

Roger's Dilemma: A Situational Examination of Ethical Behavior in the Presence of Internal Control Deficiencies

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ABSTRACT: This case exposes students to decision making in an ethically and legally ambiguous situation. It also asks them to practice using their ethical sensitivity by identifying situations where ethical conflicts are present. Students will learn the Securities and Exchange Commission's definition of insider trading and gain an understanding of the Supreme Court's recent interpretations regarding the specifics of what constitutes insider trading. Students will also learn about the legal protection afforded to whistleblowers under the Sarbanes-Oxley Act and learn about the code of ethics requirement applicable to public company's senior financial officers and the chief executive officer. Finally, students will be exposed to the definition of an internal control deficiency and learn how to identify two types of internal control deficiencies.

Keywords: insider-trading law; corporate code of ethics; whistleblowing; internal control; Sarbanes-Oxley Act; internal control deficiency.

INTRODUCTION

Roger McDaniels sat in front of his computer pondering his immediate future. He had just finished an impromptu meeting with Beth Sullivan from the internal audit department and his confidence was shaken. Both Roger and Beth left the meeting wondering if their recent decisions were for the best.

Roger's accounting career began approximately ten years ago when he became a CPA. Over the last decade, Roger had been successfully employed in a variety of accounting positions. It therefore came as no surprise to Roger when three months ago, he was contacted by an executive recruiter and offered the CFO position at Solodor Pharmaceuticals (SP). SP's mission was to conduct tests on Celenza, a new drug that had been developed to fight acute lymphoblastic leukemia. If successful, Celenza had the potential to increase the average life expectancy of affected patients by up to six years. Celenza offered terminal patients the most hope of any drug in over a

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decade. Although not stated publically, it was known in the industry that other pharmaceutical companies did not want to incur the significant costs associated with developing a similar drug because sales of a new drug would merely cannibalize sales from their current, but less effective medications.

Upon accepting the employment offer from SP, Roger felt very exhilarated. If SP's mission was successful, not only would Roger be handsomely rewarded (as his compensation package provided him with numerous stock options, which in themselves would likely make Roger a millionaire), but Roger would also play a part in extending the lives of numerous terminally ill patients. Given the history of death in his family from various forms of cancer, more specifically the death of his father from leukemia when he was only a child, Roger was all too aware of the pain and mental anguish associated with terminal illnesses.

Upon starting his new position, Roger was not surprised to learn that, similar to other new pharmaceutical companies, SP was currently experiencing severe cash flow problems. Thus, the immediate priority for Roger was to procure a round of additional equity financing. If Celenza was shown to be successful, it had the potential to be a cash cow. However, in its current state, SP had no expectations of any Celenza sales occurring for at least two more years because extensive testing was needed before the FDA's Center for Drug Evaluation and Research would even consider approving the drug. Without obtaining a minimum of \$5,500,000, SP would run out of money and be forced to liquidate within the next four months. This would not only leave Roger unemployed but would make his stock options worthless. It would also put Celenza's future in jeopardy.

Roger recently held meetings with three different financiers and pessimistically awaited their responses. Due to the weak economy, raising significant equity financing was an extremely difficult task. Therefore, when Steve Butler called to arrange a breakfast meeting, Roger was anxious.

Steve Butler was a senior vice-president of Cambridge, a venture capital firm with access to over a billion dollars. If SP's management team impressed Steve, Roger knew the firm's current financial woes would be solved. However, if SP's management team failed to impress...well, Roger chose not to concentrate on that option.

The breakfast meeting between Roger and Steve came and went with Steve appearing to be extremely intrigued with the market potential of Celenza. At the end of breakfast, Steve suggested that Cambridge would potentially be willing to invest up to \$5,500,000 but only after conducting a thorough analysis of Celenza's research progress.

Accordingly, two weeks after the breakfast meeting, scientists from Cambridge spent ten days examining the research that SP had conducted to date on Celenza. Roger was feeling cautiously optimistic because Steve's team seemed to be impressed. However, as weeks went by Roger's pessimism began to return. It had been three weeks since the team had visited SP and Roger had yet to hear from Steve.

Two days later the phone rang in Roger's office. After realizing it was Steve calling, Roger attempted not to act apprehensive. During the call, Steve explained that his firm was in the process of preparing a share purchase agreement in which Cambridge would purchase up to 55 percent of SP. Cambridge was willing to pay \$100,000 for each 1 percent of SP ownership, conditional on obtaining a controlling interest in SP. After hanging up, Roger exhaled deeply and exhaustively leaned back in his chair as he considered Cambridge's proposal. On the positive side, the news of an equity purchase could not have come at a better time since SP's creditors were phoning daily requesting payment. On the negative side, obtaining the required \$5,500,000 meant Cambridge would effectively control SP. Cambridge had a reputation for replacing the management teams in firms that it acquired and for pursuing a high-price/low-volume marketing strategy. The possibility of being fired would be catastrophic for Roger since he had to be employed by SP for at least one year before his stock options would fully vest. Cambridge's marketing strategy would also be in contrast to the desires of SP's current management team who wanted to maximize profits—but also

planned on being socially responsible by implementing a low price/high volume marketing strategy. Roger clenched his jaw in agony because he knew that a high-price/low-volume strategy meant that Celenza would only be available to the wealthy and not available to those who were covered by traditional health insurance policies.

After waiting a sleepless week during which no draft agreement appeared, Roger became increasingly agitated. Roger did not want to act hastily but after he could wait no longer he phoned Steve's office. Although Steve was out of the office, Roger reached Steve's assistant and asked to see a draft of the purchase agreement. The assistant agreed to overnight a hard copy of the deal.

Upon returning from lunch the next day, Roger noticed a UPS package resting on the corner of his desk. As he tore open the document Roger's heart palpitated with nervous excitement. As he glanced over the first sheets he immediately noticed that this was not a draft of the agreement between Cambridge and SP but a final copy of a deal between Cambridge and Dugas Incorporated that was to be announced the next day.

Roger's first instinct was to throw away the draft without reading it because it was obvious to Roger that Steve's assistant had made a mistake and sent him a copy of the wrong deal. However, curiosity got the best of Roger so he decided to read over the entire document. Afterward, Roger checked the Internet for details of Dugas Incorporated. There did not seem to be any public information available about a deal between Cambridge and Dugas Incorporated. Now consumed with interest, Roger noticed that Dugas Incorporated was currently trading on the New York Stock Exchange at \$3.14 per share, down from a yearly high of \$28.45. He next reviewed a few financial news articles that expressed concern regarding Dugas Incorporated's cash flow. The articles also expressed doubt that Dugas Incorporated would be able to obtain the additional financing it needed to stay afloat.

Roger reclined in his chair realizing that he was privy to a very significant piece of information. In less than 24 hours Dugas Incorporated would announce Cambridge's investment. This news was sure to have a significant impact on the price of Dugas Incorporated's stock. Roger contemplated just how high their stock price would go, maybe \$10, maybe \$15, maybe even past its yearly high.

Roger could not believe his good fortune. A grin slowly crept across Roger's mouth as he accessed SP's operating account and used every last dollar to purchase 470,000 shares in Dugas Incorporated. Roger was actually giddy with excitement and found that he could barely contain himself. With the profits that SP would make once the news regarding Dugas Incorporated went public, he had single handedly prevented SP from surrendering control to Cambridge. He had never felt better about himself. Roger was now fully confident that he would remain at SP long enough for his options to vest. As Roger left his office that day he realized that his actions would stop Cambridge from imposing a high-price/low-volume marketing strategy on SP such that only the very wealthy could afford Celenza. Roger found it satisfying to help people who so desperately needed it.

A month later, Roger's actions were discovered by Beth Sullivan, an internal auditor at SP, while performing a routine test on a stratified sample of cash transactions. Beth discovered that Roger used SP's operating funds to purchase shares in Dugas Incorporated just one day before the stock price skyrocketed. This discovery led Beth, who was unsure if she should further investigate the transaction, to request an impromptu meeting with Roger. Beth chose to discuss the situation with Roger rather than her immediate superior because SP's corporate structure was such that the head of the internal audit department ultimately reported to Roger, the CFO.

The meeting had only begun when Roger somewhat aggressively instructed her to simply drop the transaction from her sample. To underscore his point he made sure to mention that he was her boss's boss, and ultimately the person in charge of the internal audit department. Sensing that Beth was uncomfortable with his instructions, Roger slumped forward exhaustively and elaborated on his

heartfelt reasons for having used corporate funds to purchase the shares in Dugas Incorporated. After her meeting with Roger, Beth experienced an uneasy feeling in the pit of her stomach.

It was now two months since Beth's meeting with Roger but Beth still felt queasy when she contemplated Roger's actions. She had lain in bed the previous night tossing and turning unable to sleep. As she showered that morning she considered that it was important to ensure that she acted legally in spite of ethicality. People were thrown in jail for violating the law not for violating ethics. She resolved that in spite of thinking that perhaps Roger had behaved ethically, she had to behave rationally. If she reported Roger's actions, there was no way by which she could be held legally responsible for any of Roger's actions. There was also no means by which Roger or SP could fire her, for the Sarbanes-Oxley Act of 2002 (SOX), provided her with protection from their retribution. She never realized that reading the Occupational Safety and Health Administration (OSHA) fact sheet in SP's lunchroom would help her resolve such a significant dilemma. After many bored lunch breaks she could now recall the fact sheet verbatim:

An employer covered under SOX may not discharge or in any manner retaliate against an employee because he or she: provided information, caused information to be provided, or assisted in an investigation by a federal regulatory or law enforcement agency, a member or committee of Congress, or an internal investigation by the company relating to alleged mail fraud, wire fraud, bank fraud, securities fraud, violation(s) of SEC rules and regulations, or violation(s) of federal law relating to fraud against shareholders.

As Beth arrived at work that morning, after a brief stop at the local coffee shop, she confidently wrote a letter to SP's Board of Directors informing them of Roger's actions.

After reading the letter, the Board of Directors has requested that you prepare a report that explicitly addresses the following:

REQUIREMENTS

- Requirement 1:** Identify all of the stakeholders involved with Roger's decisions (i.e., those individuals and/or parties affected in some way by Roger's decisions) and the potential impact of his actions on each of them.
- Requirement 2:** Ethical sensitivity is a personal characteristic that enables an individual to recognize when an ethical issue is present. Using your ethical sensitivity, identify the various ethical conflicts present in this case.
- Requirement 3:** Publicly traded companies are required to establish a corporate code of ethics. Exhibit 1 provides background information regarding the "Code of Ethics" requirement and Exhibit 2 displays SP's own Code of Ethics. Considering the information in the case, the actions of Roger, and SP's Code of Ethics, please discuss if Roger's conduct was in violation of Part A of SP's Code of Ethics.
- Requirement 4:** Discuss the internal control deficiencies at SP that put the company at risk of violating Part B of the Code of Ethics. An internal control deficiency exists when a control either does not exist or when a control does not permit management to prevent, detect, or correct employee actions that are not consistent with the company's objectives. For your reference, Exhibit 3 provides a widely accepted definition of internal control.
- Requirement 5:** Investigate Roger's actions and determine whether his conduct was in violation of Part C of SP's Code of Ethics. To help you assess the legality of the situation, Exhibit 4 provides background information regarding the judicial system's interpretation of what constitutes insider trading.

Requirement 6: Beth acted as an internal whistleblower when, instead of following the normal chain of reporting, she bypassed her direct supervisor and informed the Board of Directors of Roger's actions. Discuss if her behavior was truly ethical, keeping in mind that her actions may have an adverse effect on those individuals suffering from acute lymphoblastic leukemia.

EXHIBIT 1

Background Information on a Corporate Code of Ethics

The Sarbanes-Oxley Act of 2002 (SOX) was implemented after numerous corporate accounting scandals (e.g., Enron, WorldCom, and Tyco). The purpose of SOX was to improve investor confidence in the capital markets. Of specific interest to SP's situation is Section 406 of SOX, which requires that public companies adopt a code of ethics applicable to the company's senior financial officers and the company's chief executive officer. The company must disclose the code in their annual report or on a website. As per Section 406 (SOX 2002), the "Code of Ethics" is:

written standards that are reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
- Compliance with applicable governmental laws, rules, and regulations;
- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- Accountability for adherence to the code.

EXHIBIT 2

Solodor Pharmaceuticals' Code of Ethics

The following code of ethics is applicable to all employees of Solodor Pharmaceuticals. As employees of Solodor Pharmaceuticals we will:

- A. always be honest and ethical;
- B. ensure reliable and relevant financial reporting;
- C. comply with all applicable governmental laws, rules, and regulations; and
- D. adhere to this code and quickly report any employee found in violation of it to Solodor Pharmaceuticals' Board of Directors.

EXHIBIT 3

Definition of Internal Control

Internal control is defined as a process designed to help the organization accomplish its objectives. Within organizations, internal control is established through an organization's reporting structure, the decision rights, and authority given to specific departments and to individual employees. To ensure controls are working as intended, information about the controls should be gathered and

communicated to those responsible for monitoring the effectiveness of the controls. Internal control plays an important role in protecting the organization's resources from unintended use and fraud (

EXHIBIT 4

Background Information on Insider Trading

Definition of Insider Trading

Insider trading occurs when an individual has material, nonpublic information about a company and uses that information to trade in the company's securities (Material, nonpublic information is defined as information that is not available to the public that would be important to an investor in making a decision to buy or sell a security.

The Securities Exchange Act of 1934 ("the 1934 Act")

Section 16(b) of the Securities Exchange Act of 1934 directly addresses insider trading, making it illegal for insiders to profit by trading on the basis of material, nonpublic information that they possess Section 16(b) defines insiders as directors, officers, and those owning more than 10 percent of the company's stock.

Section 10(b) of the 1934 Act indirectly addresses insider trading, making it unlawful for an individual to use "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe" Expanding on Section 10(b), the SEC adopted Rule 10(b)5 prohibiting "any person, directly or indirectly" from engaging in fraud or misrepresentation when trading securities, prohibiting individuals from deceiving any person in connection with the purchase (or sale) of securities.

While the 1934 Act is relatively easy to apply to corporate *insiders* who trade on material, nonpublic information, it is far more difficult to determine whether the provisions of the 1934 Act apply when an individual *outside* of the company trades on material, nonpublic information.

Recently, the Supreme Court adopted the "misappropriation theory" of insider trading, which holds that a company's information qualifies as property. Misappropriation is the intentional, illegal use of another person's property by an individual responsible for taking care of the other person's property. The Supreme Court cited the following rationale for adopting misappropriation theory, "it is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for personal benefit" Thus, the court's message is that individuals who obtain material, nonpublic information through confidential relationships are not at liberty to exploit it.

The Supreme Court adopted misappropriation theory as a result of *United States v. O'Hagan* O'Hagan was a partner in a law firm that represented Grand Met, a company planning to purchase a large amount of stock in the Pillsbury Company. When O'Hagan learned of the deal, he purchased stock options in Pillsbury, making a fortune. O'Hagan's rebuttal to the charge that he violated Section 10(b) of the Securities and Exchange Act of 1934 was that, because he did not owe a fiduciary duty to Pillsbury, he did not commit fraud by trading on the basis of the material, nonpublic information. The Supreme Court rejected O'Hagan's argument stating, "The misappropriation theory holds that a person commits fraud ... when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the *source* of the information." Further, the Supreme Court affirmed information as property stating, "A company's confidential information ... qualifies as property to which the company has a right of exclusive use."

In 2000, the SEC adopted Rule 10(b)5-1 to more clearly define when a purchase or sale of securities occurs “on the basis of” material, nonpublic information. The rule defines trading “on the basis of” material, nonpublic information as those situations where the trader is aware that (s)he possesses material, nonpublic information. The SEC adopted Rule 10(b)5-2 in 2000 to provide guidance as to situations where an individual owes a duty of trust or confidence with regards to the misappropriation theory of insider trading (A duty of trust or confidence is owed when:

- “[a] person agrees to maintain information in confidence.”
- “Whenever the person communicating the material, nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material, nonpublic information expects that the recipient will maintain its confidentiality.”

In sum, this exhibit demonstrates that insider-trading laws are largely established by judicial opinion. While the Securities Exchange Act of 1934 definitively prohibits company insiders from trading on the basis of material, nonpublic information, it is less clear in defining when it is prohibited for individuals outside of an organization to trade on the basis of material, nonpublic information. Further, the judicial system’s interpretation of what constitutes insider trading by those outside an organization has changed dramatically over time.