Quandary at National Health Company

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Case ID 040801

Abstract

National Health Company (NHC) became one of the nation's leading providers of healthcare during the early 2000s, through aggressive mergers and acquisitions. The company provides both in and out patient care such as convalescent care, rehabilitation, physical therapy, outpatient surgical centers, ultrasounds, mammograms, MRI's, CT scans, and other medical services. The company's rapid expansion initially resulted in a substantial amount of profit and success in the healthcare market. However it became increasingly difficult to maintain the growth and expansion in light of the economic climate, continued pressure from Medicare, the insurance companies to cut costs, competition from other health field carriers and the concern over potential government funded health care programs. As the NHC's management failed to sustain the expected growth, its management resorted to other strategies that not only maintained the expectation of its shareholders, but would also allow management to keep their extravagant life style.

In this case, we will follow the struggles and anguish faced by Karen Larson, NHC's Chief Financial Officer, as she battles her way through making the right financial and corporate governance decisions and not to allow herself to be allured, by fancy titles, avarice and greed as well as upper management pressure placed before her. We will present not only the decisions she has to make but also the outcome of her decisions.

Background

National Health Company (NHC) is one of the nation's largest providers of healthcare. It is ranked in the top ten nationally in terms of size and revenue. The company reached its ranking by expanding rapidly through aggressive mergers and acquisitions throughout the late 1990's through the 2006. The company had 50 facilities across the nation in 1990. By 2006 the company had purchased another 28 hospitals and 45 outpatient rehabilitation facilities from National Health Enterprise. In 2003, NHC purchased ReLive, a major healthcare chain. In 2005, NHC acquired Medical Surgical Corporation, Novacare, Health Imaging, Horizon and several other healthcare providers, with acquisition costs totaling approximately $2.5 billion. The buying binge positioned the company as one of the major players in the healthcare industry.

As the expansions continued, the NHC's stockholders became accustomed to a period during which they enjoyed double digit growth rate in their investments. Yet, once this growth began to truly slow down, management and Karen Larson, NHC's Chief Financial Officer ("Karen") did not pay any heed but instead took various steps to ensure that the price of the stock would continue to soar.

In December 2008, Karen was celebrating a triumphant moment in her career. She had been made the CFO in a company she loved. For Karen, this moment did not come soon enough. For 20 years, she had set her sight on this position. She had toiled in the trenches, putting in long hours and sacrificing even her vacation time in hopes of attaining her dream job. Achieving this position was a fitting culmination of her years of dedication. It was a richly deserved reward that she cherished and relished. Now Karen was too pre-occupied with her thoughts. As she sat huddled in the corner of her dark prison cell, surrounded by belligerent, mentally unstable inmates, Karen Larson's mind could not help but revisit the fateful day when her plunge from the

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lofty perch in a major corporation to the bowels of prison began. Painfully, it was time for her to trace back her steps to what had brought her here.

The Plan

No sooner had Karen settled on her new position, when her troubles started. Approximately nine months into her new job, Karen Larson was lying awake, sleepless and listless on her bed. Her thoughts wandering around the meeting she had earlier in the day with several other members in upper-level management. George Dawson ("George"), the CEO of the company had gathered all the members of upper-level management with direct relations to the finance and treasury departments. George had started the meeting with a speech about how proud he was to be working with such trustworthy and loyal associates, and how he was very fond of everyone and how they were all like family to him. After George's welcoming introduction, the real topic of the meeting came into play. George stated that, "I'm sure you're all aware of our current financial position as a company." Karen and everyone there nodded with the understanding of his statement. He continued, "This recent quarter has been very bleak, the bleakest one this company has ever seen in its history." Everyone continued to nod in agreement with his words. George went on, "However, I believe our company can pull through this stumble. All I ask is a small favor in order to bring the company to new heights." A deep silence swept across the room in the anticipation of his next words. "All I ask is that we hide the stumble we had this quarter from the public. Not everyone in the public might agree with our strengths and abilities. And if word got out that we the giant in the healthcare industry was faltering, it would hurt the company as a whole. And we wouldn't want that now would we?" Whispers started out among everyone all at once, at the notion of what was being asked of them. George, the CEO of the company, the one that she had looked up to, was asking her and everyone else in the room to commit fraud and falsify the accounting books and records. George started to silence the whispers, as he continued, "I will hold personal responsibility in this act and request. All I'm asking for is to make this one quarter look positive to the eyes of the public. And next quarter, I'll ensure the company truly has a positive quarter. I'll let you all think it over for a few days, and we'll continue this meeting then."

Over the next several days Karen agonized over the decisions that she was going to have to make, yet there were so many unanswered questions. These questions continued to spin in her mind. Was she really a part of the play to deceive the public? And if she wasn't, should she tell someone about the company's wrongdoings and the CEO? She thought about the sincerity of George Dawson when he stated that he would bring the company into positive cash flow over the next quarter, in line with the financial markets expectations. Then she thought about all her fellow associates, all of her friends and all of the people who worked under her. She had been working for NHC for over 20 years, she had worked hard and diligently to gain her last position as Chief Financial Officer. She had also worked hard to gain the trust and loyalty of her fellow associates. However, what the members of top management had asked her to do against the oath she had sworn when she became a CPA, and her fiduciary duties as one of the officers in the company. It also went against the very morals and fibers of her upbringings and had left her in utter turmoil. She continued to ponder. What would have been the outcomes if the company had reported a loss? What would have been the outcomes if she and those involved did not get caught in the fraud they were about to commit? What was she going to do?

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The Afterthought

A debate raged in Karen's head. She thought if she agreed to commit fraud then the company would have no reason to lay off any of their workers. All of the jobs would be saved. But then what if the jobs were saved but the investors lost their money? She shook the thoughts out of her head. It was only going to be this one quarter, as far as she could tell and dared to believe and hope for. She convinced herself then that agreeing to commit to the act would be the best course, especially if everyone else in the meeting agreed to it. She didn't want to be the outcast, nor did she want to disappoint everyone. She didn't want to constantly have to look over her back with all the ridicules about why she didn't go along with the decision. And she definitely wasn't going to tell anyone for fear of losing her own position in the company; the position that she had worked so hard to achieve. Karen had finally decided that she was going to accept the CEO's plea.

The next meeting took place around October of 2009. The meeting room was quiet. All her fellow upper management associates looked tired, as if they too didn't get very much sleep the last few days. But they also all had a stern look; she could tell that everyone else probably went through a similar ordeal to her own. She could also see in their eyes, as they waited for George, that they were all going to agree with what George had proposed a few days earlier.

As George walked through the doors of the meeting room, he was quick to notice the deadly silence, and was quick to break it and get down to business. He asked, "So has everyone come to a decision?" They all nodded their heads. "What is it then?" George asked, "Are you with or against me?" A short silence fell over everyone, as no one seemed willing to be the first to admit to conspiring to the devious plan. Then Patricia Kim the corporation's in-house counsel stood up and gave her answer, "I agree to your idea George and stand behind you and your decision all the way." At that moment, everyone else was quick to chime in with similar affirmations.

The rest of the meeting went into a discussion of how they were going to hide this from the public and cover their tracks to make it difficult for an auditor to find the deception, if one ever came to investigate. The plan that they came up with was to decrease a contra asset account as well as the expense accounts, either of which would increase earnings and correspondingly the assets. In addition, they were going to create fictitious journal entries to correspond with the generally accepted accounting principles. Furthermore they were going to create false documents to support the bogus accounting entries.

After the meeting adjourned, George came into Karen's office and said "we are going to be reporting all of this additional income and with the capital gain NHC had from the sale of an asset this year, I am concerned about the inability from a cash flow standpoint for NHC to pay its corporate income tax. We need to find a way to offset the company's potential tax liability, which in part was due to a large capital gain from the sale of an asset and I would like you to consider some of the tax shelters out there." Karen wanting to help out George came across a tax shelter, called "Son of Boss", [1]which was designed to reduce capital gains. The transaction is a

[1] "Son of Boss" tax shelters were designed to reduce federal income tax obligations from the sale of a business or other appreciated assets. Assume that the statute of limitations was not an issue, as in the Supreme Court case of *U.S. vs. Home Concete & Supply, LLC, 566 U.S.___(2012).* Assume that our client's executive offices are located

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"listed transaction" with the IRS. However, George had made it clear that it was necessary to defer any immediate issues with their taxes with the Securities and Exchange Commission (SEC) or the Internal Revenue Service (IRS) and requested that Karen not file the listed transactions form with the IRS. Karen complied with this request in order to please her boss.

The Aftermath

The plan went off without a hitch. Everything had gone according to plan. However, the next quarter rolled by and passed rather quickly and still George didn't or couldn't hold up his end of the bargain. They all held another similar meeting, and George asked to continue the plan for another quarter. One quarter after another came and passed with no end to the accounting and financial subterfuges insight. Then one day, rather unexpectedly and without discussing it with anyone, George sold his stocks of NHC.

Even though NHC's business was supposedly booming, the first of National Heath Company's accounting problems started to surface in late 2010 after George sold $85 million in stocks several days before the company posted a large loss, the first in the company's history. The SEC started to investigate whether or not George's decision to sell his stocks was related to the posting of a large loss. NHC hired an outside law firm to review George's stock sale in order to try to postpone the SEC's investigation. The outside law firm concluded that the sale and profit loss were not related. This however did not ease the SEC's suspicions. The SEC not only looked into the stock sale but began examining the books and records of the company along with the FBI. As the investigations progressed, various employees were interviewed, including Karen. The FBI and the Department of Justice met with Karen and offered her a reduced sentence if she would come clean with what she knew. On the evening of June 13, 2012, FBI agents executed search warrants at the company's headquarters after the company's CFO Karen agreed to wear a wire, in which she was able to get George to talk about the fraud.

A number of months thereafter, the Federal Grand Jury issued indictments against all upper management, including Karen for committing fraud, for falsifying NHC's books and records, and for aiding and abetting to defraud shareholders. Now, less than a year later, Karen agreed to a plea deal in which she would be sentenced to 18 months in prison and a fine of $500,000 in return for her cooperating with the government. Had she not cooperated with the government she could have received 10 years.

As Karen Larson sat outside the courtroom waiting to testify for the government against George, the government's first defendant, she began to recollect her thoughts on her misguided actions and the ordeals she would now have to go through. She no longer was a CFO, she no longer had a job, she lost her CPA license, she lost her right to practice before the IRS, she was facing 18 months in prison and when she get out of prison, she could look forward to repaying $500,000 in restitution.

What could she have done to avoid these problems, especially of the devastating pitfall of languishing in prison for 18 months? How she could be so foolish, Karen muttered to herself in retrospection. What was she thinking? How could she possibly believe that the fraud would

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in Texas in which is a 5th Circuit case, *Klamath Strategic Inv. V. U.S.* 568 F.3d 537 (5th Cir. 2009), held that the transaction lacked any economic substance and was nothing more than a sham.

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only last a quarter? George was a human, not a god. Karen sighed deeply. She had allowed herself to be deceived. She had been myopic to think that she could save her own skin and her colleagues' jobs through fraud. Perhaps now, Karen thought bitterly, she would be able to clearly discern her misguided actions to ensure that she never acts in that manner again. With at least another year of her life devoted to testifying on behalf of the government against other defendants with respect to the fraud committed by NHC and its officers and directors and 18 months of prison time yet to serve, Karen will certainly have sufficient time to dwell on all her missteps.

Questions for Discussion

1. What are the laws governing the proper practice of accounting and finance?
2. What are the protections afforded to a whistle blower?
3. What are Karen Larson's fiduciary duties toward the company as vice president to the CFO?
4. Aside from participating in the scheme, what are Karen Larson's other options in face of the dilemma?
5. What are the pros and cons of each of her options?
6. May the IRS impose a tax preparer penalty under IRC §6694?
7. Has the Corporation violated any of the tax laws where the IRS could impose a penalty? If so, under what sections of the Internal Revenue Code?
8. What ethical duties were violated by Karen under the AICPA Statements on Standards for Tax Services as well as those set forth under Circular 230?

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