

Qwest Communications: A Case Study Of Fraud And Greed

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ABSTRACT

This case study examines the unethical and illegal activities that occurred at Qwest Communications. Headquartered in Denver, Colorado, top level managers at Qwest fraudulently manipulated the firm's financial reports in order to artificially inflate Qwest's revenue and profit levels. Former Qwest CEO, Joseph Nacchio, was charged and convicted of insider trading by selling Qwest stock during the time period when the fraud occurred within the company. In March 2008, Joseph Nacchio's conviction was overturned by a federal appeals court.

Keywords: Qwest Communications, Ethics, Fraud, Joseph Nacchio

INTRODUCTION

This case highlights the ethical issues related to a Colorado based telecommunications company, Qwest Communications. Formerly nicknamed as the Denver Baby Bell, Qwest Communications was involved in numerous illegal and unethical activities that took place by the top managers, including the former CEO, Joseph Nacchio.

In 2003, Qwest was accused of falsifying financial documents by swapping pieces of equipment with other telecommunication providers and recording the transactions as revenue. Qwest would sell fiber optic cables to another telecommunications provider and then buy the same types of cables from the provider at the same cost. This “swapping” of equipment resulted in a net zero balance between Qwest and the other companies, but Qwest “booked” these swaps as revenue. In addition, Qwest executives issued “side letters” which resulted in some retroactive financial changes in the agreements of some of the swapped equipment. These “after the fact” side letters were not shown to Qwest's CFO or to its external auditor, Arthur Andersen.¹

On February 25, 2003, the Justice Department indicted four former top level executives at Qwest for fraud. Those indicted were: Grant Graham, who was the former Chief Financial Officer for Qwest's Global Business Unit; Thomas Hall, who was the Senior Vice President for Government and Educational Solutions Group within the Global Business Unit; John Walker, who was a Vice President in the Government and Educational Solutions Group; and Bryan Treadway, who was an Assistant Controller at Qwest. These four executives were accused of falsifying financial documents by immediately recording as revenue a purchase order with the Arizona School Facilities Board before all the work was completed in implementing a statewide school computer network. This instant recognition of all the revenue of the contract was in violation of SEC rules. By recognizing a higher revenue level than allowed in this specific transaction, Qwest was able to increase their financial results by more than 33 million dollars for the second quarter of 2001 when Qwest was actually experiencing weak overall sales. These four executives were charged with conspiracy to commit an offense against the United States, securities fraud, and wire fraud.²

By October 2004, the total amount of fraudulent financial transactions had been raised to \$8 billion. Qwest agreed to pay \$250 million to settle with the federal government without admitting or denying guilt in their actions.

¹ Kris Hudson. “Secret Letters May be Key to Qwest Prosecution.” *Denver Post*. February 27, 2003.

² Department of Justice. “Four Former Qwest Communications Executives Indicted for Fraud”. www.usdoj.gov. February 25, 2003.

Qwest was also ordered to appoint a chief compliance officer for the company. The federal investigation also revealed that Qwest lack internal controls and had poor bookkeeping which led to a number of serious accounting errors. These errors included a \$56 million overstatement of operator service revenue, \$200 million which was improperly capitalized related to Qwest's design service centers, and an understatement of \$850 million in expenses related to its merger with US West.³

On March 15, 2005, former CEO and Co-Chairman, Joseph Nacchio, was charged with fraud and other securities violations. Nacchio's lawyer responded by stating that "(t)he SEC has ignored (Nacchio's) good faith reliance on Qwest's extensive governance and disclosure process, which involved significant participation and advice of many other responsible people. As Mr. Nacchio has consistently stated, he did nothing wrong and did not instruct anyone else to do anything wrong during his tenure at Qwest."⁴ In addition, Nacchio argued that he believed Qwest was going to have a strong future since the company was negotiating on some national security contracts which had to remain confidential. As a result, he could not publicly explain why he was so optimistic about the future growth potential of Qwest.⁵ The SEC alleged that Nacchio and other executives at Qwest illegally profited by selling shares of Qwest stock while having information pertaining to the poor financial performance of the company.⁶

In June 2005, Qwest's former CFO, Robin Szeliga, was charged with insider trading related to a stock sale she made in April 2001. Joe Nacchio was also involved in heavy selling of Qwest stock during the same time period. During the last week of April 2001 and the first two weeks of May 2001, Nacchio sold stock worth \$49 million, which became a pretax profit of \$42 million. The prosecution alleged that Szeliga knew by April 2001 that Qwest could not reach their revenue targets without extraordinary one-time sales and the recording (as revenue) the swaps of fiber cable with other telecommunication companies. Instead of misleading investors, Nacchio argued that he was just presenting puffery and corporate optimism about Qwest.⁷ However, prosecutors claim that Nacchio told his employees, "(T)he most important thing we do is meet our numbers. It's more important than any individual product and it's more important than any individual philosophy. It's more important than any individual cultural change that we're making. We stop everything else when we don't make the numbers".⁸

On July 13, 2005, former CFO, Robin Szeliga, pled guilty to one count of insider trading. Szeliga admitted that she had improperly sold 10,000 shares of Qwest stock in which she received a profit of \$125,000. She sold the shares based on having access to information that was not available to the public.⁹

On October 31, 2005, Qwest announced a tentative agreement in which the company would pay \$400 million to settle outstanding shareholders lawsuits based on their fraudulent financial reporting. The shareholder lawsuits alleged that Qwest and its former officers and board members had concealed information pertaining to how the company was booking revenue.¹⁰

In December 2005, Joseph Nacchio was indicted on 42 criminal counts of insider trading for alleging illegally profiting from selling over \$100 million in stock with access to insider information. The prosecutors accused Nacchio of developing "a manipulative and deceptive" scheme in which he refused to disclose the financial problems facing Qwest. It was the beginning of the end for Nacchio who had taken over the top position at Qwest in 1997 after working for AT&T. Nacchio resigned from his position at Qwest in June 2002.¹¹ Federal prosecutors stated that "(b)eginning as early as August 2000, Nacchio was specifically and repeatedly warned about the material,

³ U.S. Securities and Exchange Commission. "SEC Charges Qwest Communications International Inc. with Multi-Faceted Accounting and Reporting Fraud". www.SEC.GOV. October 21, 2004.

⁴ Stacy Cowley. "SEC Accuses Former Qwest Head of Fraud". *Computerworld*. March 16, 2005.

⁵ Anonymous. "Ex-Qwest CEO to Feds: Wrong Number". CNNMoney.com. November 21, 2005.

⁶ Dennis K. Berman. "Qwest Ex-Chief Nacchio Is Hit With SEC Civil Fraud Lawsuit". *The Wall Street Journal*. March 16, 2005.

⁷ Jeff Smith. "Questionable Time; Inquiry Focuses on Period in '01 When Nacchio Sold Stock". *Rocky Mountain News*. June 11, 2005.

⁸ Sandy Shore. "Ex-Qwest CFO Pleads Guilty to Charge." *Associated Press*. July 14, 2005.

⁹ Sandy Shore. "Ex-Qwest CFO Pleads Guilty to Charge." *Associated Press*. July 14, 2005.

¹⁰ Associated Press. "Qwest Announces Settlement With Shareholders." MSNBC.com. November 1, 2005.

¹¹ Don Mitchell. "Former Qwest CEO Joe Nacchio Is Indicted". *Associated Press*. December 20, 2005.

nonpublic financial risk facing Qwest, and Qwest's ability to achieve its aggressive publicly stated financial targets. Nacchio's stock sales accelerated in January 2001 as he became aware of additional material, nonpublic information." Prosecutors were demanding that Nacchio forfeit \$100,812,582 or the total of the proceeds from the questionable stock sales. The prosecutors continue by stating "(i)nsider trading is a crime as we've said in the past and it's important for corporate executives to recognize that when they are in possession of information that the public is not, they are under a duty to abstain from trading, buying or selling stock during that time."¹²

On March 19, 2007, Joe Nacchio's criminal trial for insider trading started in Denver. During the trial, former investor relations chief at Qwest, Lee Wolfe, testified that Nacchio projected high revenue growth levels of 15 and 17 percent when a major factor of the growth was a one-time sale of network capacity. Wolfe stated that "Qwest found ways and Mr. Nacchio found ways to trivialize and minimize the one-time transactions, and way understated the true impact they were having."¹³

On April 9, 2007, the defense rested its case in the Nacchio trial without Nacchio testifying in his own defense. It is considered a risk when a top level executive takes the stand in his or her own defense since the responses of the CEO could leave an impression of being arrogant and/or evasive.¹⁴ On April 19, 2007, Joseph Nacchio was found guilty on 19 of the 42 counts of insider trading. The 19 guilty counts represented \$52 million of stock sales executed by Nacchio.¹⁵ On July 27, 2007, Joseph Nacchio was sentenced to 6 years in prison for his illegal insider trading activities. The judge also ordered Nacchio to pay a fine of \$19 million and forfeit \$52 million that was illegally earned from stock sales in 2001.¹⁶

Nacchio appealed his conviction and claimed that he and Qwest were being punished by the federal government since Qwest refused to participate in a National Security Agency (NSA) program which Qwest felt was illegal. Six months before the September 11 attacks, the NSA asked Qwest whether they would be willing to participate in a warrantless surveillance program in order to obtain personal information about their customer's phone records. When Qwest refused, NSA cancelled the negotiations with Qwest over high security level contracts, which Nacchio claimed was the basis of his optimistic future forecasts. As a result, he did not mislead investors with his glowing statements pertaining to Qwest's future financial growth.¹⁷ On March 17, 2008, a federal appeals court overturned Joseph Nacchio's insider trading conviction. By a vote of 2 to 1, the court ruled that during the trial, the judge had committed an error by not allowing a key expert defense witness to testify. However, Nacchio can be tried again and the appeals court's ruling implied that there appeared to be sufficient evidence to try Nacchio again. The expert defense witness, Daniel Fischel, was going to present to the jury an analysis to determine whether Nacchio's stock sales would be considered suspicious or not. The appeals court also agreed with the judge that the information pertaining to secret government contracts should not be submitted as evidence in the trial.¹⁸ In July 2008, the prosecution was able to have the full appeals court review the result of the trial instead of the previous three-member court. The full appeals court started to review the case in September 2008.¹⁹

AUTHOR INFORMATION

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¹² Ken Belson. "Ex-Chief of Qwest Is Indicted". *The New York Times*. December 21, 2006.

¹³ Bloomberg News. "Ex-Qwest Official Says Chief was Misleading on Growth". *The New York Times*. March 22, 2007.

¹⁴ Dan Frosch. "Defense Rests in Trial of Ex-Qwest Chief". *The New York Times*. April 10, 2007.

¹⁵ Dan Frosch. "Ex-Chief at Qwest Found Guilty of Insider Trading". *The New York Times*. April 20, 2007

¹⁶ Dan Frosch. "Ex-Qwest Chief Gets 6-Year Sentence". *The New York Times*. July 28, 2007.

¹⁷ Ellen Nakashima and Dan. Eggen. "Former CEO Says U.S. Punished Phone Firm". *The Washington Post*. October 13, 2007.

¹⁸ Dionne Searcey and Ashby Jones. "Nacchio Conviction Is Overturned by Court". *The Wall Street Journal*. March 18, 2008.

¹⁹ P. Solomon Banda. "Prosecutors: Nacchio's Conviction Should Be Upheld". *Associated Press*. September 16, 2008.

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