reckless disregard for the truth; and employed devices, and artifices to defraud in connection with the purchase and sale of securities, which were intended to, and did: (i) deceive the investing public, including plaintiffs, regarding, among other things, WorldCom's financial condition and business prospects; (ii) artificially inflate and maintain the market price of WorldCom stock and debt securities; and (iii) cause plaintiffs to purchase WorldCom stock and debt securities at artificially inflated prices.

623. Pursuant to the plan and course of conduct described herein, Salomon and Grubman participated, directly and indirectly, in the preparation and/or issuance of the statements and documents referred to above, i.e., the analyst reports issued by Salomon and Grubman during the Class Period. These statements and documents were materially false and misleading in that, among other things, they misrepresented, and failed to disclose, Salomon's conflicted position with respect to WorldCom, as alleged herein.

624. At all relevant times, the material misrepresentations and omissions particularized herein directly or proximately caused the damages sustained by plaintiffs.

625. Salomon and Grubman engaged in the foregoing scheme to misrepresent WorldCom's true status and to consummate the acquisitions and the May 2000 and May 2001 Offerings, and maintain and/or inflate the prices of WorldCom's stock and debt securities, to obtain extremely lucrative work from WorldCom. As more fully described above, WorldCom retained

Salomon for extremely lucrative investment banking and brokerage services, including: (a) WorldCom's retention of Salomon as a Lead Underwriter and/or Book Manager for each of the May 2000 and May 2001 Offerings during the Class Period; (b) WorldCom's retention of Salomon as its "financial advisor" on the major acquisitions made or sought to be made by WorldCom; (c) WorldCom's retention of Salomon to manage its corporate stock option plans for WorldCom employees; and (d) WorldCom's designating Salomon as the broker for WorldCom employees' stock transactions.

626. Further, Salomon and Grubman adopted and disseminated false statements made by Ebbers – at Grubman's direction – for the purpose of presenting to the investing public coordinated, reinforcing false and misleading statements from both WorldCom and Salomon. In connection with and at the time of the making of false statements by Ebbers, Grubman adopted those statements and gave them his imprimatur. Those false statements made by Ebbers are attributable to Grubman and Salomon. As with the analysts reports, Salomon's and Grubman's adoption of Ebbers' false statements was committed, directly and/or indirectly, "in connection with" the purchase of WorldCom securities, within the meaning of Section 10(b) and Rule 10b-5.

627. For example, in February 2002, Grubman scripted, caused and directed Ebbers to make untrue and/or misleading statements of material facts on February 7, 2002, in a conference call with analysts, in furtherance of WorldCom's fraud. Specifically, in that conference call with analysts, described above, Grubman caused and directed Ebbers to state that WorldCom "stand[s] by our accounting" and that the Company was viable and had no liquidity issues, and to omit mention of the true financial condition of WorldCom. Ebbers' statements in that conference call followed the detailed script Grubman wrote for him in a series of e-mails sent in the days leading up to that call, set forth at 320 - 326 above. As the second component of this scheme, Grubman

issued two reports within the next twenty-four hours that were intended to and did buttress the false and misleading statements Grubman had caused Ebbers to make.

628. Through those acts, Salomon and Grubman violated Rule 10b-5(b), by adopting Ebbers, untrue and/or misleading statements of material fact. Ebbers made statements in the February 7 conference call at Grubman's direction and instruction, and those statements are attributable to Grubman. Grubman, in connection with and at the time of the making of those statements, adopted those statements and gave them his imprimatur through his reports of February 7 and 8, 2002, in which he discussed the February 7 conference call, reported on Ebbers' recitation of the untrue and/or misleading statements Grubman used Ebbers as a conduit to make, and urged investors to purchase WorldCom securities on the basis of those statements.

629. At the time of said misrepresentations and omissions, plaintiffs were ignorant of their falsity, and believed them to be true. Plaintiffs could not, in the exercise of reasonable diligence, have known the actual facts, including the fact that the false and misleading statements made by Ebbers and Grubman on February 7 and 8, 2002, had been secretly coordinated in order to maximize their fraudulent impact on an unsuspecting investing public.

630. The markets for WorldCom securities were open, well-developed and efficient at all relevant times. As a result of the aforementioned deceptive schemes, materially false and misleading statements, and failures to disclose the full truth about WorldCom and its financial condition, performance, and business, the securities traded at artificially inflated prices during the Class Period, reaching a high closing price of approximately $96.75 per share for the stock and $109.25 for the Notes, until the time the adverse information referred to above was finally provided to and digested by the securities markets. Plaintiffs purchased or otherwise acquired the securities relying upon the integrity of the market prices and market information relating to WorldCom, or in

the alternative, upon defendants' false and misleading statements, and in ignorance of the adverse, undisclosed information known to defendants, and have been damaged thereby.

631. The prices of WorldCom securities declined materially upon the various partial public disclosures of the true facts about the fraudulent and improper practices which had inflated their prices, including the false and misleading analyst reports, the false and misleading statements of others that are attributable to Grubman, and the deceptive schemes as alleged herein. Plaintiffs have suffered substantial damages as a result of their purchases of the WorldCom securities.

632. By virtue of the foregoing, Salomon and Grubman violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

COUNT XI

(Against Defendants Citigroup and Salomon for Violations of Sections 20(a) of the Exchange Act)

633. This Count is asserted on behalf of all Class members. Plaintiffs repeat and reallege each and every allegation contained above, as if fully set forth herein.

634. Plaintiffs assert this Count for violations of Section 20(a) of the Exchange Act against Citigroup and Salomon.

635. Through their positions of control and authority as (a) the 100% owner of Salomon, and (b) Grubman's employer, defendant Citigroup was able to and did control, directly and indirectly, the content of the public statements disseminated by Salomon and Grubman, and Salomon was able to and did control, directly and indirectly, the context of analyst reports issued by Grubman. With knowledge of the falsity of the statements contained therein or in severely reckless disregard of the truth about the analyst reports issued by Grubman, Citigroup and Salomon caused the false and misleading statements and omissions of material facts as alleged herein.

636. Citigroup is the controlling corporate parent of Salomon, and Salomon was

Grubman's direct employer. As such, these defendants are presumed to have had the power to control or influence the particular transactions giving rise to the securities violations alleged herein, and exercised the same.

637. By reason of their ownership, management and direct supervising positions with respect to Grubman, Citigroup and Salomon were "controlling persons" within the meaning of Section 20(a) of the Exchange Act. Citigroup had the power and influence to direct the management and activities of Salomon, Grubman and other Salomon managers, directors and employees, and to cause them to engage in the unlawful conduct complained of herein. Salomon had the power and influence to direct the activities of Grubman, and to cause him to engage in the unlawful conduct complained of herein.

638. Because of their positions, Citigroup and Salomon had access to adverse non-public financial information about the relationship between and among WorldCom, Ebbers, Sullivan, Salomon and Grubman, as well as the falsity of the analyst reports issued by Salomon and Grubman, and acted to conceal the same, or knowingly or recklessly authorized and approved the concealment of the same.

639. By virtue of the foregoing, these defendants have violated Section 20(a) of the Exchange Act.

640. Plaintiffs have been damaged by the violations of these defendants as described in this Count and seek recovery of damages caused thereby.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs pray for judgment as follows;

A. Certifying this action as a Class Action on behalf of the Class pled in this Complaint;

B. Awarding Plaintiffs compensatory damages, together with appropriate prejudgment

interest at the maximum rate allowable by law;

C. Awarding Plaintiffs their costs and expenses for this litigation, including reasonable attorneys' fees, expert fees and other disbursements; and

D. Awarding Plaintiffs such other and further relief as may be deemed just and proper under the circumstances.

JURY DEMAND

Pursuant to Rule 38 of the Federal Rules of Civil Procedure, Plaintiffs hereby demand a trial by jury as to all issues so triable.

DATED: New York, New York
December 1, 2003

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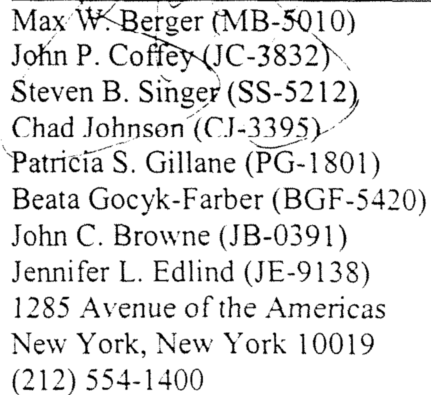
& GROSSMANN LLP



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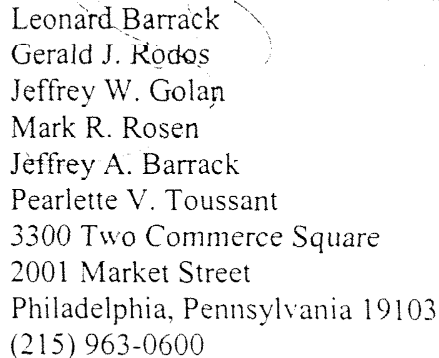

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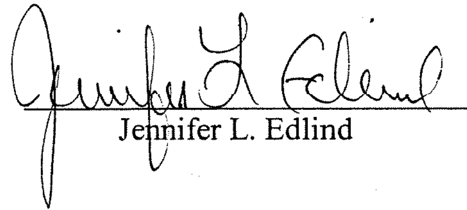
CERTIFICATE OF SERVICE

I, Jennifer L. Edlind, Esquire, hereby certify that a true and correct copy of the foregoing Corrected First Amended Class Action Complaint of Lead Plaintiff Alan G. Hevesi, Comptroller of the State of New York, as Administrative Head of the New York State and Local Retirement Systems and as Trustee of the New York State Common Retirement Fund, on Behalf of Purchasers and Acquirers of All WorldCom , Inc. Publicly Traded Securities is being served on this date upon all involved parties by sending a copy of the same to all counsel listed on the attached service list by first-class mail, postage prepaid.

Dated: New York, New York
December 2, 2003



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