

PRIVILEGED & CONFIDENTIAL

DETERMINED TO BE AN ADMINISTRATIVE MARKING

E.O. 12065, Section 8-102

By *JWH* NARS, Date *5/2/2012*

REQUEST FOR COMMISSION ACTION

Control No.: DS-02-123-

PRIVILEGED AND CONFIDENTIAL

ACTION MEMORANDUM

February 4, 2002
LA-2563

TO: The Commission

FROM: Pacific Regional Office/Los Angeles

RE: Global Crossing Ltd. ("Global Crossing")

RECOMMENDATION: That the Commission issue a formal order to determine whether there have been violations of Section 17(a) of the Securities Act of 1933 and Section 10(b), 13(a), and 13(b) of the Securities Exchange Act of 1934, and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2 thereunder.

ACTION REQUESTED BY: Duty Officer

OTHER DIVISIONS OR OFFICES CONSULTED: Office of General Counsel (David Frederickson x. 0968, Scot Draeger x. 0852)
Office of the Chief Accountant (Mike Kigin x. 4421)
Division of Corporation Finance (Mary Kosterlitz x. 2843)

PRIOR COMMISSION ACTION: None

SOURCE OF CASE: Newspaper report in the Los Angeles Times on January 30, 2002

UNIQUE, NOVEL OR COMPLEX ISSUES: None

TENTATIVE SUNSHINE ACT STATUS: Not applicable

SMALL ENTITY STATUS: Not applicable because Global Crossing is an issuer whose assets exceed \$5 million

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PRIVILEGE

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I. SUMMARY

The staff has commenced an expedited investigation of possible accounting fraud at Global Crossing Ltd. and seeks a formal order to secure relevant documents by subpoena from, *inter alia*, the company and its auditor, Arthur Andersen. Global Crossing, a telecommunications company that spent billions over the past five years building a worldwide fiber optic network, filed for bankruptcy protection in New York on Monday. The Commission has filed a notice of appearance in that bankruptcy, which is reportedly the fourth or fifth largest ever. On Wednesday, January 30, the press reported that an officer of Global Crossing had questioned Global Crossing's accounting in a letter to the company's top lawyer, five months before the bankruptcy filing. The staff has obtained a copy of the letter, which attacks the company's accounting for the sale of long-term contracts to provide fiber-optic capacity, known in the telecommunications industry as "Indefeasible Rights of Use" or "IRUs." The whistleblower's letter questions Global Crossing's reporting of revenue from IRUs in three consecutive quarters, both in its pro forma reports (as "Cash Revenue" and "Adjusted EBITDA") and in its GAAP revenue total (in the Form 10-K for the company's year ended December 31, 2000, and in Forms 10-Q for its quarters ended on March 31, 2001 and June 30, 2001).

In view of recent events, it is essential in cases of possible financial fraud to subpoena relevant records immediately in order to prevent their destruction. It is in the public interest to demand relevant documents by subpoena as early in this investigation as possible, in order to conduct an expedited fact-finding investigation as to whether Global Crossing properly reported its financial position and the results of its operations.¹

II. RELEVANT ENTITIES

A. Global Crossing Ltd., a Bermuda corporation, has offices in Beverly Hills, California, as well as in Madison, New Jersey, where its accounting function is based. Global Crossing was founded in 1997, and made an initial public offering of its stock in 1998. Originally listed on the NASDAQ and then the New York Stock Exchange, the company's common stock began trading on the OTC Bulletin Board (OTCBB) on January 29. The company's original business was to lay fiber-optic cables around the globe, but under a rapid succession of CEO's (five in the five years of its existence), the company appears to have become more of a financial and deal-making vehicle, premised on highly optimistic expectations for growth. Global Crossing has never turned a profit, and has lost about \$7 billion, while its market capitalization has fallen from a peak of \$48 billion to just \$267 million. The closing price on the OTC-BB on February 1 was less than \$.12.

¹ The Enforcement staff has recently learned that Global Crossing had discussions with staff from the Division of Corporation Finance and the Office of the Chief Accountant. The Enforcement staff is aware that the substance of those discussions may affect the course and scope of the investigation and any possible enforcement action. The Enforcement staff, nevertheless, believes that expedited consideration of this recommendation is necessary in light of the serious allegations and the effect on the market.

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On January 28, 2002, Global Crossing and certain of its affiliates (excluding Asia Global Crossing and its subsidiaries) commenced Chapter 11 cases in the United States Bankruptcy Court for the Southern District of New York and coordinated proceedings in the Supreme Court of Bermuda. In becoming the fourth-largest bankruptcy in U.S. history, Global Crossing is seeking to restructure with a \$750 million investment from a pair of Asian technology companies, which is expected to wipe out existing shareholders and leave little for bondholders and banks. Global Crossing's petition discloses debts of \$12.3 billion and assets of \$22.4 billion (over \$8 billion of which is goodwill and intangibles).

B. Gary Winnick, the largest shareholder of Global Crossing, founded the company with a \$20 million investment. He has since sold shares in the company for combined proceeds of about \$600 million. A former sales executive at Drexel Burnham Lambert under Michael Milken, Winnick joined the high-yield "junk" bond business in 1972. He left in 1985, five years before Drexel Burnham collapsed.

C. Roy Olofson was Global Crossing's vice president for finance through November 2001, when he was terminated. A California resident, Olofson began his career at PricewaterhouseCoopers, and has served as CEO or treasurer of various retail companies.

D. Daniel Cohrs is Global Crossing's Chief Financial Officer.

III. FACTS

The staff is seeking to determine whether Global Crossing materially overstated revenues in the three consecutive quarters ended on June 30, 2001, by improperly accounting for revenue streams stemming from long-term contracts to provide capacity on international telecommunications networks. These contracts, known as an "Indefeasible Rights of Use" or IRUs, generally require a carrier such as Global Crossing to provide its customers with capacity at a fixed price for a long period, usually 20 or 25 years. In some cases, carriers mutually agree to swap transactions involving IRUs, whereby both carriers are obligated to supply bandwidth to each other. Carriers do not necessarily use their own networks to fulfill their IRU obligations, sometimes contracting with other carriers in what is essentially a price arbitrage or hedge. Carriers such as Global Crossing have found IRUs attractive not only because they lock in customers for a long period, but also because they generally require an upfront payment by the customer.

Global Crossing became increasingly dependent on IRUs for revenue during its short life as a Wall Street darling. For example, for its quarter ended June 30, 2001 ("June 2001 Quarter"), the company reported it had revenues of slightly over a billion, and that over half (\$567 million) derived from IRUs. This trend of increasing dependence on IRUs came to a halt in the company's third quarter ("September 2001 Quarter"), when revenue from IRUs fell sharply.² Analysts commenting on the company's results that quarter (which, for the first time, did not

² Revenue for September 2001 Quarter was almost 50% lower than the same period the prior year, when revenue was reported as \$1.4 billion.

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meet Wall Street's expectations) noted that the glut in international telecommunications capacity, had resulted in drastically reduced prices and the reluctance of carriers to enter into long-term, fixed-price contracts.

A significant portion of Global Crossing's IRU agreements reportedly involve reciprocal agreements to buy capacity from other carriers. For example, the Form 10-Q for the June 2001 Quarter discloses that \$345 million was received from significant carrier customers who signed contracts during the quarter to purchase \$380 million of capacity on the "Global Crossing Network." The note also discloses that Global Crossing entered into several agreements with the same customers to lease or buy capacity.³ For the June 2001 quarter, these purchase commitments totaled \$358 million.

In August 2001, Global Crossing's vice president of finance, Roy Olofson, called into question the company's accounting for IRU revenue. In a five-page letter to the company's general counsel, Olofson stated that he was "very disturbed" by Global Crossing's accounting and financial reporting matters for the company's prior three quarters,⁴ namely the June 2001 quarter, and the quarters ended on March 31, 2001, and December 31, 2000. (Of the three quarters discussed in the letter, only the earliest one was audited, as part of Arthur Andersen's year-end audit of the financial statements for the 2000 fiscal year.)

In his letter, Olofson alleged that Global Crossing's quarterly releases announcing "Cash Revenue" and "Recurring Adjusted EBITDA" were deceptive because these figures were not based on actual cash and included increasingly greater amounts of cash receipts for future sales and services. He concluded his lucid analysis with the observation that the metrics of "cash revenue" and "Recurring Adjusted EBITDA" were very misleading in that they erroneously suggested that cash was being earned in the relevant periods. He further alleged that the company, under pressure to meet Wall Street's quarterly expectations, began recording revenue before the criteria for revenue recognition had been met. In addition, Olofson suggests that IRU sales in the first and second quarters of 2001 which were structured with other companies as reciprocal agreements, involve "round tripping" the cash, in wash transactions, some of which did not even involve cash.

In press reports, the company has denied that there is anything improper about its accounting. The company's chief financial officer, Daniel Cohrs, told the Wall Street Journal, "I am the first to admit that our financial statements are complicated." But, he said, the practices were standard across the industry, and the company made full disclosure of its transactions to

³ "During the quarter, the Company entered into several agreements with various carrier customers for the purchase or lease of capacity and co-location space. These transactions were implemented in order to acquire cost-effective local network expansions; to provide for cost-effective alternatives to new construction in certain markets in which the Company anticipates shortages of capacity; and to provide additional levels of physical diversity in the network as the Company implements its global mesh architecture. The cash commitments totaled \$358 and \$625 for the three months ended June 30, 2001 and March 31, 2001, respectively, including the cost of the possible construction of the Caribbean System as discussed in "Liquidity and Capital Resources" on page 20."

⁴ Global Crossing uses a calendar fiscal year.

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investors, breaking out revenue from long-term leases separately from other sales. "Accounting has nothing to do with where we are today." The staff is scheduling a meeting for the week of February 11, with Cohrs and Arthur Andersen, who have offered to explain Olofson's allegations.

The staff plans to investigate whether Global Crossing falsely reported revenue relating to IRU transactions, either in its "pro forma" disclosures or in the financial statements included in its quarterly reports for the first two quarter of 2001, or its annual report on Form 10-K for its year ended on December 31, 2001.

IV. LEGAL ANALYSIS

A. Violations of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5

Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act are violated when material facts are either omitted or misstated, when any device, scheme or artifice to defraud is employed or when any practice operates as a fraud upon any person in the offer or sale, or in connection with the purchase or sale of securities. SEC v. Texas Gulf Sulpher Co., 401 F.2d 833, 847 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971); see also Aaron v. SEC, 446 U.S. 680, 681 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976). Material errors in annual and quarterly reports have been found to satisfy the "in connection with" requirement of Section 10(b), in that they are clearly documents that an investor would rely on in deciding whether to purchase securities. SEC v. Benson, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1987). Violations of Section 10(b) and Rule 10b-5 occur when an issuer publicly disseminates false and misleading documents through filings with the Commission and trading thereafter occurs in the issuer's securities. SEC v. Texas Gulf Sulpher Co., 401 F.2d at 858-59. The staff is investigating whether the financial statements included in Global Crossing's public filings for FY 2000 and its two quarters ended on March 31 and June 30, 2001, were materially false or misleading.

B. Possible Violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13 Thereunder

Global Crossing may have violated Section 13(a) and Rules 13a-1, 13a-13 and 12b-20 thereunder. Section 13(a) of the Exchange Act requires all issuers subject to the reporting requirements of the Exchange Act, such as Global Crossing, to file periodic and current reports with the Commission containing such information as the Commission's rules prescribe. Rule 13a-1 requires certain issuers to file annual reports with the Commission and Rule 13a-13 requires such issuers to file quarterly reports. Issuers must disclose in these reports their net earnings, among other things. Section 13(a) requires that issuers supply accurate information in their annual and quarterly reports. A violation of Section 13(a) is established if annual or quarterly reports are shown to contain materially false or misleading information regarding such items as the levels of a company's income or expenses. SEC v. Kalvex, Inc., 425 F. Supp. 310, 316 (S.D.N.Y. 1975). The annual and quarterly reports, filed on Forms 10-K and 10-Q,

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which in turn requires conformity with generally accepted accounting principles. 17 C.F.R. § 210.4-01(a)(1). Rule 12b-20 requires such reports to contain any additional information necessary to ensure that other statements in the reports are not, under the circumstances, materially misleading.

C. Possible Violations of Exchange Act Section 13(b) and Rules 13b2-1 and 13b2-2 Thereunder

Exchange Act Section 13(b)(2)(A) requires that every issuer of securities registered pursuant to Section 12 of the Exchange Act keep books and records which, in reasonable detail, accurately and fairly reflect its transactions and disposition of assets. Section 13(b)(2)(B) requires such issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 13b2-1 thereunder prohibits any person from falsifying or causing to be falsified any book or record subject to Section 13(b)(2)(A). Exchange Act Section 13(b)(5) prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record, or account described in Section 13(b)(2). The staff is investigating whether there was any falsification or inflation of figures with respect to the company's accounting records.

Rule 13b2-2 of the Exchange Act makes it unlawful for an officer or director of an issuer to make or cause to be made a materially false or misleading statement, or omit or cause the omission of any material fact necessary to make the statements made not misleading in light of the circumstances, to an accountant in connection with an audit or examination of financial statements, or the preparation of any documents required to be filed with the Commission. See SEC v. Benson, 657 F. Supp. 1122, 1132 (S.D.N.Y. 1987). The staff will investigate whether Global Crossing or any of its officers materially misrepresented Global Crossing's financial condition and if so, whether any of its officers made any material misrepresentation to its outside auditors, Arthur Andersen, in connection with its audit of the FY 2000 financial statements, or to its internal accountants in connection with any of its Commission filings.

**V.
 NEED FOR A FORMAL ORDER**

The staff is conducting an expedited investigation of serious allegations of wrongdoing by a major American company, whose bankruptcy filing this week was a factor in a 250-point drop in the Dow on Monday. While the staff has already secured representations from both Arthur Andersen and Global Crossing that all relevant documents are secure and will be preserved, a formal order will assist in obtaining all relevant documents and testimony swiftly and completely.

**VI.
 RECOMMENDATION**

Based on the foregoing, the staff recommends that the Commission issue a formal order in this matter.