

**The Deregulation Paradox
The Telecommunications Industry in Crisis**

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Abstract

Beginning in the early 1980's, the US under the Reagan administration actively promoted a policy of economic deregulation. The policy was designed to foster greater economic competition by allowing the marketplace to establish priorities and professional standards of business conduct rather than needless government intervention. In principle, deregulation is suppose to foster competition and thereby open markets to new service providers. The problem, however, is that complete and unfettered deregulation can sometimes create the very problem it was meant to solve; namely, a lack of competition.

This paper will consider the causes and consequences of deregulation policy and its direct and indirect impact on US media and telecommunications business operations. Special attention is given to the deregulation paradox and three factors that have contributed to market failure outcomes, including: 1) concentration of ownership, 2) corporate misconduct and 3) lack of regulatory oversight. A basic argument of this paper is that free market competition does many things well, but it is highly imperfect when it comes to policing itself.

Biography

Richard A. Gershon, Ph.D., (Ohio University, 1986) is Professor and co-founder of the Telecommunications Management program at Western Michigan University where he teaches courses in Telecommunications Management, Law and Policy and Communication Technology. Dr. Gershon is the author of *Telecommunications Management: Industry Structures and Planning Strategies* (2001) and *The Transnational Media Corporation: Global Messages and Free Market Competition*, winner of the 1998 book of the year by the U.S. National Cable Television Museum.

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INTRODUCTION

Beginning in the early 1980's, the US under the Reagan administration actively promoted a policy of economic deregulation. The policy was designed to foster greater economic competition by allowing the marketplace to establish priorities and professional standards of business conduct rather than needless government intervention. The resulting cost savings was expected to spur productivity and new product development. As part of that effort, the Reagan administration reduced the stringency of many industrial standards required by such government agencies as the Securities Exchange Commission (SEC) and the Environmental Protection Agency (EPA) to name only a few.

Perhaps no one championed the cause of deregulation more than the Federal Communications Commission (FCC) under the leadership of its former Chairman, Mark Fowler. As one *Business Week* commentator noted: "The FCC has become Washington's most advanced laboratory for the antiregulation theories of the Reagan administration." ("Has the FCC Gone too Far," 1985, p. 48) It was during Fowler's tenure at the FCC, that the US telecommunications industry experienced the most dramatic effects of deregulation put into practice. Such deregulatory efforts included the breakup of AT&T,¹ the passage of the Cable Communications Policy Act of 1984² and more recently, the passage of the Telecommunications Act of 1996.³

The U.S. economy is experiencing a period of economic instability, somewhat reminiscent of the 1930s. What is similar is not the depth of the recession, but the level of corporate misconduct and total loss of investor confidence. How did this happen? The common element found in both time periods is the conflict of interest that benefited insiders (Kuttner, 2002). In contrast to the Chicago School of economic theory, which espouses the benefits of a deregulated economy, market forces were unable to detect or discipline the self-dealing and opportunism that proved irresistible during the high growth years of the 1990's. Despite President George W. Bush's assertion that some corrupt individuals failed the system, the argument can be made that it is the current system of deregulation that has failed ("Let the Reforms Begin," 2002, pp. 26-27).

The telecommunications industry in particular has been in a state of economic turmoil. Investors have lost some \$2 trillion as stock prices have fallen more than 95% from their previous highs. Since 2001, more than a half a million workers have lost their jobs in the media and telecommunications fields in what was once regarded as the strongest part of the US economy. Dozens of debt ridden companies ranging from Winstar to Global Crossing have filed for bankruptcy. And on July 21st, 2002 the telecommunication industry experienced an unprecedented level of instability when corporate giant WorldCom filed the largest bankruptcy claim in US corporate history.

PERSPECTIVES ON DEREGULATION AND MARKET FAILURE

The globalization of economic activity has forced developed and developing nations of the world to carefully consider their national economic policies. The once sacrosanct government monopolies, including airlines, steel and telecommunications, are feeling the international winds of change. There is a growing realization that if such government protected monopolies do not move fast enough in providing advanced services at the right cost, they will soon find themselves being outperformed by their international rivals. The result is a worldwide movement to deregulate (or lessen) government involvement in business and to privatize (or sell-off) state-owned companies (More, 1997; Gershon 1997).

A basic tenet of free market competition is that the private sector is the primary engine of growth. Free market competition means opening one's banking and telecommunication systems to private ownership and competition and providing a nation and its citizens with access to a wide variety of choices (Friedman, 1999). The rules of free market competition extend internationally as well. It presupposes a willingness to open up one's domestic market to foreign direct investment. It further attempts to eliminate, or at least reduce, tariffs and quotas on imported goods. Not all countries adhere to the principles of free market competition in the same way. According to Bauer (1999), there exists widely divergent views concerning the best ways to achieve effective competition.⁴

Worldwide telecommunications policy has been guided by a belief in the superiority of competition as an economic organizing principle for the industry. Paradoxically, while the idea of competition is widely embraced as a blueprint for practical policy decisions, there exist widely divergent views as to what constitutes competition and how it impacts efficiency. Moreover, policy prescriptions differ dependent on the conceptual lens chosen. (p.1)

The Deregulation Paradox

In principle, deregulation is suppose to foster competition and thereby open markets to new service providers. The problem, however, is that complete and unfettered deregulation can sometimes create the very problem it was meant to solve; namely, a lack of competition. Instead of fostering an open marketplace of new players and competitors, too much consolidation can lead to fewer players and hence less competition (Mosco, 1990; Gershon, 2001, 1997; Demers, 2000, 1999). Researchers like Mosco (1990) call it the "mythology of telecommunications deregulation." Other writers such as Demers (2000), refer to it as the "great paradox of capitalism." Gershon simply calls it the "deregulation paradox." (2001, 1997) As Demers (2000) points out,

The history of most industries in so-called free market economies is the history of the growth of oligopolies, where a few large companies eventually come to dominate. The first examples occurred during the late 1800s in the oil, steel and railroad industries... Antitrust laws eventually were used to break up many of these companies but oligopolistic tendencies continue in these and most other industries (p. 1).

What is most important, however, is that deregulation can lead to very real and lasting forms of market failure.

Market Failure

Market failure occurs when an existing market fails to achieve an efficient allocation of resources (Newberry, 1989; Wolf, 1979). Although the origins of the theory of market failure can be traced back several hundred years, the contemporary version of this theory owes much to William Baumol's *Welfare Economics and the Theory of the State* (1952), Paul Samuelson's seminal paper entitled, "*The Pure Theory*

of Public Expenditure (1954), Francis Bator's paper entitled, "*The Anatomy of Market Failure*" (1958) and Ronald Coase's paper, "*The Problem of Social Cost*" (1960).

Market failure happens when an existing market fails to achieve an efficient allocation of resources (Newberry, 1989; Wolf, 1979). Economists provide multiple reasons for why this occurs, including the improper allocation of scarce resources (e.g. electromagnetic spectrum), the management of public resources by private firms (broadcast licenses), the lack of competition in a given market (US local telephony) corporate misconduct (Enron, WorldCom) etc. The externality can be higher costs to the consumer, a lowering in the quality and availability of goods and services in the marketplace and the loss of investor confidence. As Wallis & Dollery (1999) point out, the problems associated with market failure provide the classic rationale for government intervention.

This paper will consider the causes and consequences of deregulation policy and its direct (and indirect) impact on US media and telecommunications business operations. Special attention is given to the deregulation paradox and three factors that have contributed to market failure outcomes, including: 1) concentration of ownership, 2) corporate misconduct and 3) lack of regulatory oversight. A basic argument of this paper is that free market competition does many things well, but it is highly imperfect when it comes to policing itself.

CONCENTRATION OF OWNERSHIP

Global competition has engendered a new competitive spirit that cuts across nationalities and borders. A new form of economic Darwinism abounds, characterized by a belief that size and complementary strengths are crucial to business survival. The transnational media corporation (TNMC) has become the most powerful economic force for global media activity in the world today. As Herman and McChesney (1997) point out, transnational media are a necessary component of global capitalism. They provide the informational and ideological environment that enables international free market trade to occur. As today's media and telecommunication companies continue to grow and expand, the challenges of staying globally competitive become increasingly more difficult.

The success of any business is dependent upon its ability to plan for the future. Strategy formulation can be a response to a triggering event and/or it can involve a change in direction for the company as a whole. Strategy formulation presupposes an ongoing willingness to enlarge and improve the flow of a company's products and services. There are different kinds of strategy depending upon the organization and its long range goals. At issue, is the decision by the organization and its senior management to pursue what can be described as a high risk strategy.

Mergers, Acquisitions and Strategic Alliances

Mergers, acquisitions, and strategic alliances represent different ways that companies can join (or partner together) to achieve increased market share, diversify product line and/or create greater efficiency of operation (Chan-Olmsted, 1998; Gershon, 2001). The decades of the 1990's and early 21st century witnessed an unprecedented number of international mergers and acquisitions that has brought about a major realignment of business players. Concerns for

antitrust violations seem to be overshadowed by a general acceptance that such changes are inevitable in a global economy. The result has been a consolidation of players in all aspects of business, including banking, aviation, pharmaceuticals, media and telecommunications (Compaine & Gomery, 2000; Albarran, & Chan-Olmsted, 1998; Gershon, 2000, 1997).

Starting in 1995, the field of media and telecommunications took advantage of deregulatory and privatization trends to make ever-larger combinations. This was evidenced by a number of important mergers and acquisitions, including: Walt Disney's \$19 billion purchase of Cap.Cities/ABC (1995), WorldCom's purchase of MCI Communication for \$36.5 billion (1997), AT&T's \$48 billion purchase of TCI Inc. (1999), Viacom's purchase of CBS for \$37 billion (1999) and America Online's purchase of Time Warner for \$162 billion (2001), to name only a few (Compaine & Gomery, 2000). The goal, simply put, is to possess the size and resources necessary in order to compete on a global playing field. Table 1. identifies the major mergers and acquisitions of media and telecommunication companies in the U.S. for the years 1999-2001.

**Table 1.
Mergers and Acquisitions: Media and
Telecommunication Companies (1999-2001)**

| Mergers & Acquisitions | Description | Price | Time |
|--|--|--------------|-------------|
| Vivendi S.A. and Seagrams (Universal and Polygram) | French media group Vivendi S.A. purchased \$ Seagrams Co, Ltd which owns Universal Studios and Polygram Records for \$43.3 billion. | 43.3 Bil. | 2001 |
| Vodafone and Mannesmann | Vodafone, a British wireless provider and Mannesmann a German based telecom. company have completed a merger at a cost of \$190 billion. | \$190.0 Bil. | 2001 |

| | | | |
|--------------------------------------|--|--------------|------|
| America On-line and Time Warner | AOL acquired Time Warner Inc. for \$162 billion. This represents the first combination of a major Internet service provider with a traditional media company. | \$162.0 Bil. | 2001 |
| AT&T & Media One Group | AT&T purchased Media One for \$60 billion which in combination with its TCI cable holdings makes AT&T the largest MSO in the U.S. | \$ 60.0 Bil. | 2000 |
| Verizon -- Bell Atlantic & GTE | Bell Atlantic purchased GTE for \$52.8 Bil. in a major stock swap that allows the company to enter the business of long distance telephony. | \$ 52.8 Bil. | 2000 |
| Viacom and CBS | Viacom purchased CBS Inc. for \$37 billion. Viacom has major investments in cable programming and film production. | \$ 37.0 Bil. | 2000 |
| AT&T & TeleCommunications Inc. (TCI) | AT&T purchased TCI Inc. for \$48 billion thus enabling AT&T to offer cable television, local and long distance telephone service, and enhanced information services. | \$ 48.0 Bil. | 1999 |
| SBC Communications & Ameritech | SBC purchased RBOC Ameritech for \$62 billion which will allow SBC to increase its telephone network in the midwest and east. | \$ 62.0 Bil. | 1999 |

Sources: R. Gershon and Company Reports

When Mergers and Acquisitions Fail

Not all mergers and acquisitions are successful. As companies feel the pressures of increased competition, they embrace a somewhat faulty assumption that increased size makes for a better company. Yet upon closer examination, it becomes clear that this is not always the case. Often, the combining of two major firms creates problems that no one could foresee. A failed merger or acquisition can be highly disruptive to both organizations in terms of lost revenue, capital debt and a decrease in job performance. The inevitable result is the elimination of staff and operations as well as the potential for bankruptcy. In addition, the effects on the support (or host) communities can be quite destructive (Wasserstein, 1998).

There are four reasons that help to explain why mergers and acquisitions can sometimes fail. They include: 1) the lack of a compelling strategic rationale, 2) failure to perform due diligence, 3) postmerger planning and integration failures and 4) financing and the problems of excessive debt (“The Case Against Mergers,” 1995).

The lack of a compelling strategic rationale. The decision to merge is sometimes not supported by a compelling strategic rationale. In the desire to be globally competitive, both companies go into the proposed merger with unrealistic expectations of complementary strengths and presumed synergies. More often than not, the very problems that prompted a merger consideration in the first place become further exacerbated once the merger is complete.

Failure to perform due diligence. In the highly charged atmosphere of intense negotiations, the merging parties fail to perform due diligence prior to the merger agreement. The acquiring company only later discovers that the intended acquisition may not accomplish the desired objectives (“The Case Against Mergers,” 1995). Often the lack of due diligence results in the acquiring company paying too much for the acquisition.

Postmerger planning and integration failures. One of the most important reasons that mergers fail is due to bad postmerger planning and integration. If the proposed merger does not include an effective plan for combining divisions with similar products, the duplication can be a source of friction rather than synergy. Turf wars erupt and reporting functions among managers becomes divisive. The problem becomes further complicated when there are significant differences in corporate culture (Gershon, 2000, 1997).

Some of the aforementioned problems can be seen in the case of AOL/Time Warner.

AOL/Time Warner

On January 10, 2000, America Online (AOL), the largest Internet service provider in the U.S. announced that it would purchase Time Warner Inc. for \$162 billion. What was particularly unique about the deal was that AOL with one fifth of the revenue and 15% of the workforce of Time Warner was planning to purchase the largest TNMC in the world. Such was the nature of Internet economics that allowed Wall Street to assign a monetary value to AOL well in excess of its actual value. What is clear, however, is that AOL President, Steve Case, recognized that his company was ultimately in a vulnerable position. Sooner or later, Wall Street would come to realize that AOL was an overvalued company. At the time, AOL had no major deals with cable companies for delivery. Instead, it was dependent on local telephone lines and satellite delivery. Nor did it have any real content to speak of. Enter Time Warner which has both. The proposed venture was promoted as the marriage of old media and new media. In principle, an AOL/Time Warner combination would provide AOL with broadband distribution capability to Time Warner's 13 million cable households. AOL/Time Warner cable subscribers would have faster Internet service as well as access to a wide variety of interactive and Internet software products ("Showtime," 2001, pp. 57-64).

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

In the meantime, AOL's Robert Pittman was assigned the task of overseeing the post merger integration.

In the weeks and months that followed, the economic downturn and subsequent loss of advertising had a strong negative impact on AOL's core business. AOL found itself financially weaker than it was a year earlier because of rising debt and a falling share price which left it without the financial means to pursue future deals. As an example, AOL was counting on cable television (and the deals that go with it) to deliver the broadband capabilities from its online entertainment and news services that it promised at the time of the merger. And AOL/Time Warner executives have angered big institutional investors by missing growth targets and spinning financial reports to make their performance look better than it was. Adding to the tension were new questions about AOL's accounting practices ("AOL Reshuffles its Management Deck," 2002). The once hoped for synergies did not materialize, leaving the company with an unwieldy structure and bitter corporate infighting. The combination of events led to the retirement of AOL/Time Warner CEO Jerald Levin and the forced resignation of COO Robert Pittman who was expected to one day become the CEO of the newly combined company ("Failed Effort," 2002).

For Time Warner CEO, Jerald Levin, pursuing the AOL merger was intended to be his final legacy. It should be understood that Jerald Levin has a long history of strategic decision-making. Earlier in his career, Levin was the leading force behind HBO's commitment to use satellite communication, thereby, redefining the future of long haul television distribution and giving new meaning to the term cable network services. Levin was also the same person who in 1990 helped engineer Time's merger with Warner

Communication. In 1996, he led the charge in acquiring Turner Broadcasting. And for better or worse, Levin was the man behind the AOL/Time Warner merger. In retrospect, Levin was a victim of empire building; that is, a love of deal-making and a singular willingness to decide what deals, products and strategies were best for his company, his shareholders and the public at large. As Lieberman (2002) notes, “he frequently made those decisions alone, without opening himself up to questions or critics” (p. 2B) In his single minded pursuit of the deal, Levin failed to give Time Warner a collar (or escape clause) in the event that AOL’s position and stock value dramatically changed prior to the execution of the deal. In the end, Levin bet the future of Time Warner on the deal, leaving employees, investors and consumers questioning his motives as well as having to sort through the unintended consequences of that action.

CORPORATE MISCONDUCT

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

of rational self-interest under those circumstances can lead to a market failure outcome.

Questionable Actions and Corporate Misconduct

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

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

Who are the senior executives in question and how did the system of deregulation fail? Former Qwest CEO Joseph P. Nacchio sold \$248 million worth of stock before he was pushed out of the scandal plagued company. Nacchio may be eligible for a severance package worth more than \$10 million. Global Crossing founder, Gary Winnick sold \$734 million of his shares before his company filed for bankruptcy. Dennis Kozlowski, former CEO of Tyco, was charged with evading payment of more than \$1 million in sales

tax on paintings by Monet, Renoir and others. He is also accused of extorting some \$70 million for personal gain. John Rigas, founder and CEO of Adelphia Communications received more than \$67 million in undisclosed loans and received \$1 million per month in soft cash for a period covering two years. And former WorldCom CEO., Bernard Ebbers borrowed \$408 million from his company before he was ousted with loans remaining to be paid. He was also given a severance package giving him a \$1.5 million pension for life.

Table 2. provides an overview of questionable actions and corporate misconduct of several notable US business and telecommunications firms. In several instances, the companies identified in this table have filed for bankruptcy. In several instances, the CEO and/or senior executives were indicted for fraud. In all instances, the said companies represented have experienced a serious decline in stock value.

**Table 2.
Questionable Actions and Corporate Misconduct
Select Examples**

| Company | Senior Executive | Questionable Actions and Corporate Misconduct | Consequences |
|-----------------|-------------------------------------|---|---|
| Adelphia Comm. | John Rigas President and Founder | received more than \$67 million in undisclosed loans and received \$1 million per month in soft cash for a period covering two years. | Rigas has been indicted for fraud. |
| Arthur Anderson | Joseph Beradino President & CEO | his company was found guilty of criminal obstruction of justice. | Beradino has resigned from the company Anderson has ended its role as an auditor of publicly companies after 89 years. |
| | David Duncan Senior Accountant | engaged in criminal obstruction of justice by the improper shredding of documents | pleaded guilty |

| | | | |
|-------------------|--|--|--|
| Enron Corporation | Kenneth Lay President & CEO | amassed \$152 million in payments and stock. A complex web of partnerships was used to hide more than \$1 billion in debt and inflate profits. | Company has filed for bankruptcy |
| | Andrew Fastow | is accused of directing efforts to create highly questionable outside partnerships and then covering up such actions with deceptive accounting practices | |
| Global Crossing | Gary Winnick President & CEO | sold \$734 million of his shares before his company filed for bankruptcy. | Company has filed for bankruptcy |
| Qwest Comm. | Joseph P. Nacchio President & CEO | the company is accused of deceptive accounting practices. Nacchio sold \$248 million worth of stock before he was forced out of the company. Nacchio may be eligible for a severance package worth more than \$10 million. | |
| ImClone Systems. | Samuel D. Waksal | trying to sell \$5 million in ImClone shares and tipping two family members after learning that the FDA wouldn't review ImClone's key drug application. | Waksal was indicted for insider trading. |
| Tyco Inc. | Dennis Kozlowski, President & CEO | was charged with evading payment of more than \$1 million in sales tax on paintings by Monet, Renior and others. He is also charged with extorting some \$70 million for personal gain. | Kozlowski has been indicted for fraud. |
| WorldCom | Bernard Ebbers President and CEO | borrowed \$408 million from his company before he was ousted with loans remaining to be paid. He was given a severance package giving him a \$1.5 million pension for life | Company has filed for bankruptcy |
| | Scott D. Sullivan Chief Financial Officer | inappropriately accounted for \$3.8 billion in expenses, thereby inflating profits and falsifying reports to the SEC. | Sullivan has been indicted for fraud |
| | Buford Yates Dir. of General Acc. | helped carry out Sullivan's orders and supervised co-conspirators. | Yates has been indicted for fraud |

Sources: Wall Street Journal, Business Week

WorldCom

Starting in the mid-1990's, Mississippi based WorldCom quickly rose to become the number two long distance telephone carrier in the US. Along the way, the company used its soaring stock to make 60 acquisitions, including a hostile takeover of MCI in 1998.

Beginning in early 2002, WorldCom has suffered a stunning reversal of fortune. WorldCom has become the focus of intense scrutiny by regulators and law enforcement officials after the disclosure that the company improperly overstated earnings by \$3.8 billion in 2001 and the first quarter of 2002 ("Congress Begins," 2002). The fallout has been significant.

WorldCom has subsequently filed for bankruptcy and discharged 17,000 of its employees (or 28% of the company's workforce). WorldCom has seen its stock plummet from a one time high of \$64.50 per share to stock that is trading at 83 cents per share.

The company's bond holders and other creditors have also suffered heavy losses. WorldCom is carrying \$30 billion in debt. It must pay \$172 million in interest and maturities in 2002, rising to \$1.7 billion in 2003 and \$2.6 billion in 2004. All this comes at a time when WorldCom's assets are worth far less than its \$32 billion debt due to the softness of the telecom. market. Prior to the accounting disclosure, President and CEO Bernie Ebbers was forced to resign from the company

In the meantime, WorldCom's former Chief Financial Officer, Scott D. Sullivan and accounting director Buford Yates were indicted in August 2002 by US Federal Prosecutors for fraud and misrepresentation. WorldCom also faces pressure from an employee lawsuit over the loss of value in its retirement plan resulting from the accounting disclosures. It isn't clear why WorldCom's misstatements weren't caught immediately by its outside auditors. The answer

may have something to do with the accounting firm responsible for its financial audit; Arthur Anderson, the same company responsible for the Enron debacle and the shredding of documents. The firm signed off on WorldCom's financial statements. Anderson later issued a statement that CFO Sullivan had been deceptive in his financial reporting to the company's auditors.

The Strange Tale of Jack Grubman

In the second half of the 1990s, Salomon Smith Barney (SSB) analyst Jack B. Grubman may have been the most influential person in the telecommunications industry. Grubman, who grew up in Philadelphia, rose to become the industry's most powerful broker, helping companies startups raise millions in start-up capital, persuading investors to bid up stock prices and even counseling CEOs on strategy and acquisitions. He personally befriended many of the industry's top CEOs and it was not uncommon for him to sit in on corporate board meetings ("Inside the Telecom Mess," 2002).

More than most analysts, Grubman was a player in the industry he covered. Jack Grubman was the person most responsible for recruiting AT&T executive Joseph P. Nacchio to become CEO of Qwest Communications in 1996. He helped WorldCom CEO Bernie Ebbers launch a hostile bid for MCI Communications in 1997. And he advised SBC Communications Inc. on its Ameritech acquisition in 1998. Between 1998 and 2000, Grubman helped SSB raise \$53 billion for telecom players, more than any other firm on Wall Street. ("Rainmaker in a Firestorm," 2002). In return, SSB, a subsidiary of Citigroup, received lucrative underwriting contracts valued at several hundred million dollars as well as millions more for providing mergers and acquisitions advice to its list of telecom. clients. Grubman himself was paid about \$20 million a year.

Today, Jack Grubman is under investigation for promoting stocks that were seriously compromised by his deep involvement with the companies he covered. Given his high profile, individual investors believed in Grubman's picks because they thought he was providing impartial advice on his favorite stocks; the traditional job of a Wall Street analyst. At least 10 telecommunication companies he recommended have filed for bankruptcy, including Global Crossing and WorldCom. Most problematic, was that Grubman continued to give investors bad advice maintaining 'buy recommendations' on Global Crossing, Worldcom and other failed companies until the very end.

What is clear is that Grubman's professional interests were deeply conflicted and he has come to personify the blurred lines between the obligations of a Wall Street analyst, external business consultant and investment banker. In an interview with *Business Week*, Grubman once commented: What use to be a conflict is now a synergy." ("Rainmaker in a Firestorm," 2002, p. 44) The crucial legal question is whether Grubman's advice was tainted by SSB's parent company Citigroup in an effort to win (and maintain) lucrative underwriting contracts or whether his stock picks were motivated by self-interest. According to John Coffee, Columbia University,

There has not been an analyst of any note who has not been leaned on by an investment banking division, which cares more about pleasing a potential or current client than about the overall objectivity of an analyst's rating. ("Crisis at Citi," 2002, p. 38)

In August 2002, Jack Grubman resigned from Salomon Smith Barney claiming that public criticism and media scrutiny have impaired his ability to do his job. He was given a \$32 million severance package.

THE LACK OF REGULATORY OVERSIGHT Administrative Agencies and Corporate Boards

The problems associated with market failure (concentration of ownership, high prices, service quality etc.) provide the classic rationale for government intervention. Public policies intended to remedy the problems associated with market failure usually take the form of a legislative mandate or an administrative assignment of tasks. The government sponsored task force (or Congressional inquiry) is expected to produce certain outcomes which are intended to address the shortcomings of the market. They are often given exclusive control in a particular field. The appointment is seldom contested by the public at large. Defining the proper goals and objectives for such organizations are hard to establish in principle and whose outcomes for success are harder still to evaluate in practice (Wolf, 1979). When such government sponsored task forces fail, they do so in large measure because their performance is not subject to the forces of the market. Wenders (1990) takes the argument one step further by adding that the competition for votes (or public approval) in the political marketplace will often supersede good economic decision-making. The proposed solutions and desired outcomes can sometimes fail to achieve goals that are in the public's best interest (Wenders, 1990; Hazlett, 1986; Wolf, 1979).

Alfred Kahn in his classic work, *The Economics of Regulation: Principles and Institutions* (1971) notes that most government regulation is designed to supplement the activity of the markets. In other words, it attempts to compensate for the imperfections of the market. As an example, the FCC's decision to impose "must carry" requirements on US cable operators was designed to protect the interests of small, independent stations that wanted to ensure guaranteed placement on local cable operating systems. Otherwise, such

stations ran the risk of not being carried by the local cable operator. Under the terms of Retransmission Consent, "must carry" requires the cable operator to reserve a channel allocation for all local broadcasters who request placement on the system.⁵ The underlying assumption is that a totally free market would not provide sufficient protection to small, independent broadcasters. Government regulation under such circumstances is intended to compensate for market imperfections while leaving the fundamentals of the marketplace mechanism intact.

Wilson (2000) argues that public utility regulation seeks to replace the market. "Public utility regulation is not a response to market imperfections; rather, it is a response to conditions of market failure." (p. 43) The goal of public utility regulation is not to compensate for market imperfections, but to correct for market failure. By setting prices, controlling the number of firms in an industry and setting standards for service quality, the regulatory agency is usurping the functions normally performed by the market.

The Role of Corporate Boards

The role of a corporate board of directors is to provide independent oversight and guidance to a CEO and his/her staff of senior executives. This can involve everything from approving new strategic initiatives to reviewing CEO performance. Corporate boards provide a level of professional oversight that embodies the principles of "self regulation." The problem occurs when a corporate board of directors ignores its fiduciary responsibility to company stockholders by failing to challenge questionable corporate strategy and by permitting unethical business practices to occur. More problematic, is when a corporate board loses its sense of independence.

In recent years, many CEOs have tended to operate with corporate boards that have proven highly compliant rather than objective. It was not uncommon to find corporate boards that were packed with men and women loyal to the CEO. At WorldCom, for example, the company's board of directors gave its approval to lend CEO Bernie Ebbers a \$408 million loan so that he could cover a margin call on his personal investment in the company's stock. Tyco's board approved a \$20 million bonus to one of its own members for helping with the acquisition of CIT Group Inc., which the company later sold off for nearly half the purchase price. Another board member had a controlling interest in two firms that got more than \$3.5 million to lease an aircraft and provide pilot services to Tyco from 1996-2002.

Enron Corporation

The case of Enron Corporation case calls into question the rights of investors and the obligations of a corporate board of directors to provide a modicum of corporate oversight. At Enron, accounting firm Arthur Anderson told the board's audit committee in 1999 that Enron was a "maximum risk" client that was "pushing the limits" of appropriate accounting practices. The board chose not challenge Enron's own internal accounting practices nor did it ask Arthur Anderson to take a more careful approach in auditing Enron's books (Byrne, 2002). In 2000, the same Enron board approved \$750 million in cash bonuses to Enron executives in a year when the company reported net income of \$975 million. That represents over 60% of what the company earned that year in net income. It should be noted that the directors at Enron were paid \$350,000 a year in cash and stock options to provide professional oversight. Perhaps most telling,

was the decision by the Enron board not to address the claims made by Enron employee Sharon S. Watkins regarding the company's involvement in a series of highly complex multibillion off-the-books partnerships.

What is clear is that Enron's Board of Directors knew about and could have prevented many of the risky business dealings and accounting practices that led to the company's demise. In a six month US Congressional inquiry, the subcommittee on investigation reported:

.... that much of what was wrong with Enron was known to the board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-book activity and excessive executive compensation...

By failing to provide sufficient oversight and restraint to stop management excess the Enron Board contributed to the company's collapse and bears a share of the responsibility for it (Byrne, 2002, pp. 50-51)

DISCUSSION

The challenges and difficulties faced by today's media and telecommunications companies call into question some basic assumptions regarding deregulation and the principle of self-regulation. This reality overturns several decades of conventional wisdom about the efficiency of free markets (Kuttner, 2002). The primary difficulty is that market discipline and self-regulation noticeably failed in several instances when it came to unscrupulous dealmaking, failed business strategy, the undue concentration of ownership, insider trading and deceptive accounting practices. During the high water mark years of the 1990's, investors went along for the ride, delighted as long as stock performance kept rising. US regulators and corporate boards were unwilling or unable to spot and regulate

fraud when it occurred. And given the respect accorded deregulation and the low esteem placed on government regulation, the US Congress would not permit regulatory agencies (the FCC, the SEC, the FTC etc.) to challenge the activities of corporate America (Crew & Kleindorfer, 2002).

In industries like telecommunications, deregulation led to competitive overbuilding and mergers that were sheer economic waste. The collapse of antitrust enforcement stimulated a wave of economic combinations that may in the end serve no purpose other than the undue concentration of market power and the enrichment of senior executives (Kuttner, 2002). Deregulated markets do many things well. But they are not effective at policing themselves or allocating resources in those sectors of the economy that are natural monopolies or where social services are required.

In the wake of the Enron and WorldCom debacles, researchers, policy analysts and government officials are recognizing the need to take a new activism in monitoring the actions of wayward companies. Several have proposed regulatory and business reforms that would improve corporate conduct in the marketplace. Examples include:

- 1. Regulate Auditors:** Either expand the power of the SEC or create an altogether new oversight board responsible for auditing standards, license auditors, with the power to punish transgressors.
- 2. Revamp CEO Compensation:** The size and attractiveness of stock options (and the fact that they were treated as expenses) gave executives too much incentive to cut corners and push up stock prices for the short term. Instead, options should be charged against corporate income rather than expenses. Moreover, they should not be exercisable for a period of at least 5 years.
- 3. Make CEOs More Accountable:** The SEC should endorse national guidelines for all publicly traded companies doing business in the US. Among the provisions CEOs and CFOs must personally certify the accuracy in reporting of the income statement.

4. Make Corporate Boards More Independent: The number of men and women who sit on corporate boards should be independent. They should take a leading role on audit, compensation and nominating committees.

5. Regulate Wall Street Analysts: The SEC should endorse national guidelines that would reduce an obvious conflict of interest that allows analysts to recommend stocks as part of a larger effort to stimulate future business opportunities with the issuing companies.

In the end, the problem is not deregulation or market economies. Rather, the problem is a failure to recognize that there is no such thing as wholly free markets devoid of regulatory oversight. A policy of deregulation does not excuse an administrative agency or a corporate board from making tough decisions when the economic imperatives (and public welfare) require them to do so. The failure to step in and provide proper oversight is nothing more than an abdication of responsibility of the public trust.

Deregulation, if taken to its logical conclusion, can sometimes create the very problem it was meant to resolve; namely, a lack of competition or reduction in service quality.

When all that's left is Standard Oil (or a telecommunications equivalent), it's too little – too late to start dusting off the Sherman Antitrust Act. Likewise, regulatory agencies (and corporate boards) need to be vigilant in monitoring the actions of wayward companies and senior executives who promote high risk strategy or engage in corporate misconduct. Deregulation is, admittedly, a delicate balancing act that requires the administrative agency to assume its proper role as the nation's "defender" of the public interest while fostering the best features of the marketplace mechanism.

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Endnotes

¹ *United States v AT&T*, 552 F Supp 131 (DDC 1982), *Maryland v United States*, 460 US 1001 (1983).

² Cable Communications Policy Act of 1984, 47 U.S.C. (1984).

³ Telecommunications Policy Act of 1996, section 204 (to be codified at 47 U.S.C. § 309(k)(1)).

⁴ Some countries, accordingly, tailor the rules of free market trade to protect certain industries or quality of life issues. As an example, Japan is highly protective of its banking industry ("Rebuilding the Banks," 1999), whereas, France is highly protective of its culture. In sum, free market trade in its varying forms provides the basic architecture for today's global economy.

⁵ Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992). (codified in various sections of 47 U.S.C.).