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Outside Counsel: Attorneys say MCI settlement proves present system works

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As we Mississippians are far too aware, WorldCom filed Chapter 11 bankruptcy in July 2002 in the Bankruptcy Court for the Southern District of New York, causing thousands of investors throughout our country to lose billions.

Less than one month later, the bankruptcy court appointed former U.S. Attorney General Richard Thornburgh to investigate the circumstance and causes of WorldCom's demise. In the course of doing so, Thornburgh discovered a program adopted by MCI to substantially reduce its state tax obligations.

The structure of the program was relatively straightforward: Each WorldCom subsidiary made payments to the WorldCom parent company in exchange for the brainpower of the parent company's top management. The total payments between 1998 and 2002 were approximately $20 billion.

The WorldCom program contained two significant flaws: The payments were grossly excessive and were mischaracterized as "royalties." The questions which remained unaddressed by Thornburgh were how these flaws affected the company's income tax obligations to the state of Mississippi from 1998-2002.

When Thornburgh's findings were released, Billy Quin, a partner in the Jackson office of Lundy & Davis, had been engaged by several hundred WorldCom investors to pursue claims against Citigroup, Arthur Andersen and others whose fault caused them to lose their investments in WorldCom stocks and bonds.

Quin recognized the open questions of Thornburgh's report and developed several alternative theories which supported the conclusion that MCI owed a substantial amount of income tax to Mississippi.

Quin's first theory was that the payments were fully taxable service fees, akin to the payments an out-of-state client makes to an in-state lawyer. In this instance, the $20 billion in payments would be taxed at the state's 5 percent corporate income tax rate, which would render $1 billion in unpaid income tax.

Alternatively, Quin theorized that the payments were partially service fees and partially null and void overpayments which should be sent back to the subsidiaries for taxation in the states from which the payments were made. In this event, the income tax owed Mississippi would be substantial, but Tax Commission assistance and expert analysis would be needed to ascertain the exact amount.

Finally, Quin theorized that the payments were not service fees, but instead were dividends masquerading as royalties. In this case, the state would be entitled to fully tax the approximately $1.9 billion in payments made in 1998, but could not tax payments made from 1999 through 2002.

The reason for this odd exemption was particularly disturbing, yet informative: WorldCom successfully lobbied the Legislature in 1998 to exempt from gross income dividend payments from subsidiary companies to their corporate parent. This action was evidence that the payments were likely dividends, and that MCI owed approximately $95 million in unpaid income tax.

Quin, and his Lake Charles, La.-based law partners, Hunter Lundy and Clayton Davis, met with Attorney General Jim Hood on Jan. 20, 2004 to explain the WorldCom royalty program and its potential ramifications for the state. Hood was intrigued by the presentation, but remained skeptical of the case theories and Lundy & Davis' ability to finance and prosecute such a substantial endeavor.

Hood requested that the attorneys continue to develop their theories; he notified them that, in the meantime, he would pass the case theories along to several other Mississippi-based law firms he knew to possess the legal acumen, financial ability and adequate staff levels to assist Lundy & Davis in the case. The Langston Law Firm was the only firm to express an interest in the case. Shortly thereafter, Joey Langston and Hunter Lundy, classmates and friends from their days at Millsaps College, persuaded the attorney general to move forward with a claim against MCI.

Langston and Quin were not the only interested Mississippians to read the WorldCom Bankruptcy Examiner's report. Representatives of the Tax Commission also read Thornburgh's report, but failed to identify WorldCom's income tax debt. Instead, the Tax Commission concluded the company only owed approximately $3 million in franchise taxes. The Tax Commission filed its $3 million franchise tax claim on March 26, 2004, knowing full and well that the time to file franchise tax claims in the bankruptcy court had long since passed.

Less than one week later, on March 31, 2004, Hood amended the state's claim, opting to forgo the franchise tax claim and instead pursue $1 billion in unpaid income taxes - the $1 billion figure representing the largest amount the state could be owed pursuant to the attorneys' case theories. This amendment set the stage for what proved to be the attorneys' most difficult task: Obtaining the Tax Commission's endorsement and support of an income tax debt it failed to recognize.

Seventeen other states filed claims against MCI, alleging that WorldCom had taken improper tax deductions associated with the royalty payments. These states demanded the payments be nullified, and that each state be allowed to tax the deducted income as if the deductions had never been taken.

Further, these states, with the assistance of the Multi-State Tax Commission, contended that Mississippi should not be allowed to tax any portion of the $20 billion, on grounds that such would be tantamount to double-taxation. Hood and his special assistants resisted these charges on grounds that double-taxation is neither uncommon nor unwarranted when a taxpayer fraudulently conceals income.

Negotiations with MCI were spearheaded by Langston, and proved prolonged and difficult. MCI initially offered the state nothing, contending that the state should simply nullify the payments and allow the states from which the payments came tax the money. Later, MCI offered all states $330 million to distribute among themselves as they saw fit.

After this offer was also rejected, MCI offered the state $20 million to satisfy its claim. The state rejected this offer, and notified MCI that it intended to cease negotiations and prosecute its claim in the bankruptcy court.

A few days later, MCI notified the state that it had dismissed its former counsel and hired Mike Moore. Moore advised the company that it should make a final attempt to fairly resolve the Mississippi claim. His advice was followed, and on April 7, 2005, the parties reached a settlement which ultimately paid the state an amount of money and property which exceeded $100 million. In addition, MCI paid the state's attorneys $14 million.

The MCI case offers a clear illustration of the positive incentives attendant to empowering the attorney general to contract with outside counsel on a contingency fee basis.

The attorneys who handled the MCI matter never would have pursued the case against such overwhelming odds had they been unable to contract on a contingency fee basis, or had they known their work product would be shopped around to the lowest bidder. The net result of this chilling effect would have left the state with what the Tax Commission sought in the first instance: nothing.

For years, Republicans have praised the efficiency and capability of the private sector in resolving matters of public interest. The MCI case is this principle in action, and Mississippi is better for it.