

Enlightened entertainment: what are friends for? a business ethics case study

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ABSTRACT

The case focuses on a Chief Financial Officer's ethical dilemma resulting from the Chief Executive Officer's decisions that appear to serve him and his friend rather than the stockholders. Students are provided an opportunity to evaluate an ethical dilemma from multiple perspectives. The teaching note provides several questions that can be used by the instructor to guide student analysis. Since students can approach ethical decision making from a variety of perspectives, the teaching note also offers multiple solutions (code, outcome, values, editorial, and rule analysis) and sections from the American Institute for Certified Public Accountants (AICPA) Code of Professional Conduct. This case is appropriate for use in business ethics, legal environment of business, business law and accounting courses.

Keywords: AICPA Code of Professional Conduct, business ethics, ethical analysis, ethical dilemma, management indiscretion

Note: This is a fictitious case developed for educational use. All statements, names, numbers, dates, etc. used herein were created for the purposes of this case and should not be construed as factual.

INTRODUCTION: THE CASE

Enlightened Entertainment, Inc. (EEI) is a publicly traded company that engages in the production and distribution of motion picture entertainment products online and through traditional delivery arrangements. Ira Simon founded the company in southern California some twenty-five years ago and, after later taking the company public, remains as chairman of the board of directors and Chief Executive Officer (CEO). Even though the total capitalization of EEI is only \$200 million, there is a full complement of executives including president, chief operating officer, chief financial officer, chief information officer, and general counsel. EEI decision-making appears to be based on perceived benefit of executive management. There is no mission statement or strategic plan for the company. Strategic decisions are made with the stated intention of maximizing stock value although it appears many such decisions are also made with the intent of ensuring that the CEO maintains his position in the company. The compensation level of executive management is approximately 25% above the norm for companies of comparable size. Neither the company nor its management participates in any civic or philanthropic activities.

Ira Simon met Billy Meacham when Ira was struggling to get on his feet financially with his new company (EEI). Since that time they have remained fast friends and have belonged to the same social circles for decades. They occasionally get together for dinner, drinks and discussions about various topics. Meacham owns several automobile dealerships in the Los Angeles area. Meacham was one of the early investors in EEI and still owns 1,000,000 shares (<2%) of EEI stock.

Boyd Ashcroft has been a very successful business man, owning several local franchise restaurants. Ashcroft and Meacham, in addition to their respective individual businesses, had formed a partnership, B & B Partners, to facilitate other investments. Fifteen years ago B & B Partners loaned \$2,000,000 to EEI when EEI was experiencing a cash crunch. Twelve years ago EEI repaid the \$2,000,000 plus interest to Ashcroft as instructed by B & B Partners as payment in full. Unfortunately, Ashcroft was experiencing financial difficulties and did not remit to Meacham as agreed. Meacham sued Ashcroft, but was unsuccessful in collecting any award. Meacham then sued EEI for one-half of the amount, \$1,000,000 plus interest, and litigation has been on-going for the last 10 years. EEI's general counsel, Rick Turner, indicated on multiple occasions that there was a high probability that EEI would win the case based on his assessment and that of outside counsel.

In the last quarter of 2008 the U.S. economy was under severe stress with record unemployment, massive financial institution failures, and near trillion dollar federal "bailouts". The domestic auto industry was on the verge of bankruptcy due in no small part to sales declines of forty percent or more. As a result, Billy Meacham was experiencing financial setbacks unimagined just months prior and stood to lose virtually all the personal wealth he had amassed over his lifetime.

At the beginning of December 2008, Simon called Chris Meyers, a Certified Public Accountant (CPA) and the CFO (Chief Financial Officer) of EEI, and Rick Turner, the general counsel, into his office on a Monday morning. Simon provided the two with a brief overview of the history of B & B Partners' dealings with EEI, including recent settlement discussions between Simon and Meacham. Then he directed Turner to write up an agreement between EEI and Meacham effectively ending the ongoing litigation in return for a \$50,000 cash payment from EEI to Meacham. Meyers was concurrently directed to issue a check for \$50,000 to Billy Meacham. Turner and Meyers expressed severe reservations to Simon since all indications were

that the litigation may well have been near final resolution in the judicial process. Simon ended the exchange by saying it was a business decision he made to end the litigation and put an end to the ongoing legal costs. Legal costs to date were approximately \$20,000 an amount which EEI stood to recover if the judicial outcome was favorable to EEI.

After a lengthy discussion Meyers and Turner scheduled another meeting with Simon on Tuesday morning to discuss the proposed Meacham settlement. Meyers and Turner presented what they believed were well reasoned arguments as to why the proposed settlement was not advisable. Simon was unmoved and reiterated his position that he was making a business decision that, in his opinion as CEO, was best for all concerned.

Meyers is very uncomfortable with the decision made by Simon and is considering taking the issue to the board of directors. However, the board members were all handpicked by Simon and are unlikely to risk opposing their benefactor. Each board member receives \$25,000 for each of the four one-day board meetings they attend annually. Additionally, only one of the nine board members (an attorney) is sophisticated enough in business dealings to understand the potential ramifications of Simon's actions.

THE TEACHING NOTE

This case is appropriate for use in undergraduate business ethics courses, legal environment of business courses, business law courses, or undergraduate/graduate accounting courses. This case deals with issues of corporate governance, management indiscretion or perhaps managerial malfeasance relating to a public company all in an ethics setting. The write-up of the solution to this case is also a useful vehicle for student preparation of either a professional memo or an executive summary. Both provide reinforcement of technical writing skills.

CASE QUESTIONS

Although not included in the body of the case, to allow instructor discretion regarding guidance, the following six questions can be provided to student users of this case. This provides a more structured approach which may be appropriate for undergraduate students.

- 1) What are the facts relating to the proposed settlement?
- 2) What don't you know that would be helpful?
- 3) If there is an ethical dilemma what is it?
- 4) Who are the stakeholders in this situation?
- 5) What are the alternatives?
- 6) What is the best alternative for Chris Meyers?

THE CASE SOLUTION

1) What are the facts relating to the proposed settlement?

The following facts can be identified: (a) there was a loan made to the corporation; (b) the loan was made by a partnership that consisted of one minority stockholder and one non-stockholder; (c) the corporation paid back the loan to the partner who was not a stockholder in the corporation; (d) the partner receiving payment did not share the proceeds with his partner; (e)

the unpaid partner, who also is a stockholder in the corporation, sued the corporation; (f) after ten years of litigation, the Chief Executive Officer (CEO) of the corporation decided to offer a settlement.

2) What don't you know that would be helpful?

It might be helpful to have answers to the following questions: (a) Are Meacham and Ashcroft a true legal partnership? What is the nature of their business? If they are a partnership, what does the partnership agreement say about this sort of issue? If the partnership agreement is silent, does the state law address disputes amongst partners in this type of situation? If so, what guidance does it give? Did the loan come from the partnership or from the two individuals acting outside of the partnership? How was it documented to make sure it was not a partnership loan if it was not meant to be? (b) Is the \$50,000 a proposed settlement offer or is it the result of some negotiation between Simon and Meacham? (c) What was the procedural history of this dispute? Were there early attempts at negotiation, mediation, arbitration, etc.? (Note: It is our understanding that there were no earlier official attempts to negotiate or settle). (d) What are the terms of the release of liability? (e) Why did Simon choose to offer a settlement (or agree to a settlement) when the litigation was near its end? (f) Was there a stock buy-back program approved by the board?

3) If there is an ethical dilemma what is it?

The main ethical dilemma in the case deals with Meyers. Is it ethical for a Chief Financial Officer, Certified Public Accountant (Meyers) to cut a check for an agreement made under the circumstances listed above without approval from the board or the stockholders? Additional ethical dilemmas to discuss include: Is it ethical for the CEO of a corporation (Simon) to offer a settlement to a friend in need when it appears that a dispute between the corporation and the friend will be resolved in the corporation's favor? EEI: Is it ethical to pay \$100,000 for board members to attend four meetings per year? Is it ethical to have a board that lacks sophistication regarding corporate business dealings?

4) Who are the stakeholders in this situation?

At least eight stakeholders can be identified, they include: (a) Chris Meyers and his dependents; (b) Ira Simon; (c) Billy Meacham; (d) Rick Turner; (e) Other management personnel of EEI (President, Chief Operating Officer, Chief Information Officer, etc.); (f) Board of Directors of EEI; (g) Stockholders of EEI; (h) Potentially Boyd Ashcroft (if he was a party to the litigation which he should have been)

5) What are the alternatives?

- A. Write the check on the orders of the CEO
- B. Tell the CEO that you need to run something like this past the Board or the Stockholder
- C. Refuse to write the check and resign
- D. Buy back Meacham's stock (If EEI has a stock buy-back program in effect at this time and Meacham was to request that EEI purchase his shares. It should be noted that EEI cannot

- make an offer to acquire Meacham's shares since to do so would likely be considered a tender offer by the SEC which raises multiple legal issues beyond the scope of this case.)
- E. Try to convince Simon that it is not in the best interest of the company to settle with Meacham by looking at the public relations aspects of the settlement. Point out how bad it might look.

6) What is the best alternative for Chris Meyers?

This response depends on the objective of the instructor. For example, using this case in an accounting course to familiarize students with the American Institute for Certified Public Accountants (AICPA) Code of Professional Conduct will provide one response. Alternatively, if the instructor wants the students to do a thorough ethical analysis different responses will likely surface.

EVALUATING ALTERNATIVES WITH THE COVER MODEL

For the analysis of alternatives the 'Cover Model' for ethical decision-making by Mitchell and Yordy (2010) is used. This model incorporates many of the ethical theories found in business ethics textbooks and asks students to examine an ethical dilemma from multiple perspectives to achieve a well-reasoned answer. As such, the remaining discussion in the teaching note examines the previously stated alternatives (A-E) using each of the five components of the Cover Model (i.e. code, outcome, values, editorial, and rules analysis). If the instructor wishes, it is appropriate to select one or more components of the Cover Model while eliminating others. For example, they could have students focus on values analysis and editorial analysis when examining alternatives and determining the best course of action for Chris Meyers. Although not included in the teaching note, additional solution models that may be more familiar to the instructor are also appropriate.

CODE ANALYSIS

The Code Analysis requires students to look at any codified behavioral guidelines such as statutes, regulations, or codes of conduct or ethics (profession, industry or company specific). In this section, students would examine the alternatives (A-E) from case question 5, in relation to any relevant codes.

A. Write the Check

Statutes and Regulations. There generally is nothing illegal or in violation of regulations in settling a lawsuit and writing a check to the other party as directed by one's superior. Assuming that the payment will be accurately reflected in the financial statements, there is no violation of the Sarbanes-Oxley Act.

In law, the duty of care and a duty of loyalty are imposed on officers and directors of corporations. As CFO, Meyers is most likely subject to those duties. The duty of care requires an officer to act as a reasonably prudent officer would act, investigating alternatives and making a reasonable (not perfect or best) business judgment. The duty of loyalty requires that the officer not serve two masters. In this case, Meyers probably is fine writing the check as there is

uncertainty in whether the law suit will be won. There is an argument that Simon will be violating the duty of loyalty since he appears to be putting friendship before the best interest of the company.

AICPA Code of Professional Conduct. (a) The AICPA Code of Professional Conduct espouses certain values. One of these, integrity, looks at what is “right or just.” (Conduct section 54.03). Writing the check to Meacham when there is a high probability that EEI will win the lawsuit and recover all costs may be seen as a violation of this principle. At the same time, there never is certainty in lawsuits and EEI may lose and owe Meacham \$1,000,000. (b) While there are no indications in the case that Simon intends to obfuscate settlement of the litigation in the financial statements, Meyers should be careful that the settlement is appropriately disclosed in those statements. (AICPA Code of Professional Conduct section 102.02).

State Law. Students should do some investigating based on the particular laws of the state. For example: (a) Section 8.42 of the American Bar Association (2003) Model Business Corporations Act (3rd edition) states,

“An officer shall discharge his or her duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the officer reasonably believes to be in the best interests of the corporation. The officer is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by either: 1. One or more directors, officers or employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented. 2. Legal counsel, public accountants or other persons as to matters the officer reasonably believes are within the person's professional or expert competence.”

(b) See also, Arizona Revised Statutes, Section 10-842 (Arizona’s codification of the Model Business Corporations Act, Section 8.42).

B. Board Approval

Tell Simon that he must receive Board approval. For this situation, one must look to the Bylaws of the organization. If the bylaws do not require clearance of the board for checks of this magnitude, or clearance of any legal settlement, then there is probably not a good basis for this request.

C. Refusal – Resignation

Meyers can refuse to write the check and/or resign from the company. There is nothing in the code to prevent this alternative although there will likely be negative consequences for Meyers

D. Buy-Back Meacham’s Stock

If there is a stock buy-back program, propose that the corporation offer to buy Meacham’s stock at market value if the CEO’s purpose is to provide cash to Meacham.

Rule 14(d) 10 of the Securities Exchange Act of 1934, sometimes referred to as the “All holders best price rule,” precludes offering to buy a stockholder’s shares unless the same offer is made to all stockholders of that class of stock.

There may be fraud issues. For example Section 44-1991 of the Arizona Revised Statutes states,

“It is a fraudulent practice and unlawful for a person, in connection with a transaction or transactions within or from this state involving an offer to sell or buy securities, or a sale or purchase of securities...directly or indirectly to do any of the following: 1. Employ any device, scheme or artifice to defraud. 2. Make any untrue statement of material fact, or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. 3. Engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit.”

E. Convince Simon

Try to convince Simon that the proposed settlement is not in the best interest of the company by looking at the public relations aspects of the settlement. Point out how bad his proposed action might look even though there is nothing illegal about persuasion.

Code Analysis: Conclusion

The result of this analysis is that there is nothing legal or codified to prevent Meyers from pursuing any of the alternatives unless it entails the purchase of Meacham’s stock. Even so, students may wish to eliminate the stock buy back plan as impracticable.

OUTCOME ANALYSIS

The Outcome Analysis is centered in the ethical idea of Utilitarianism. In this analysis students do a cost/benefit analysis of each alternative as indicated in Table 1 (appendix). Students must determine which alternative has the higher positive net impact. Again, students may wish to eliminate the stock buyback option at this point due to the significant risk involved.

VALUES ANALYSIS

The Values Analysis is based in values ethics. For the purpose of business ethics, students look to evidence of the company’s values to determine if the alternatives are in line with those values. That evidence typically comes in the form of Mission Statement and company culture. The values of EEI are stated in the text of the case: decision-making at EEI tends to reflect a protective stance toward existing management. There is no mission statement or strategic plan.

A. Write the Check

This option will allow Simon to move past the issue and put some closure to it. Lack of attention to continued litigation may protect his position. From Meyers’ perspective, this option

is uncomfortable based on his personal ethics and it may be reason to evaluate the person/organization fit.

B. Board Approval

Tell the CEO that you need to run something like this past the Board or the Stockholders. Simon won't like this option as he is more likely to feel his position is at risk. In addition, the Board may buy into the culture of protecting the CEO and so will automatically approve his actions. On the personal side, this may allow Meyers to feel like he has done all he can do.

C. Refusal - Resignation

Refuse to write the check and resign. This won't have negative consequences for Simon. He will find someone to replace Meyers who will write the check. From Meyers' point of view, this may allow him to walk away feeling guilt free.

D. Buy-Back Meacham's Stock

Propose that the corporation offer to buy Meacham's stock at market value if Simon's purpose is to provide cash to Meacham. Simon may be willing to do this as it makes the settlement look like a legitimate business transaction while protecting his position as CEO. At the same time, there are significant business risks (as they would have to make the same offer to all shareholders or risk SEC censure).

E. Convince Simon

Try to convince Simon that it is not in the best interest of the company to settle with Meacham by looking at the public relations aspects of the settlement point out how bad it might look. Simon will have to weigh the negative publicity associated with "cronyism" with the negative publicity of ongoing litigation. If Meyers can be persuasive, this would be in line with the company culture of protecting the CEO.

Values Analysis: Conclusion

The result of this analysis will depend in part on the class's vision of the company values and any discussion of person/organization fit. To stay true to the company's values and yet be true to his own values, Meyers should first try to persuade Simon not to issue the check. A second option to discuss seriously with the class is the issue of Meyer's resignation.

EDITORIAL ANALYSIS

This analysis asks the students to take any negative publicity from the cost/benefit analysis (or brainstorm for negative publicity effects if it did not come out in the Outcome Analysis) and apply the values to those effects. It asks, "For each alternative, what is the negative publicity effect and how does the decision-maker feel about addressing that effect?"

A. Write the Check

Negative publicity could focus on the duty of loyalty and duty of care problems of the CEO and the blind following by the CFO. Per the statement of the case, Meyers is not comfortable with this situation and having to defend that position.

B. Board Approval

Tell the CEO that you need to run something like this past the Board or the Stockholders. Chances are good that there would be no negative publicity effect here. But if this alternative is selected and the Board approves the payment, the negative publicity may focus on the duty of loyalty or care problems with Simon selecting the Board. The media may focus on the attempt to create a false appearance of fairness. Again, Meyers may not be comfortable facing the stockholders and analysts to defend a decision to issue a check to Meacham after consulting a clearly biased board.

C. Refusal-Resignation

The resignation of a member of senior management always brings close scrutiny by investors and analysts. This scrutiny would likely discover the reason for the resignation possibly leading to significant negative publicity for EEI. Although it is unlikely that Meyers would be viewed negatively by stockholders or analysts, he may have a difficult time finding another CEO that would hire him. If Meyers refuses to write the check, and it leads to continued litigation and a subsequent loss by the company requiring a \$1,000,000 payment, the negative publicity would be significant.

D. Buy-Back Meacham's Stock

Propose that the corporation offer to buy Meacham's stock at market value if Simon's purpose is to provide cash to Meacham: The negative publicity here would focus on the personal relationship of Meacham and Simon. The negative publicity for Meyers may be minimal but he would be associated with a company where this relational decision-making is accepted. There may be further negative publicity related to violation of SEC rules if the offer is only made to Meacham.

E. Convince Simon.

Try to convince Simon that the proposed settlement is not in the best interest of the company by looking at the public relations aspects of the settlement. Point out how bad it might look. Meyers would try to use the editorial analysis to convince Simon that the decision is not a good one. If Meyers attempts and fails, then writes the check, the negative publicity would relate to his knowledge that it was a poor decision (in the eyes of the public) and yet he acquiesced in the end.

Editorial Analysis: Conclusion

The result of this analysis will depend in part on Meyers' personal values. Students should discuss their own values and which alternative they would feel most comfortable defending if they found themselves in Meyers' circumstance.

RULE ANALYSIS

Rule Analysis is based in Kant's categorical imperative and asks, "What would the world be like if everyone made the decision I am about to make?" The key to this analysis is that this does not allow anyone to minimize his or her impact.

A. Write the Check

Meyers can write the check on the orders of the CEO. If everyone in Meyers' situation wrote the check, it could erode what little faith Americans have in corporations. There would be a perception that all corporations are out to benefit the friends of the corporate leaders to the detriment of the shareholders.

B. Board Approval

Tell the CEO that you need to present something like this to the Board or the Stockholders. If all CFOs approached uncomfortable decisions in this manner, it could lead to a re-evaluation of corporate decision-making to clarify what the Board or shareholders need to see. It also could create more distrust between the CEO position and the financial positions within corporations resulting in less efficient operations.

C. Refusal – Resignation

If all CFO's in similar situations refused to write the check, it could improve corporate stewardship.

D. Buy-Back Meacham's Stock

Selective repurchase of stock to settle unsolidified but potential debt could result in a lack of trust in corporate America. Additionally such action appears to be in violation of SEC rules.

E. Convince Simon

Try to convince Simon that settlement is not in the best interest of the company by looking at the public relations aspects of the settlement. Point out how bad it might look if all CFO's attempt to persuade their CEO's to take various courses of action because of perceived ethical problems. It could result in CEO's hiring less ethical-focused CFO's or it could result in more vibrant discussion among corporate leadership as leaders seek to make the best decisions for the corporation.

Rules Analysis: Conclusion

Students will have to look at these globalized effects and determine under a values-based approach which alternatives result in a better world and which in a worse world.

EPILOGUE

The first thing that Meyers did was contact the law firm that provides advice to EEI regarding SEC matters to determine his obligations under the Securities Act of 1933, the Securities Exchange Act of 1934, and subsequent rules and regulations. The response he received from the engagement partner was “you have met your obligations under the Acts and other than making the necessary disclosures of the settlement in the appropriate SEC filings you have no further legal obligations”.

Two days after directing the CFO and general counsel to draw up the agreement and issue the check, but prior to executing the agreement and paying Meacham, EEI receives a summary judgment from the court. This court action absolves EEI of any obligation to Meacham and allows EEI to seek \$20,000 reimbursement from the partnership for legal fees. Simon was visibly upset at this turn of events and instructed general counsel to drop the issue and not seek reimbursement.

REFERENCES

- AICPA Code of Professional Conduct: Section, 54.03.
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Arizona Revised Statutes: ‘Fraud in Purchase or Sale of Securities’, Sec. 44-1991.
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Sarbanes-Oxley Act: 2002, Public Law 107-204.
Securities Exchange Act: 1934, Rule 14(d) 10.

Table 1
OUTCOME ANALYSIS

ALTERNATIVE	PROS	CONS
Write the check on the orders of the CEO	It is easy It ends the dispute Meacham and Simon are happy	The shareholders may not be happy There may be negative publicity as it appears Simon is benefiting his friend
Board approval Tell the CEO that you need to present something like this to the Board or the Stockholders	It may be easy as Simon may be amenable to it No negative job consequences for Meyer	Board picked by Simon so it is doubtful they would oppose him on this and it may just be an exercise for appearance's sake. May alienate or anger Simon
Refuse to write the check and resign	If it is consistent with Meyer's values, then he hasn't violated his personal ethics	Someone else may eventually write the check. Meyers is out of work – may have dependents and/or debt Such an action may alienate him with other public company executives
Buy back Meacham's stock at market value to provide cash to Meacham.	May meet the needs of Meacham without the appearance of impropriety	Does not resolve the dispute and company may still lose and owe Meacham money. This action, if proposed by the company, will likely be perceived by the SEC as a violation of Rule 14(d) 10, which would create serious problems with this regulatory agency as well as potentially other stockholders.
Convince Simon it isn't in the best interest of the company.	Helps Simon see the bigger picture and make informed choice.	May have negative job consequences for Meyers in the future. May not be effective if Simon is intent on helping his friend.