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International Corporate Governance at Bellsouth: A corporate scandal in Nicaragua

Gobierno Corporativo Internacional en Bellsouth: Escándalo corporativo en Nicaragua

Abstract: This article arises from research of a course in International Corporate Governance of our Ph.D. from the University of St. Gallen (Switzerland) and applied in a company that has suffered a scandal which would affect its operations in Nicaragua. The analysis applied from the KISS Principles of the professor Dr. Martin Hilb of University of St.Gallen. The violations of law that underlie the case described in this paper stem from actions and omissions relating to BellSouth's subsidiary in Nicaragua, Telefonía Celular de Nicaragua, S.A. This is a reflexion article is only for academic purposes.

Keywords: Corporate governance, violations, scandal, KISS principles.

JEL: M16

Resumen: Este artículo surgió a partir de una investigación de un curso de *International Corporate Governance* de nuestro doctorado en la Universidad de St. Gallen (Suiza) y se aplicó en una compañía que hubiese sufrido un escándalo, el cual afectó sus operaciones en Nicaragua. Para el análisis se aplicaron los principios KISS del profesor Dr. Martin Hilb, profesor de la mencionada universidad. Las violaciones del derecho y de la ley que subyacen en el caso descrito en este documento son producto de las acciones y omisiones relativas a la filial de BellSouth en Nicaragua, Telefonía Celular de Nicaragua, S.A. Este artículo de reflexión es solo para fines académicos.

Palabras clave: Gobierno corporativo, violaciones, escándalo, principios KISS.

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Introduction

Over the last decade, BellSouth expanded its operations into Latin America by acquiring telephone companies in 11 countries: Venezuela, Brazil, Argentina, Colombia, Peru, Chile, Panama, Ecuador, Uruguay, Nicaragua and Guatemala. In the early years of BellSouth's expansion into Latin America, BellSouth acquired minority ownership positions in the local companies and allowed its local in-country partners to manage the companies' daily operations. In a gradual shift of strategy that came around the year 2000, BellSouth began acquiring majority ownership of the local companies and exercising greater management control over their operations.

As will be explained later, the violations of law that underlie the case described in this paper stem from actions and omissions relating to BellSouth's subsidiary in Nicaragua, Telefonía Celular de Nicaragua, S.A.

Background

BellSouth Corporation (now under the name AT&T) is an American telecommunications holding company based in Atlanta, Georgia. It serves close to 34 million customers in the United States and in 18 other countries, making it one of the world's largest communications companies. It provides local telecommunications as well as wireless local and long distance service, long distance access, cable and digital television, Internet access, and other electronic commerce. What is more, BellSouth is a leading advertising and publishing company, putting out many advertising directories, including The Real Yellow Pages Online. The company began as a regional subdivision of AT&T, or a so-called Baby Bell company, with a market in the southeastern United States. This region remains a principal source of income for the company, with approximately 40 percent of BellSouth's revenues comes from providing traditional local telephone service there. It is in no way a strictly regional entity, however, with the remaining revenue coming from other services both in and outside the South.

BellSouth was one of the seven original Regional Bell Operating Companies after the U.S. Department of

Justice forced the American Telephone & Telegraph Company to divest itself of its regional telephone companies on January 1, 1984. In a merger announced on March 5, 2006 and executed on December 29, 2006, AT&T Inc. acquired BellSouth for approximately US\$ 86 billion (1.325 shares of AT&T for each share of BellSouth). The combined company retained the name AT&T. The merger consolidated ownership of Cingular Wireless and Yellowpages.com, both of which were previously joint ventures between BellSouth and AT&T.

Since the merger, wireless services previously offered by Cingular Wireless have been offered under the AT&T name. Furthermore, BellSouth has officially become AT&T South, with its Bell Operating Company operating as AT&T Southeast. On June 30, 2007, it ceased to perform under the BellSouth name, and it was the last of the Regional Bell Operating Companies to keep its original corporate name after the 1984 AT&T breakup, and the last one to retain the Bell logo. Cincinnati Bell, an independent Bell System franchise, and not part of the AT&T breakup, still employs the "Bell" name, but ceased the use of the Bell logo in mid-2006. Verizon still uses the Bell logo on payphones and on the back of Verizon trucks, but not as a key symbol. Malheur Bell, a wholly-owned, but separately-operated subsidiary of Qwest Corporation, continues to use the logo, and is now the last former AT&T entity to continue to use the Bell logo. (Bellsouth Corporation corporate history, 2010, p.1)

AT&T, originally the American Telephone & Telegraph Company, has Alexander Graham Bell to thank for its true origins. With his invention of the telephone in 1876, came the foundation of the company that would become AT&T. This brand has since become one of the most well-known and reliable telephone services globally.

In 1984, through an agreement between the former AT&T and the U.S. Department of Justice, AT&T agreed to divest itself of its local telephone operations but retain its long distance, R&D and manufacturing arms. From this arrangement, SBC Communications Inc. (formerly known as Southwestern Bell Corp.) was born.

Twelve years later, the Telecommunications Act of 1996 caused an upheaval of the status quo in the market. SBC Communications Inc. established itself as a global communications provider by acquiring Pacific Telesis Group (1997), Southern New England Telecommunications (1998) and Ameritech Corp. (1999). In 2005, SBC Communications Inc. acquired AT&T Corp., creating the new AT&T.

With the merger of AT&T and BellSouth in December 29, 2006, and the consolidated ownership of Cingular Wireless and YELLOWPAGES.COM, AT&T was in a position to lead the industry in one of its most significant transformations since the invention of the telephone more than 130 years ago (AT&T corporate history, 2010, p.1).

Telefonía Celular de Nicaragua, S.A. ("Telefonía"), a Nicaraguan corporation headquartered in Managua, Nicaragua, is an indirectly majority-owned subsidiary of BellSouth. When it was founded in 1997, Telefonía was Nicaragua's only provider of wireless telephone services. From March 1997 through June 2000, BellSouth held a 49 percent ownership interest in Telefonía and an option for an additional 40 percent. During that same period, BSI controlled Telefonía's operations by contractual agreement between BSI and Telefonía, and controlled Telefonía's management through a majority presence on Telefonía's board of directors (Securities and Exchange Commission, 2002, p.3). BellSouth increased its ownership interest in Telefonía to 89 percent in June 2000. Telefonía is commonly known as BellSouth Nicaragua.

The incident: A framework of facts

The following information is based on *El Nuevo Diario* (Nicaragua), 01/25/00, 01/26/00, 01/28/00; *La Prensa* (2000), 01/25/00, 01/29/00, 01/31/00: BellSouth de Nicaragua, a subsidiary of US-based BellSouth, was at the heart of a scandal involving influence-peddling in the National Assembly. As previously stated, in 1997 BellSouth acquired a 49 percent ownership interest in Telefonía, and an option granted by members of a Nicaraguan family, the co-owners, to acquire an additional 40 percent. When BellSouth acquired its minority interest in Telefonía, a Nicaraguan law, Article 29 of the General

Law of Telecommunications and Postal Services, prohibited foreign companies such as BellSouth from acquiring a majority interest in Nicaraguan telecommunications companies. For BellSouth to exercise its 40 percent option, as it intended, the Nicaraguan legislature would have to repeal the Article 29 foreign ownership restriction.

Related to BellSouth's acquisition of Telefonía, BellSouth and the Nicaraguan co-owners formed an agreement allowing BellSouth operational control of Telefonía, under which BellSouth became responsible for Telefonía's daily operations and for its long-term business planning. Moreover, after BellSouth's investment in Telefonía, Telefonía's board of directors was restructured, and four of the six Telefonía board seats were filled by BellSouth personnel.

In October 1998, Telefonía hired Ethel Argüello de Calderón, the wife of Silvio Americo Calderón, the chairman of the Nicaraguan legislative committee which supervised Nicaraguan telecommunications. Mr. Americo Calderón later ran for a seat on the Consejo Supremo Electoral (CSE). Following their agreement, Mrs. Argüello de Calderón was to be responsible for providing various regulatory and legislative services, including lobbying for repeal of the foreign ownership restriction. Although she had prior financial and operations experience in the telecommunications area, she had no prior legislative experience. It was known at the time that she had recently been fired from her job with local fixed-line provider Empresa Nicaragüense de Telecomunicaciones (ENITEL) because of allegations of corrupt practices. Telefonía hired Mrs. Argüello de Calderón to provide services to Telefonía over a three-month trial period for a monthly fee of US\$ 6,500, making her the second most-highly paid individual on Telefonía's payroll.

The lobbyist worked predominantly on the repeal of the foreign ownership restriction. Because her husband chaired the legislative committee with jurisdiction over the foreign ownership restriction, BellSouth knew that by having hired Argüello de Calderón it had violated the U.S. Foreign Corrupt Practices Act ("FCPA"). Although a former local in-house Telefonía attorney approved Mrs. Argüello de Calderón's continued employment, BellSouth

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officials knew, or should have known, that the lawyer lacked sufficient experience or training to enable him to properly and effectively judge the situation in hand.

During Argüello de Calderón's employment at BellSouth, her husband, the legislator, drafted the text of the proposed repeal of the foreign ownership restriction and enlisted support for the proposed repeal from other Committee members. He scheduled and presided at a hearing in April 1999, during which his Committee heard arguments from BellSouth and others advocating repeal of the foreign ownership restriction.

In May 1999, Telefonía ended the employment of Mrs. Argüello de Calderón, and in June 1999, Telefonía recorded the total sum of US\$ 60,000 paid to her as consulting services and as a severance payment. In September 1999, the Committee put forward the proposed amendment for approval to the Nicaraguan National Assembly. In December 1999, the National Assembly approved the amendment and voted to repeal the foreign ownership restriction. BellSouth exercised its 40 percent option and increased its ownership interest in Telefonía to 89 percent in June 2000 (Securities and Exchange Commission, 2002, p.3).

In an interview with the newspaper *El Nuevo Diario* in January 2000, Mr. Carlos Fernández Roque, Telefonía's General Manager at the time of the scandal, argued that he had warned BellSouth officers in the U.S. that the company was violating U.S. law. Fernández told lawyers of BellSouth in February 1999 about the arrangement with Calderón's wife. In May of that same year, company lawyers went to Managua and ordered Telefonía's directors to fire her (based on *El Nuevo Diario* (Nicaragua), 01/25/00, 01/26/00, 01/28/00; *La Prensa* (2000), 01/25/00, 01/29/00, 01/31/00) (Nicaragua).

Shortly thereafter, Fernández argued that the Nicaragua directors forced him to resign, offering him US\$ 165,000 to sign a document affirming that the company had violated no laws. Fernández refused to sign and decided later to sue the company and to inform the mass media his version of the events.

Through Telefonía's public relations director Julie Hershkowitz, the company denied hiring Calderón's wife to influence legislation. Hershkowitz argued that the company had not used any corrupt tactics and that the telecommunications law had been changed after Calderón's wife left the company. Furthermore, she stated that the amendment would in fact benefit the Nicaraguan people, who would receive better service.

In the National Assembly, congressman Noel Vidaurre of the Partido Conservador de Nicaragua (PCN) claimed that BellSouth had "bought" Calderón, through his wife, and advised him to resign from the Assembly and withdraw his candidacy for the Consejo Supremo Electoral (CSE) seat. He also criticized colleague Wálmaro Gutiérrez of the PLC Party, who had argued that Calderón had not been involved in influence-peddling as this was not an offense recognized by Nicaraguan law.

Calderón denied he was influenced by BellSouth with regards to pressuring the change in legislation, and pointed out that various other firms such as Consejo Superior de la Empresa Privada (COSEP) and ENITEL also supported the change in the telecommunications law. According to him, allowing foreign ownership of Nicaraguan businesses would encourage more foreign investment and would help the privatization process of ENITEL and other state companies. He accused Fernández, Telefonía's former General Manager, of attacking him and his wife to discredit BellSouth and to boost his chances of winning his lawsuit.

But an editorial in the newspaper *La Prensa* argued that, the existence or lack thereof of the crime of influence-peddling in Nicaraguan law notwithstanding, Calderón should publicly apologize for his actions. If Calderón did not foresee the implications of a conflict of interest in his wife's employment with BellSouth, said the editorial, "we are then facing a case of total incompetence and lack of good judgement, and he should resign his post".

Telefonía violated Section 13(b)(6) of the Exchange Act, which requires companies which hold 50 percent or less of the voting power to proceed in good

faith and to use their influence, as far as reasonably possible under the circumstances, to ensure that the entity complies with the FCPA's "books and records" and "internal controls" provisions. BellSouth, during the relevant period, held less than 50 percent of the voting power of Telefonía, yet through its operational control, had sufficient influence to ensure that Telefonía complied with the FCPA's books and records and internal controls provisions. Although BellSouth was, or should have been, able to ensure the compliance of Telefonía, the latter created false books and records by improperly recording payments to Mrs. Calderón as "consulting services". BellSouth failed to devise and maintain a system of internal accounting controls at Telefonía, sufficient to detect and prevent FCPA violations (Securities and Exchange Commission, 2002, p.4).

There were several warning signals which should have alerted BellSouth to the illegal nature of their actions. For example, in Venezuela, in 1991, BellSouth acquired a minority interest in Telcel, Venezuela's leading wireless internet provider. In August 1997, BellSouth increased its ownership percentage, thus acquiring a majority interest. Telcel contributed more revenue to BellSouth's Latin American Group segment than any other Latin American BellSouth operation.

Between September 1997 and August 2000, former Telcel senior management authorized payments totaling approximately US\$ 10.8 million to six offshore companies. Telcel recorded the disbursements in Telcel's books and records based on fictitious invoices. The invoices indicated, without detail, that Telcel had received professional, computer and contracting services from the companies. However, there were no service or vendor agreements supporting the alleged services, and, in fact, no services were rendered. BellSouth has been unable to properly identify the circumstances or purpose of the payments, or the identity of their ultimate recipients.

In other words, Telcel created false books and records by improperly recording the falsely documented, unsubstantiated payments to the offshore companies as authentic services. In addition, Telcel's internal controls failed to detect the unsubstantiated payments for a period of at least two years. This

control deficiency has further impeded BellSouth from determining the circumstances of the payments, or the identity of their recipients. Telcel violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, commonly referred to as the "books and records" and "internal controls" provisions, respectively, of the FCPA. These acts generally require that a company with a class of securities registered pursuant to Section 12 of the Exchange Act make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect their transaction and disposition of assets. They must also devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: transactions are executed in accordance with management's general or specific authorization; transactions are recorded as necessary to permit preparation of financial statements conforming to generally accepted accounting principles or any other criteria applicable to such statements and to maintain accountability for assets; access to assets is permitted only in accordance with management's general or specific authorization; and the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences (Securities and Exchange Commission, 2002, p.4).

General:

These practices occurred not only in Nicaragua, but in different countries, all violating FCPA law.

The consequences

The Securities and Exchange Commission (SEC) filed BellSouth a penalty for US\$ 150,000. The SEC also ordered BellSouth remedial actions (Securities and Exchange Commission, 2002, p.4).

Corporate Governance at Telefonía will be analyzed utilizing the reversed KISS principle (Hilb, 2008, p. 12-13):

a) Keep It Situational:

- Multinationals have to pay a lot of attention to their subsidiaries' boards (subsidiary governance). In Telefonía's case, its board was not a "puppet

c) Keep It Integrated:

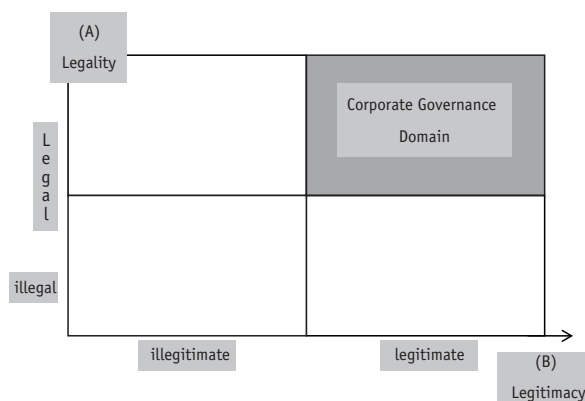
- One of the major weaknesses of many boards is poor succession planning. As a preventive measure, there should be in place a succession planning system, where successors are nominated in advance and with sufficient time. In the case of Telefonía, there is no evidence of a formal succession planning both for director and for key top managers.
- With everything that is happening in the world today, it is mandatory that a company has proper personnel compensation policies. These policies have to take into consideration both the short term and long-term horizon of the company (i.e. 60% of bonus based on a one-year basis and 40% of bonus based on a four-year basis) (Hilb, 2009, p. 13). The key performance indicators should not only be financial, such as revenue, net income, and EVA or Economic Profit, but customer, operational and learning related indicators (i.e. Kaplan and Norton’s four perspectives on the Balanced Scorecard). In the case of Telefonía, there is no evidence of such a personnel compensation policy. All compensation was short term and purely financial oriented.

d) Keep It Controlled:

- Legal and ethical compliance are two of the most important board tasks. Good corporate governance should emphasize both legitimacy and legal domains (Figure 3). One of the greatest areas of improvement is ethical compliance. And there is a difference between ethical compliance and legal compliance. Sometimes an action or issue can be legal (permitted by the law), but not legitimate. Also, policies of good behavior are worthless if they are just written in paper, and not followed and enforced by the company’s leadership. In Telefonía’s case, there was a violation of both legal and ethical issues. First, regardless of whether the crime of influence-peddling exits in Nicaraguan law, it was unethical for Telefonía to hire the wife of a congressman who was in charge of passing a law that would have benefitted Telefonía. As mentioned before, corporate governance has to be on both the legality and legitimacy domains. If Telefonía did not foresee

the implications of a conflict of interest in the employment of the congressman’s wife, there was a showing of complete incompetence and lack of judgement in the Board. Second, Telefonía, a subsidiary of a U.S. company, BellSouth, had violated the Foreign Corrupt Practices Act. This was illegal.

Figura 3.
Corporate Governance Domain



Source: Hilb, M. (2008). *New Corporate Governance*. Springer. New York.

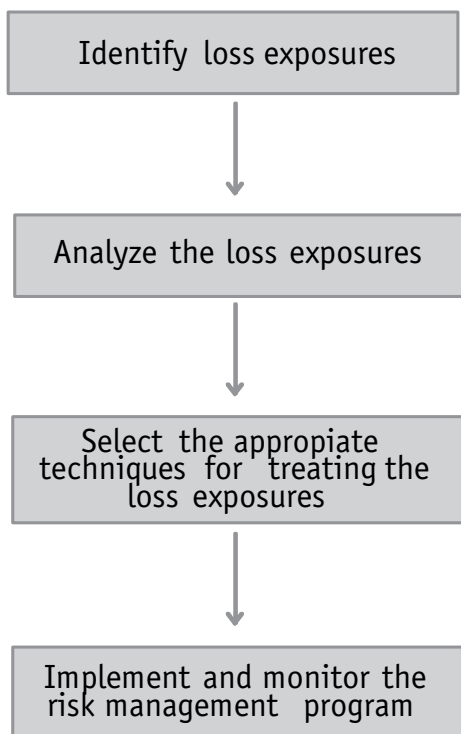
- Two of the main responsibilities of a Board are the control and direction of the organization. Boards cannot delegate these functions. Companies need to be proactive, and therefore should not wait for new regulations; they should take preventive measures. In Telefonía’s case, there is no evidence that these evaluations were conducted.

Managing Risks

Risk management is the identification, assessment, and prioritization of risks. This has to be followed by the coordinated application of resources to minimize, monitor, and control the probability and impact of unfortunate future events (Hubbard, 2009, p.46). Risks can come from improbability in financial markets, plan failures, cultural topics, market related, legal responsibilities, credit risk, calamities, natural causes, unexpected events and disasters as well as deliberate attacks from any rival. (Figure 4).

Figura 5.

Steps in the Risk Management Process



Source: Rejda, G. (2008). *Principles of Risk Management and Insurance (Third Edition)*. Pearson. Boston.p.43

Boards that deliver competitive advantage

In the case of Telefonía, the Board definitively failed to prevent a misdeed. But a board should not only prevent a misdeed or guarantee compliance, but should find a way to add value. Instead of just being measured by its inputs –the processes and structures used by the board–, boards should be measured by outputs –the value that it adds to a corporation–.

Boards need to evolve from a ceremonial (rubber-stamp) to a progressive (not liberated) board (Charan, 2005, p.57). In progressive boards, directors operate as a group. There is mutual respect and trust among directors. Everyone participates and consensus is very frequently achieved on key issues. The Board focuses on issues that are value-

added and anticipatory, as well as those that are compliance-related.

In the case of Telefonía, the board was not ceremonial. Nor was it progressive. Instead it was a liberated board. Directors pretty much did what they wanted, without the involvement and consent of the CEO. This is how they got in trouble with compliance and legal issues, especially with the FCPA violations. Telefonía’s fate would have been different if its Board would have had a progressive approach.

Conclusions

BellSouth and Telefonía have to take remedial actions, such as the disciplining and even terminating of any employee that had an active participation in the scandal, and the formation of steps to enhance its FCPA compliance program, which should consist of a number of components, including corporate governance, policies and procedures, training, internal auditing, and corrective action and discipline. For example, every employee and supplier should be trained in the FCPA. A progressive Board of Directors should be named, replacing the old one.

The violations of law that underlie the case described in this article stem from actions and omissions relating to BellSouth’s subsidiary in Nicaragua, Telefonía Celular de Nicaragua, S.A. One of the major weaknesses of several boards is poor succession planning. As a preventive measure, there should be in place a succession planning system, where successors are nominated in advance and with sufficient time. In the case of Telefonía, there is no evidence of a formal succession planning both for director and for key top managers.

There was no set of alternative measures for the company’s success at Telefonía. Customer, owner, employee, and society indicators were not included in the measures of success. Moreover, there was a failure to manage risks, especially legal risks and violation of U.S. FCPA laws. There violations were going on while the Board and Management of BellSouth headquarters in Atlanta had initially no knowledge about.

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To sum up, this case is an important scene in a real world in order to avoid at all many events against the company's culture that affect image and reputation and of course, company death.

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