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December 10, 2017

Mr. Brown
President Topper Glass
890 Auraria Parkway
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Dear Mr. Brown,

Thank you for providing me the opportunity to research the appropriate response to Mr. Pederson's actions. Enclosed is my final report, "Recommended Response to Unauthorized Employee Loan." Within this report, you will find my recommendations for the company's response, disciplinary action, and changes to policy to mitigate future incidents.

If you have further questions or require any assistance, please contact me.

Respectfully,

Student

NOTE: Figures 1, 5, and 6 have been removed from this example.

Recommended Response to Unauthorized Employee Loan

for
Mr. Brown
President, Topper Glass

by
Student
Legal Department, Topper Glass

December 2017

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Abstract

This report provides an analysis and evaluation of the recent actions by Mr. Pederson, VP of Sales and Marketing, in regard to his borrowing of \$15,000 from the company and repaying the money in one month without interest. Methods of research included analysis of the corporate records regarding Mr. Pederson's employee history, analysis of the company's responses to incidents in the past, analysis of legal ramifications, review of scholarly resources regarding executive loans, and consideration of risks to the company. Results of this research show that Mr. Pederson should be disciplined for his actions and corporate policy should be written to cover events that could occur in the future. The report will include suggested changes to corporate policy to avoid future incidents like this one and ensure employees are satisfied with the company's response to Mr. Pederson's actions.

EXAMPLE

Introduction

Topper Glass has no specific policy in place to respond to situations in which upper management borrows company funds for a personal loan, and pays the money back before the situation is realized, without the authorization of that executive's superior. This is inconsistent with what is seen in other companies of the same market value. It is also not consistent with other corporate policies which have been established in response to specific situations with employee actions. This report examines the appropriate response to Mr. Pederson's actions.

Background

In July of 2017, James Pederson borrowed \$15,000 in company funds to pay his personal legal fees. The money was repaid in August of 2017, without interest, and the company has experienced no specific financial loss. This has not occurred within Topper Glass management before and there is no specific corporate policy regarding the action that should be taken.

The company must respond to the concerns from employees in regard to Mr. Pederson's actions, which were unauthorized. See Figure 1 in the Appendix for results of an employee survey. The current employee conduct manual does not have any reference to situations in which upper management borrows, without authorization, funds from the company and pays the loan back. There are already existing policies for when an employee steals funds from the company, without paying the money back. This situation represents a set of unique circumstances and an opportunity to update employee conduct materials to reflect the appropriate expected behavior from managers within the company.

There is also a concern because of the laws regarding disguised compensation for corporate executives. This situation should be handled carefully to avoid legal ramifications for the company. Because of Mr. Pederson's relationship with the company, as VP of Sales and Marketing, and his relationship with the President, Mr. Brown, the optimal solution will maintain objectivity to avoid any challenges to the company's ultimate decision. The goals of this report

are to describe the situation, identify possible courses of action, recommend an appropriate action for the company to take, and to describe the best steps for implementing that course of action.

Methods

Analysis of current employee conduct materials, in the Employee Handbook, is necessary before implementing any changes to ensure cohesion and consistency in the expectations of employees. There are no specific references to this kind of situation; however, there are many policies that have been implemented as a result of past incidents. Articles regarding executive loans were examined to see how other companies respond to similar situations and to understand the results, including some from the New York Times. Also, IRS resources and materials regarding what is allowed and what is not for executive compensation are explored to ensure compliance with any laws or regulations. Finally, scholarly articles from various journals were examined that provide insight into why this issue is so tightly regulated, mostly as a result of the Sarbanes-Oxley Act of 2002.

Results

The dilemma

In recent years there have been a number of high profile cases of executives receiving loans from the companies they work for and that situation turning into a public relations problem for the company, or worse, a precursor to the company suffering financial meltdowns. Also, the SEC can take action against companies or executives who engage in misleading financial statements and disclosures. See Figure 2 in the appendix for a chart of SEC actions from 2013. This presents a problem for companies that rely on investor and market confidence to remain successful and profitable. It can also present a major legal vulnerability, as the employers who engage in executive loans and other forms of disguised compensation are secondary in legal responsibility.

According to David Leonhardt in "It's Called a 'Loan,' But It's Far Sweeter," which appeared in the New York Times, more than 25% of large companies give their executives loans (Leonhardt, 2002). This was before the passing of the Sarbanes-Oxley Act of 2002, but it represents a good account of why the legislation was passed and what issues were being addressed by the legislation. Tyco, a Bermuda-based company, had loaned one of its chief executives over \$88 million over the three years before the release of the article. After this information became more public, the company's stock has fallen about 40% as a result of concern over its accounting practices. In the same article, Leonhardt discusses how George W. Bush received a loan from his own oil company, at a discounted rate, to buy shares in a company that was involved in a merger with his own. Another company, Compaq, reportedly gave one of its executives a \$5 million loan with the restriction he must stay with the company for 3 years (Leonhardt, 2002). See Figures 3 and 4 in the appendix for a chart of other corporations' stock prices following large-scale financial fraud investigations.

The list of companies that Leonhardt describes as lenders for its executives has many more names. It is often the case that the borrower uses the money to purchase stock and then pays the money back. Almost all the situations are described as *with interest* and sometimes other stipulations like remaining with the company for a specific number of years. He also discusses companies which have had public failures like Enron, which provided an executive with a line of credit. These situations, as the author describes it, are "as unusual as it is dangerous" (Leonhardt, 2002). This is a large factor resulting in the passage of the Sarbanes-Oxley Act of 2002.

Related Party Transactions and Executive Loans

Related Party Transactions (RPT) can be defined in many ways, including loans, employment of relatives, and business transactions (Balsam, 2017). According to Balsam, this is after the Securities and Exchange Commission changed the rules of disclosure in 2006. The correlation between RPTs and CEO compensation was found to be not as strong, if existing at all, after the rules change. This includes situations when there is more than one RPT. Though Balsam does not analyze specifics for other members of a company's executive team, a small sample of CFOs indicated similar results.

In "A test of the loan prohibition of the Sarbanes-Oxley Act: Are firms that grant loans to executives more likely to misstate their financial results?", Cullinan, Du and Wright suggest that there is a relationship between the Act and the accuracy of financial reports (Cullinan, Du, & Wright, 2006). This act, which was largely a response to the Enron and WorldCom collapses, was meant to restrict loans to corporate executives. Some objections to the law suggested that because many loans are used to purchase stock in the company, it could potentially have a negative effect. However, in their research, they find "companies that granted loans to executives were significantly more likely to misstate their financial statements," which was a goal of the act (Cullinan, Du, & Wright, 2006). They highlight that the two biggest objections to corporate loans are that shareholders do not support them and executive loans were evident in some of the recent financial mistakes of large corporations. In their conclusion, they highlight that some companies which had engaged in large executive loans, had negatively affected many individuals' retirement, investment, and incomes.

These objections both show how the government saw issues with the way executives receive loans from the companies for whom they work. This was not just part of the government's responsibility to regulate, but also, because of the significant negative impact that these companies' financial insecurity had on their employees and the communities they serve. In the Cullinan, Du, and Wright article, the authors specifically say that companies that engage in executive loans are far more likely to misstate their financial situation. This is negatively viewed by many investors and employees of these companies.

In the article "Executive Loans," Kahle and Shastri find that loans that have lower than market interest rates and are usually used for specific purposes (Kahle & Shastri, 2004). The three most common reasons for these loans are to purchase stock, pay taxes and exercise contractual options, and to help with relocation fees. Of these three categories, none reference personal expenses which are not related to the company. They also discuss that many of the executives who receive these loans have a higher percentage of ownership. Also, "loans are, in general, used for the

purpose they were intended for," which means most of the loans were used to exercise options in the executive's contract and not for personal expenses (Kahle & Shastri, 2004).

IRS Rules

The IRS has specific guidelines for Corporate Executive Compliance. They understand that there is "multi-faceted tax implications for all forms of executive compensation"(IRS, 2017). This has an effect on both the employee receiving the compensation and the employers who pay the compensation. In their article "Executive Compensation – Fringe Benefits Audit Techniques Guide", the IRS provides specific guidelines for ensuring many forms of compensation comply with law and regulations. This article highlights that "loans to executives should be reviewed to determine if they are genuine and to determine if the terms are being followed." The IRS suggests that to be genuine, an executive loan should meet four requirements as follows (IRS):

1. The existence of a promissory note.
2. Cash payments made according to a specific repayment plan.
3. Interest should be charged.
4. There should be security for the loan.

There is still some concern about loan forgiveness which includes situations in which an executive is required to remain with the company for a period of time and the loan will be forgiven. Also, there could be concern about unusual repayment and extreme repayment date requirements. All of these are methods to disguise compensation, which is why they must be scrutinized to ensure compliance.

Perception of the Company

Since the unauthorized loan by Mr. Pederson, the employees of the company have been upset and their sentiment is that they want something done in response. See Figure 1 in the appendix for the result of an employee survey. There is general concern that because of Mr. Brown and Mr. Pederson's relationship, Mr. Pederson will receive special treatment. Also, there is concern that the company will suffer financial loss, either because funds are taken without authorization or investors will lose faith in the company. This can already be seen in the falling of the company's

stock value since a price of 18.65 before Mr. Pederson's actions became public knowledge. See Figure 5 in the appendix for a chart of Topper Glass stock prices in November.

Uncertainties and Possible Courses of Action

There is no guarantee that the company will suffer a similar incident in the future. There is also no certainty that the recent trends in stock value are a direct result of this incident. In the past, the company has always responded to the concerns of its employees and the employees have shown satisfaction with the fact that the company took action. Also, Mr. Pederson has been a member of the executive team for over 10 years and has shown commitment to the company and its employees. His personnel file has no negative letters or notes, and he has consistently received positive reviews by the Board of Directors for his time with the company. He has received a number of positive mentions from other executives and his subordinates. There is no question that he has been a positive member of the company's management and executive team.

It is possible that dismissing Mr. Pederson would show the employees that the President believes his actions to be unforgivable. It is also possible that his dismissal would send a stern and direct message that dishonesty is punishable. However, it does not lead to the company recuperating any of the potential financial loss from the borrowed money, nor establishing a clear policy for future incidents. The legal team believes that the company has not exposed itself to any federal penalties as a result of this event and that responding in a public and open way will avoid the potential for a future penalty. Also, firing Mr. Pederson could open the company to the potential of a lawsuit for unlawful termination, which should be avoided.

Conclusion

The unauthorized loan by Mr. Pederson has provided a situation that is both new and possibly damaging for Topper Glass. The company needs to keep its Employee Handbook up to date with regards to possible situations and problems that may continue to come up in the future. The likelihood of the same thing happening again in the future is unlikely; however, the possibility of

damage to the company's reputation and financial standings is a danger the company should not take, and a risk the employees should not have to suffer.

Recommendations

Topper Glass would avoid future risk by implementing a new Employee Handbook, which reflects the actions the company will take when an employee borrows funds without authorization. The need for this change is a direct result of Mr. Pederson's actions; however, because his situation preceded the changes, they would be subject to special consideration. A note in his personnel file, as well as a formal apology is consistent with how other companies responded to past incidents of employee misconduct. Additionally, he should be required to pay appropriate interest on the amount he borrowed. To respond appropriately, the company should follow these steps to implement the recommended course of action:

1. Mr. Pederson should be subject to an interest charge for the amount borrowed and for the appropriate number of days. The accounting department should be consulted to determine an appropriate interest rate. See Figure 6 in the appendix for a graph of the interest rate received by other parts of Topper Glass's holdings.
2. An agreement, describing the situation, resolution, and results of his actions should be placed in Mr. Pederson's personnel file.
3. Mr. Pederson should issue a formal apology to the company employees and investors, including a signed agreement that he will follow company policy in the future.
4. The company should revise its Employee Handbook, to which all employees are subject, to include the case of an employee borrowing money and paying it back in the same way as Mr. Pederson.

In following these steps, Mr. Brown shows no favoritism towards Mr. Pederson, establishes a company policy as a result of his actions, and shows fair and reasonable compensation to the company for whatever financial loss it may have endured. It also avoids the potential for litigation or financial penalties which could hurt the company's financial standing. We must

respond appropriately and make changes now to avoid future damage to the company's reputation and possibly its financial security.

References

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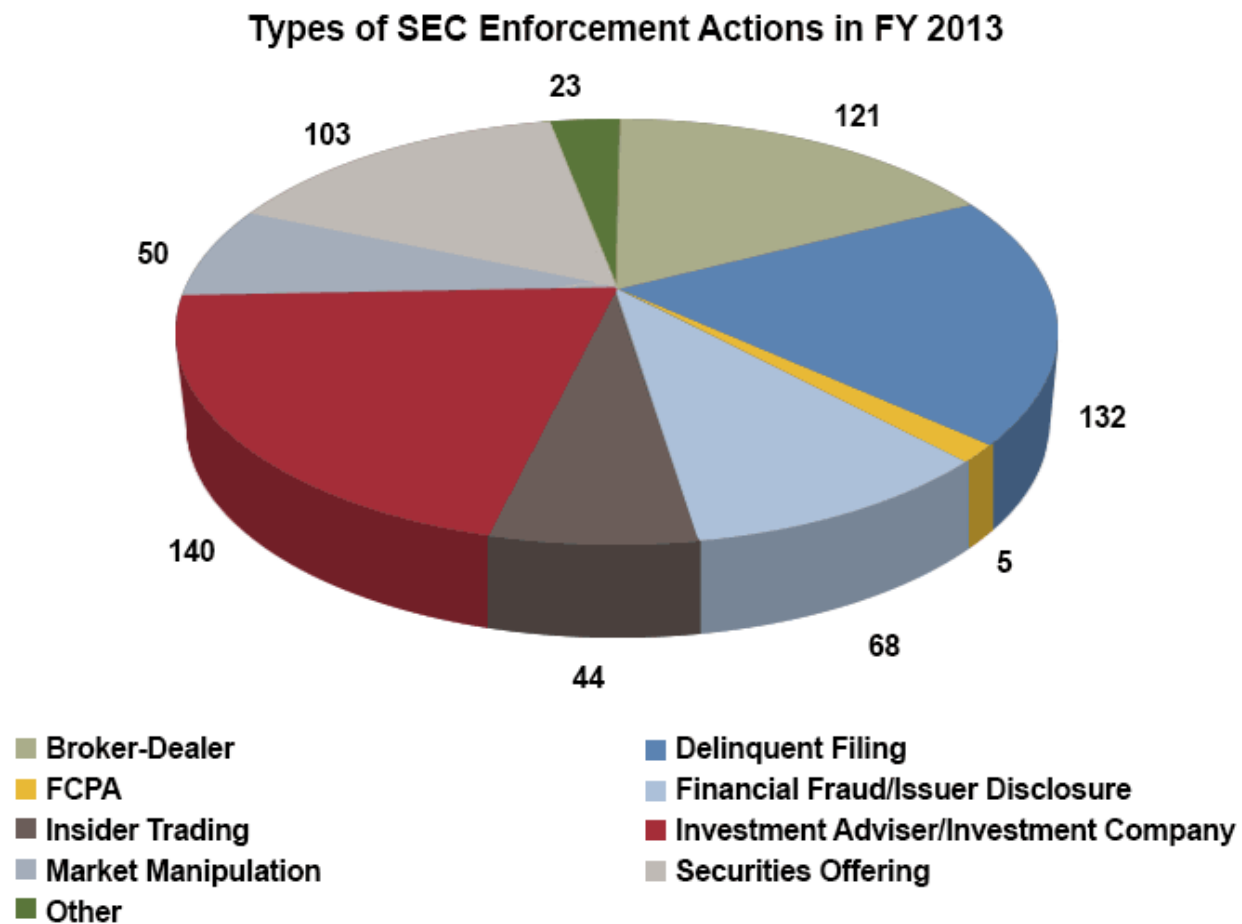


Figure 2: Types of SEC Enforcement Actions (2013). Source
<https://corpgov.law.harvard.edu/2014/03/03/sec-enforcement-year-in-review/>



Figure 3: WorldCom Stock Chart. Source
http://econc10.bu.edu/Ec341_money/Assignments/stories_fraud.htm



Figure 4: Enron Stock chart 1996-2001. Source <http://www.famous-trials.com/enron/1791-stockchart>