Summer 2017

A Case Study in Securities Law: SEC v. Baker

Edward J. Schoen
Rowan University, schoen@rowan.edu

Diane Y. Hughes
Rowan University, hughes@rowan.edu

Michelle Kowalsky
Rowan University, kowalsky@rowan.edu

Recommended Citation
Schoen, E. J., Hughes, D. I., & Kowalsky, M. A. (2017). A Case Study in Securities Law: SEC v. Baker. Journal of Legal Studies Education, 34(2), 273-315.

A Case Study in Securities Law: *SEC v. Baker*

Edward J. Schoen, Diane H. Hughes,** and Michelle A. Kowalsky* ***

I. INTRODUCTION

There are two overarching goals to this case study. First, the authors want to introduce students as early as possible in their study of business to the perils of deliberate misstatements of income in financial statement and the significant consequences that await those who do. Given the recent business scandals involving mortgage-backed securities and their contribution to the devastating 2007-2009 financial crisis,[1] the authors hope the significant penalties imposed on the executives in the ArthroCare Corporation may provide a lesson to students and perhaps dissuade them from engaging in security fraud activities in their careers.

Second, the authors seek to demonstrate to their students how the materials in Legal Environment of Business and Principles of Accounting I are interconnected. Introducing students to the illegal practice of "channel stuffing" not only makes the study of generally accepted accounting principles more understandable, but also shows that fraudulent violations of those principles can have profound legal consequence. The case study guides students through the multiple legal actions pursued by the Department of Justice (DOJ) and the Securities

---

*Professor of Management, Rohrer College of Business, Rowan University, Glassboro, New Jersey. Professor Schoen teaches Legal Environment of Business, a core course in the undergraduate business programs, and Professional, Legal and Managerial Responsibilities, a core course in the MBA program.

**Associate Professor of Accounting, Rohrer College of Business, Rowan University, Glassboro, New Jersey. Professor Hughes teaches Principles of Accounting I and II and Law for Accountants.

***Business Librarian, Rowan University, Glassboro, New Jersey. Librarian Kowalsky teaches information literacy skills in multiple disciplines to undergraduate and graduate students.

[1] *See* Edward J. Schoen, *The 2007-2009 Financial Crisis: An Erosion of Ethics: A Case Study*, J. OF BUS. ETHICS, February 23, 2016. This article was published with open access at Springerlink.com, http://link.springer.com/article/10.1007/s10551-016-3052-7.

Exchange Commission (SEC) against ArthroCare executives. Using the pleadings from these actions, students see firsthand how improper accounting practices and security law violations are deeply intertwined. Furthermore, the authors' experience as faculty members has taught them that many students approach their courses in the business curriculum as silos and too frequently do not appreciate their interconnectedness. By demonstrating how Legal Environment of Business and Principles of Accounting I reinforce each other, students will gain a deeper learning of the course materials and hopefully look for such connections in their other courses.

Part II of this case study provides a brief literature review that demonstrates the significant benefits interdisciplinary education, particularly the use of case studies, confer on students, by showing them that business challenges do not fall within a single business discipline and by assisting them to analyze complex problems as they are encountered in the field. Part III describes how business law professors can use the case study by partnering with accounting faculty members or simply using the case independently in their business law or legal environment courses. Part IV presents the case itself. The case begins with a description of the business of ArthroCare Corporation, a manufacturer of surgical devices, and its executive officers, and the scheme those officers executed to falsely inflate ArthroCare's earnings. The case next examines the criminal proceedings of the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) brought against those officers in response to their misstatements of earnings. The case finally examines the successful clawback action brought against those officers to recover their incentive-based compensation earned while ArthroCare's financial statements were noncompliant with financial reporting requirements.

Part V of provides discussion questions and suggested responses to assist the instructor and students in the exploration of several important provisions of securities law, such as the personal liability and clawback provisions of the Sarbanes-Oxley Act, the antifraud provisions of Sections 10(b) and 18(a) of the 1934 Securities Exchange Act, the liability of outside business organizations that assist executive officers to carry out their fraudulent scheme to misstate earnings, and the liability of the outside accountants who failed to uncover the financial statement misrepresentations. As explained more fully below, the answers to the discussion questions are designed to facilitate faculty members' use of the case and should also be made available to the students when they are assigned the case.

II. LITERATURE REVIEW

Calls for revision of business curricula to include interdisciplinary efforts have been ongoing in response to employer requirements, accreditation outcomes, and our own field's requests for innovation.[2] Convergence of multiple objectives and assurances of learning may therefore be the natural outcomes of interdisciplinary efforts. If it is true that "all individuals who enter into business, regardless of their choice of major and occupation, will find it necessary to be fluent in all aspects of business,"[3] then finding ways to integrate multiple disciplines at any College of Business is clearly a worthwhile goal.

Interdisciplinary curricula, and their attendant teaching structures and student assignments, have gained popularity in recent years. Evidence of the value of interdisciplinarity for building depth of student understanding is abundant and well-documented.[4] Various

---

[2] *See, e.g.*, Raef A. Lawson et al., *Thoughts on Competency Integration in Accounting Education*. 30 ISSUES IN ACCOUNTING EDUC., 149-171 (2015); Chunhui Liu, Lee J. Yao, and Nan Hu, ISSUES IN ACCOUNTING EDUC., *Improving Ethics Education in Accounting: Lessons from Medicine and Law*. 27 671-690 (2012).

[3] Lawrence B. Chonko, *Business School Education: Some Thoughts and Recommendations*, 31 MKTG. EDUC. REVIEW, 1-9 (1993).

[4] For an overview, *see* Lana Ivanitskaya et al., *Interdisciplinary Learning: Process and Outcomes*, 27 INNOVATIVE HIGHER EDUC., 95-111 (2002).

combinations of business subject content are reported in the literature in nearly every business field including marketing education,[5] legal education,[6] finance education,[7] and economics education.[8]

Classroom exercises and activities which help undergraduates integrate their learning from multiple subject areas may help to improve student engagement as well as provide evidence of complex thinking in core disciplines.[9] By presenting students with activities that require them to apply information learned from courses in multiple disciplines, instructors create opportunities for students to integrate their knowledge in meaningful ways.[10] As a result, students are able to process increasingly complex business issues, and to integrate and apply a variety of understandings about business context, regardless of the particular course or department in which that learning originated.

Specifically in the business disciplines, integration of multiple subjects into core lessons may not be as difficult as it appears.[11] Interdisciplinary teaching and learning structures likely

---

[5] *See, e.g.*, Sigfredo A. Hernandez, *Team Learning in a Marketing Principles Course: Cooperative Structures That Facilitate Active Learning and Higher Level Thinking*, 24 J. OF MKTG. EDUC., 73-85 (2002).

[6] *See, e.g.*, Michelle M. Harner & Robert J. Rhee, *Deal Deconstructions, Case Studies, and Case Simulations: Toward Practice Readiness with New Pedagogies in Teaching Business and Transactional Law*, 3 AM. UNIV. BUS. LAW REVIEW, 81-97 (2014).

[7] *See, e.g.*, Grainne Oates & Roshanthi Dias, *Including Ethics in Banking and Finance Programs: Teaching "We Shouldn't Win at Any Cost*," 58 EDUC.+ TRAINING, 94-111 (2016).

[8] *See, e.g.*, Dmitriy Chulkov & Kokomo Dmitri Nizovtsev, *Problem-Based Learning in Managerial Economics with an Integrated Case Study*, 16 J. OF ECON. & ECON. EDUC. RESEARCH, 188-197 (2015).

[9] An explanation of the cognitive and social benefits of this type of learning appears in Paul R. Pintrich, *The Role of Metacognitive Knowledge in Learning, Teaching, and Assessing*, 42 THEORY INTO PRACTICE 219-225 (2002).

[10] A comprehensive review can be found in Beau Fly Jones, Claudette M. Rasmussen & Mary C. Moffitt, *Real-life Problem Solving: A Collaborative Approach to Interdisciplinary Learning*, American Psychological Association, Washington, DC (1997).

[11] Tammy Stone, Kathleen Bollard and Jonathan Harbor summarize the needs, challenges, and solutions of this type of endeavor in *Launching Interdisciplinary Programs as College Signature Areas: An Example*, 34 INNOVATIVE HIGHER EDUC. 321-329 (2009).

already exist in most business schools, whether or not they have been explicitly identified as such. The case-based teaching model, for example, is already used by many if not all business degree programs, and it offers an effective strategy for incorporating interdisciplinary learning activities.

Because case study lessons occur regularly throughout a student's degree program, they are also ideal vehicles for delivering interdisciplinary content over time.[12] Case studies can "provide integration" and "deliver a uniform message through a student's progression" by requiring use of the various disciplines in each of many case experiences each year.[13] Similarly, many business educators would agree that "a case method class is a mission on creativity, where many perspectives and backgrounds cross each other to produce a mix of strategic and innovative ideas."[14] Use of the case structure to encourage interdisciplinary collaborations among faculty members therefore presents a common language with which to communicate across disciplinary lines.

In addition, classroom engagement methods which accompany case teaching have multiple benefits for students. The value of questioning in the case study classroom is also well-documented, since these discussions and interactions help to build students' critical thinking and

---

[12] Celeste M. Hammond suggests that law schools also adopt the case study method that is used by business schools, in order to help law students "develop legal judgment and the ability to help clients make decisions and craft solutions," in *Borrowing from the B Schools: The Legal Case Study as Course Materials for Transaction Oriented Elective Courses: A Response to the Challenges of the MacCrate Report and the Carnegie Foundation for Advancement of Teaching Report on Legal Education*, 11 TRANSACTIONS: TENN. J. OF BUS. LAW, 9-39 (2009).

[13] Christopher Bajada & Rowan Trayler, *Interdisciplinary Business Education: Curriculum through Collaboration*, 55 EDUC.+ TRAINING, 385-402 (2013).

[14] Arun Kumar Jain, *Management Education and Case Method as a Pedagogy*, 30 VIKALPA: THE JOURNAL FOR DECISION MAKERS, 77-84 (2005).

problem-solving skills.[15] Lively discussions and student-to-student conversations often occur in the classroom when sharing examples of others' behaviors involving ethical concerns.[16] Instructors, then, are able to moderate the emotional responses and monitor potential inaccuracies by focusing students on the particular ethical issues involved, and specifically how they relate to the facts of the case at hand.[17] Pedagogical research from various disciplines confirms that multiple engagement methods, such as those that occur in group preparation and discussion of a case, result in compound learning effects, irrespective of discipline.[18]

Effective business cases provide both instructors and students with enough detail and context for students to evaluate decisions and ask further questions. Since the level of detail provided to students will necessarily force them to resist generalizations, they must instead focus on the particulars of the case in order to make their determinations.[19] Naturally, any case is rarely about a single instance or aspect of business decision making; increasing awareness of

---

[15] For analysis of the interactive benefits of case method questioning and suggestions on framing questions for classroom use, *see* James Badger, *Classification and Framing in the Case Method: Discussion Leaders' Questions*, 34 J. OF FURTHER AND HIGHER EDUC., 503-518 (2010).

[16] *See, e.g.*, Susan D. Baker & Debra R. Comer, *"Business Ethics Everywhere": An Experiential Exercise to Develop Students' Ability to Identify and Respond to Ethical Issues in Business*, 36 J. OF MGMT. EDUC., 95-125 (2012).

[17] Alternately, the instructor can be a "broker of ideas who integrates, shapes, and challenges disparate [sic] ideas presented in the session," as the model above from Jain suggests. *See* Jain, *supra* note 14 at 83. The study by Badger revealed that when questions posed by the instructor were weakly constructed, both instructors and students "introduced content from related cases, personal experiences or course readings," thereby diluting the intended outcomes. *See* Badger, *supra* note 15 at 515.

[18] A representative example of this phenomenon, and specifically acquisition of "non-definitional understandings," is reported in Lawrence O. Hamer, *The Additive Effects of Semistructured Classroom Activities on Student Learning: An Application of Classroom-Based Experiential Learning Techniques*, 22 J. OF MKTG. EDUC., 25-34 (2000).

[19] Scenarios from different disciplines are likely to contain some shared essential operational features, even when the details of its company or incident are unique. For a categorization of core concepts that can be distilled from multiple types of cases, *see* Roland W. Scholzet et al., *Transdisciplinary Case Studies as a Means of Sustainability Learning: Historical Framework and Theory*, 7 INT'L. J. OF SUSTAINABILITY IN HIGHER EDUC., 226-251 (2006).

global firms, multinational situations, and differing cultural norms will require increasingly complex evaluations from students.[20] Interdisciplinary cases will thus challenge students to integrate their very best knowledge, and ideally will encourage them to do additional research when they find that they need further depth in a topic than they currently possess.[21]

Cases that specifically address ethical issues may also present a natural convergence of disciplines.[22] Since business knowledge (or lack of it or disregard for it) is often a fundamental aspect of the case which is to be explicitly considered by students, a case that presents ethical dilemmas may be an easy avenue toward interdisciplinarity.[23] As a governing theme, ethics may be the most easily accessible content in a business program, and a topic that appears in all courses and at all levels of study. Cases that present ethical themes can be modified and utilized to help integrate disciplines.

Specific efforts must thus be made to define and communicate the ways in which the business disciplines relate to one another. This case provides an example of how such a task might be accomplished by requiring appropriate levels of sophistication in students' knowledge of both accounting and business law concepts. Students will also be challenged by

---

[20] Judith White and Susan Taft discuss different theories for evaluating global ethical dilemmas in *Frameworks for Teaching and Learning Business Ethics within the Global Context: Background of Ethical Theories*, 28 J. OF MGMT. EDUC., 463-477 (2004).

[21] Susan David deMaine, in *Preparing Law Students for Information Governance*, 35 LEGAL REFERENCE SERVS. Q., 101-123 (2016), suggests that research and information competencies can be developed through problem-based learning and the case approach.

[22] *See* Elizabeth Towell et al., 10 J. OF ACAD. ETHICS, 93-112 (2012) (explaining key debates about the use of ethics as an interdisciplinary theme in business education).

[23] Diane L. Swanson called instead for a stand-alone foundational course in ethics, as well as increased focus on ethics outcomes for accreditation, in *Business Ethics Education at Bay: Addressing a Crisis of Legitimacy*, 20 ISSUES IN ACCT. EDUC., 247-253 (2005), and in *The Buck Stops Here: Why Universities Must Reclaim Business Ethics Education*, 2 J. OF ACAD. ETHICS, 43-61 (2004). Both articles and their attendant issues have been discussed at length in the business literature. Representative examples of interdisciplinary ethical teaching scenarios appear in Edward C. Tomlinson, *Teaching the Interactionist Model of Ethics: Two Brief Case Studies*, 33 J. OF MGMT. EDUC. 142-165 (2007).

interdisciplinary cases since no solutions are easily available online.[24] Any change in familiar disciplinary patterns may help to break habits of complacency on the part of both students and their professors, and open minds to addressing shared goals in new ways.

Challenges to integrating multidisciplinary content may include a variety of issues such as comfort level of instructors with content which crosses disciplines, reluctance on the part of students to discuss uncomfortable ethical issues for fear of being "wrong," or lack of institutional support and time for collaboration and development of shared goals.[25] The degree of interdisciplinary integration in departments, in degree programs, and at universities is uneven at best. In response to calls for greater interdisciplinarity in accounting education,[26] in business law education,[27] and in MBA programs as a whole,[28] the authors wish to offer this case as an example of a rich and an appropriately detailed interdisciplinary activity which simultaneously engages students in concepts drawn from both accounting and business law.

Many real-world business challenges don't clearly fall within a single business discipline. With repeated exposure to interdisciplinary thought, "learners develop more advanced

---

[24] *See* Roland J. Sparks & Jeri Langford, *An Examination of Traditional Business Case Studies: Are They Outdated in Today's Technology Connected Environment?*, 8 J. OF BUS. CASE STUD., 217-222 (2012) (exploring this issue in a pilot study).

[25] Stephen E. Loeb provides an examination of the challenges of using active learning strategies for teaching business ethics issues in *Active Learning: An Advantageous Yet Challenging Approach to Accounting Ethics Instruction*, 127 J. OF BUS. ETHICS, 221-30 (2015). Despite the obvious difficulties of translating ethical education into daily ethical behavior, assurances of learning may be easier to collect when they are anchored to interactive, interdisciplinary scenarios.

[26] *See, e.g.*, Andreas Rasche, Dirk Ulrich Gilbert, & Ingo Schedel, *Cross-disciplinary Ethics Education in MBA Programs: Rhetoric or Reality?*, 12 ACAD. OF MGMT. LEARNING & EDUC., 71-85 (2013); Steven Dellaportas *et .,.*, *Developing an Ethics Education Framework for Accounting*, 8 J. OF BUS. ETHICS EDUC., 63-82 (2011).

[27] *See, e.g,* Matthew A. Edwards, *Teaching Consumer Price Discrimination: An Interdisciplinary Case Study for Business Law Students*, 31 J. OF LEGAL STUD. EDUC., 291-324 (2014); Leonard Rymsza et al., *A Day at the Beach: A Multidisciplinary Business Law Case Study*, 27 J. OF LEGAL STUD. EDUC., 129-162 (2010).

[28] *See, e.g.*, Seung-hee Lee et al., *A Review of Case-based Learning Practices in an Online MBA Program: A Program-level Case Study*, 12 J. OF EDUC. TECH. & SOC'Y, 178-190 (2009).

epistemological beliefs, enhanced critical thinking ability and metacognitive skills, and an understanding of the relations among perspectives derived from different disciplines."[29] Therefore, increased use of interdisciplinary case studies, such as the one presented here, will help business students analyze the complex interaction of multiple business disciplines in a way that is more naturally encountered in the field. Interdisciplinary activities in the business classroom provide opportunities to help students, professors, and their programs close the gap between university study and workplace understanding. This article demonstrates the ways in which an interdisciplinary case can be used to help integrate student understanding from multiple business disciplines. *SEC v. Baker* offers students a particularly compelling intersection of legal, accounting, and ethical issues to examine. The case is best utilized as a homework reading, with subsequent whole-group and small-group in-class discussion mediated by the instructor. It case provides a clear lesson in the consequences of poor decision making, while also providing enough detail to encourage a wide range of interactions by students of all ability levels.

II. HOW TO USE THE CASE

The learning objectives of this case study are: (1) to acquaint students in legal environment of business and introductory accounting courses with some of the major enforcement provisions of the Sarbanes-Oxley Act; (2) to examine the legal implications of intentional misstatements of earnings in quarterly (Form 10-Q) and annual (Form 10-K) financial statements; (3) to introduce students to the major antifraud provisions of the 1934 Securities and Exchange Act; (4) to examine the liability of public accounting firms for negligence in auditing

[29] Lana Ivanitskaya et al, *Interdisciplinary Learning: Process and Outcomes*, 27 INNOVATIVE HIGHER EDUC., 95 (2002).

publicly traded companies; and (5) to address the ethical implications of fraudulently misstated financial statements and incentive compensation clawback provisions.

The factual scenario of the case is derived from *SEC v. Baker*,[30] a federal district court decision upholding the recapture of compensation earned by the CEO and CFO of ArthroCare Corporation in 2006-2008, during which the misstated financial statements were filed. Thereafter discussion questions are posed and suggested responses are provided to facilitate the attainment of the above noted learning objectives.

The authors of this case study teach Legal Environment of Business and Principles of Accounting I. They have been fortunate to be able to pair their courses, which are offered at the sophomore level, and simultaneously use the case to maximize the interdisciplinary value of the case. Business law faculty may want to reach out to Accounting faculty to make similar arrangements. Alternatively, if business law faculty choose to use the case independently in their courses, they can underscore the linkages between the accounting and business law courses and supplement the securities law materials, or simply reinforce their instruction in the securities law portion of their courses.

The authors believe that the case should be assigned to a team of students in Legal Environment of Business, who will summarize the case and the answers to the discussion questions in class.[31] The authors recommend that both the text of the case and the answers to the discussion questions should be made available to the students as part of the reading, because legal environment and business law textbooks generally do not provide sufficient depth to their

---

[30] SEC v. Baker, 2012 WL 5499497 (W.D. Tex. 2012).

[31] One of the authors of this case study employs student learning teams in Legal Environment of Business. The major cases covered in the course are assigned to student teams, the members of which are responsible for presenting the case in class and responding to discussion questions related to the assigned case. *See* Edward J. Schoen, *Embracing Student Learning Teams,* 36 DECISION LINE 4-7, 12 (March 2011), which examines the benefits of employing student learning teams in Legal Environment of Business.

coverage of the securities law issues to enable the students to answer the questions on their own. In presenting and explaining the case, the students will demonstrate mastery of the learning objectives noted above. The instructor can pose questions about the case and elicit student responses to insure the students present those materials correctly. The instructor may also note, if appropriate, that the same case was discussed in Principles of Accounting I, and emphasize how generally accepted accounting principles (GAAP) and legal principles are intertwined in securities law. Because the case is highly detailed and the responses to the discussion questions are fully developed, the discussion questions will not only facilitate the instructor's discussion of the legal and accounting issues explored in the case, but also will serve as a helpful summary of the securities law materials covered in the course. [32] The authors believe the case can be summarized and discussed in approximately one class period. Less time can be allotted if the instructor chooses to focus on fewer selected issues.

The authors suggest that the case also be deployed in Principles of Accounting I at the beginning of the semester to underscore the harms caused by violating GAAP and the significant penalties that can be imposed on executives who misrepresent the company's financial statements. Because the case closely examines the phony accounting treatment of sales of a

[32] One of the authors of this article has also successfully used the case as a team-based, major ethics case presentation in the Professional, Legal and Managerial Responsibilities course in the MBA program. The case not only serves as a refresher of securities law, but as basis for the application of ethical principles to assess the morality of the executives' actions. Team members are asked to address the following questions during their presentation: (1) identify the major stakeholders affected by Raffle and Applegate's scheme to inflate and misstate the earnings of ArthroCare Corporation; (2) assess whether the actions of Raffle and Applegate in engaging in "channel stuffing" were ethical or unethical under Act Utilitarianism and Rule Utilitarianism; (3) assess whether the application of the Sarbanes Oxley clawback provisions to Baker and Gluk, requiring them to disgorge their "qualifying" compensation pursuant to Sections 3(b)(1) and 304(b) of the Sarbanes-Oxley Act of 2002 is ethical or unethical under Kant's Categorical Imperatives and Rawls' Veil of Ignorance theory under two alternative assumptions: Baker and Gluk were aware of Raffle and Applegate's "channel stuffing" activities, and Baker and Gluk were unaware of Raffle and Applegate's "channel stuffing" activities; and (4) assuming PwC was negligent in certifying the financial statements of ArthroCare Corporation, is it ethical or unethical that PwC would not likely be held liable for damages suffered by investors who relied on the audited financial statements under Act Utilitarianism and Rule Utilitarianism. The formal presentation of the case in the MBA course is usually completed in twenty to thirty minutes.

surgical device, students can better understand how improperly recorded transactions can result in misleading financial statements. The authors recommend that the case be assigned as a reading to be discussed in class and that both the text of the case and the answers to the discussion questions should be made available to the students as part of the reading. The instructor can pose questions and elicit student responses to make sure the students recognize how the accounting fraud was carried out, how the recorded transactions violated GAAP, the significant harm caused by fraudulent financial statements, and the severe consequences awaiting executive officers who engage in securities fraud. The instructor should also note the importance of the Sarbanes-Oxley Act, and remind students that they will examine it in greater detail in Legal Environment of Business. The in-class review of the case should use no more than one class period.

IV. PRESENTATION OF THE CASE – LEGAL AND ACCOUNTING ISSUES[33]

ArthroCare Corporation (ArthroCare), a Delaware corporation headquartered in Austin, Texas, manufactures and markets surgical products in three business units: sports medicine; spine; and ear, nose and throat.[34] Michael Baker was President and CEO of ArthroCare from 1997 through February 2009. He resigned following an investigation into the company's revenue recognition practices.[35] Michael Gluk served ArthroCare as Vice President of Finance and Administration from 2004 to 2006 and as CFO from 2006 to 2008. He resigned in

---

[33] The statement of facts appearing in this case study is largely drawn from the complaints filed by the SEC against Michael Baker and Michael Gluk, on April 2, 2012, to Civil Action No. 1: 12-cv-00285 (W.D. Tex. 2012) (the Baker complaint), accessed on April 6, 2016, at https://www.sec.gov/litigation/complaints/2012/comp22315.pdf, and against John Raffle and David Applegate, on June 27, 2011, to Civil Action No. 1:11-cv-540 (W.D. Tex. 2011) (the Raffle complaint), accessed on April 6, 2016, at https://www.sec.gov/litigation/complaints/2012/comp22315.pdf.

[34] Baker complaint *supra* note 33, at ¶¶ 7 and 11; Raffle complaint *supra* note 33, at ¶ 7.

[35] Baker complaint *supra* note 33, at ¶ 5.

December of 2008, as a result of the same investigation.[36] John Raffle, ArthroCare's Senior Vice President of Strategic Business Units, oversaw all three business divisions, until he resigned from ArthroCare on December 19, 2008.[37] David Applegate, ArthroCare's Senior Vice President and General Manager, oversaw the Spine Division, until he resigned from ArthroCare on December 19, 2008.[38]

The spine division's principal product was the "SpineWand," a thin, needle-like device used to treat herniated disc disease. Affecting about 1.5 million people annually, herniated disc disease occurs when the soft, spongy material in the nucleus of the disc providing padding between spinal vertebrae, either through injury or aging, bulges outward and comes into contact with nerve roots causing irritation and intense, sometimes debilitating, pain. In a procedure called a "nucleoplasty," the needle is inserted into the nucleus of the disc under x-ray guidance. The needle emits radio waves that destroy some of the pulposus materials in the nucleus, and then extracts the dead materials without damaging nearby materials. The less dense nucleus then retracts, eliminating pressure in the disc and on the nerve roots thereby terminating the pain.[39]

In 2004, sales in the spine unit stagnated, because health insurers began to decline reimbursement requests for the SpineWand, causing hospitals and other health care facilities to decrease their purchases of the wands.[40] SpineWand sales to one customer, the Palm Beach

---

[36] Baker complaint *supra* note 33, at ¶ 6.

[37] Raffle complaint *supra* note 33, at ¶¶ 4, 9, and 11.

[38] Raffle complaint *supra* note 33, at ¶¶ 5, 10 and 11.

[39] *See* ArthroCare's description of the SpineWand medical device and the nucleoplasty procedure at http://biomed.brown.edu/Courses/BI108/BI108_2008_Groups/group08/treatments_nucleoplasty.html, accessed on April 6, 2016.

[40] Baker complaint *supra* note 33 at ¶ 12; Raffle complaint *supra* note 33, at ¶ 8.

Lakes Surgery Center (PBLSC), however, increased significantly because of its unique relationship with a local personal injury law firm.[41] PBLSC provided wands and performed the nucleoplasty procedures on clients of the personal injury law firm. PBLSC billed the law firm for the wand and medical services, and the law firm included those invoices as part of settlement negotiation with liability and workers' compensation insurers.[42] When the insurers settled, PBLSC got paid, enabling PBLSC not only to move a high volume of SpineWands but also to skirt the reimbursement restrictions imposed by health insurers.[43]

A detailed description of the manner in which ArthroCare fraudulently accounted for its sales to Disco and the ensuing actions by the DOJ and SEC in response the misleading financial statements ensue.

A**.** *ArthroCare's Generation of Misleading Financial Statements*

Hoping to expand PBLSC's success and assisted by Applegate, PBLSC's founder created DiscoCare to act as a distributor of ArthroCare's products.[44] The linkages between DiscoCare and ArthroCare were strong. DiscoCare hired a former top ArthroCare salesperson to run the company and several other former ArthroCare employees, some of whom remained on ArthroCare's payroll and benefit plans.[45] DiscoCare and ArthroCare shared office space in an ArthroCare branch office, and DiscoCare purchased only ArthroCare products.[46] Under the

---

[41] *Id*.

[42] *Id*.

[43] *Id*.

[44] Baker complaint *supra* note 33, at ¶ 13; Raffle complaint *supra* note 33, at ¶ 9.

[45] *Id*.

[46] *Id*.

terms of their first distribution agreement, executed on December 23, 2005, DiscoCare purchased an initial stocking order of $975,000 without contingencies, enabling ArthroCare to record the sale upon shipment and meet its fourth quarter 2005 revenue expectations.[47] To expedite the sale, Raffle rebuffed requests of finance personnel to check DiscoCare's background and credit worthiness, and extended lengthier payment terms to DiscoCare than those normally offered to other distributors.[48]

As pressure to meet earnings expectations mounted, Raffle and Applegate dramatically expanded the role of DiscoCare to overcome earnings shortfalls by: (1) recording massive sales of ArthroCare products to DiscoCare, (2) modifying their distribution agreement to enhance sales, (3) ghost writing purchase documents to corroborate sales, (4) acquiring DiscoCare to hide the fraudulent accounting entries, and (5) overstating revenues in quarterly and annual reports. Each of these efforts is detailed in the following sections.

1. *Recording Massive Sales to DiscoCare*

DiscoCare encountered unexpected delays in collecting payments from the law firm, and lacked cash to pay ArthroCare for its initial stocking order.[49] Nonetheless, under pressure to meet its first quarter 2006 revenue projections, ArthroCare agreed to expand the sales territory allocated to DiscoCare and to sell an additional $970,000 of the wands to DiscoCare. This sale permitted ArthroCare to meet its revenue target.[50]

---

[47] Baker complaint *supra* note 33, at ¶¶ 14 and 15; Raffle complaint *supra* note 33, at ¶ 10.

[48] Baker complaint *supra* note 33, at ¶ 15; Raffle complaint *supra* note 33, at ¶ 11.

[49] Baker complaint *supra* note 33, at ¶ 16; Raffle complaint *supra* note 33, at ¶ 12.

[50] *Id.*

This scenario was repeated in the second and third 2006 quarters. At the end of the second 2006 quarter, DiscoCare placed a $500,000 order, even though it had an oversupply from the first quarter and was not obligated to make additional purchases.[51] Realizing it needed only $250,000 to meet its revenue target, Raffle moved half of DiscoCare's order to the third quarter, by permitting DiscoCare to rescind the shipment through a process called "Return Merchandise Authorization."[52] This process violated ArthroCare's return policy, which permitted returns only when the product was incorrect or defective. Nevertheless, the return process permitted ArthroCare to smooth its earnings.[53] Raffle gave conflicting explanations for these transactions to ArthroCare's accounting staff (Raffle claimed he agreed to the return before the end of the quarter, but delayed paperwork and an intervening holiday pushed back its implementation), and to ArthroCare's outside auditor (Raffle claimed DiscoCare bought incorrect items and quantities and ArthroCare agreed to accept the returns to maintain good customer relations).[54] The $250,000 adjustment proved to be insufficient, and third quarter 2006 sales needed an additional boost. In response to Raffle and Applegate's request, DiscoCare placed a large $910,000 order on the final day of the third quarter, despite the fact that DiscoCare did not need and likely could not sell or pay for the products purchased.[55]

2. Modifying the Distribution Agreement.

---

[51] Baker complaint *supra* note 33, at ¶ 17; Raffle complaint *supra* note 33, at ¶ 13.

[52] Baker complaint *supra* note 33, at ¶ 18; Raffle complaint *supra* note 33, at ¶ 14.

[53] *Id.*

[54] Baker complaint *supra* note 33, at ¶ 19; Raffle complaint *supra* note 33, at ¶ 15.

[55] Baker complaint *supra* note 33, at ¶ 20; Raffle complaint *supra* note 33, at ¶ 16.

ArthroCare and DiscoCare modified their course of dealing when they entered into a new distribution agreement effective November 1, 2006.[56] In this agreement, ArthroCare agreed to pay a "monthly service fee" to DiscoCare. The service fee, based on the number and average price of the wands sold to DiscoCare, was instituted to cover DiscoCare's distribution expenses, even though DiscoCare had until this point provided these services without charge.[57] Half of the service fee was credited to DiscoCare's account receivable balance and the other half was paid to DiscoCare to enhance its cash flow and enable it to make payment on its account payable owing to ArthroCare.[58] While this arrangement reduced the DiscoCare receivable on ArthroCare's books and created the appearance it was performing, it altered the timing of ArthroCare's recognition of revenue on its sales to DiscoCare.[59] Previously, ArthroCare recognized revenue when the wands were shipped to DiscoCare. Under the revised agreement, the price varied depending on the source of payment to DiscoCare: personal injury settlement, private health insurance or workers' compensation. Hence ArthroCare was forced to delay the recognition of sales until the surgeries were performed and the price was certain.[60] The new "case completed" timing requirement immediately became an obstacle to meeting revenue projections.[61] With less than a week left in 2006, Raffle realized he needed $2 million in sales to meet ArthroCare's annual revenue target, and looked to DiscoCare for a solution.[62] Even though it was impossible

---

[56] Baker complaint *supra* note 33, at ¶ 21; Raffle complaint *supra* note 33, at ¶ 17.

[57] *Id.*

[58] *Id*.

[59] Baker complaint *supra* note 33, at ¶ 22; Raffle complaint *supra* note 33, at ¶ 18.

[60] *Id.*

[61] Baker complaint *supra* note 33, at ¶ 23; Raffle complaint *supra* note 33, at ¶ 19.

[62] *Id.*

to complete sufficient surgeries by year end to permit the recognition of sales to DiscoCare, Raffle and Applegate persuaded accounting personnel to record the additional sales to DiscoCare, promising the surgeries would be completed by the following quarter.[63] Further, Raffle and Applegate negotiated a retroactive price increase on ArthroCare's sales to DiscoCare, which increased the spine unit's sales by 10% and ArthroCare's sales by 1%.[64]

3. Ghost Writing Purchase Documents

Pressure to meet revenue projections continued in the first 2007 quarter.[65] To solve this problem, Applegate ghost-wrote a letter for DiscoCare in which DiscoCare sought to purchase a "safety stock" of wands to facilitate their timely availability to surgeons.[66] ArthroCare shipped $200,000 of the wands to DiscoCare, and recorded the sales immediately after shipment.[67] The "safety stock" concern was a fabrication. DiscoCare carried an excess inventory of the wands after its bloated 2006 purchases and did not need any more.[68] Needing more revenues at the end of the second 2007 quarter, ArthroCare shipped about $2.1 million in wands to DiscoCare and immediately recorded the sale, even though DiscoCare had only $900,000 of approved cases that could be completed before the quarter ended.[69] Raffle and Applegate hid this shortfall from ArthroCare's accounting staff.[70]

---

[63] *Id*.

[64] *Id.*

[65] Baker complaint *supra* note 33, at ¶ 24; Raffle complaint *supra* note 33, at ¶ 20.

[66] *Id.*

[67] *Id*.

[68] *Id.*

[69] Baker complaint *supra* note 33, at ¶ 25; Raffle complaint *supra* note 33, at ¶ 21.

[70] *Id.*

4. Acquiring DiscoCare to Hide Fraudulent Accounting Entries

The massive sales of wands to DiscoCare created two additional accounting issues for ArthroCare. First, DiscoCare's account receivable balance ballooned to $13 million, around 19% of ArthroCare's total accounts receivable, and increased its "days sales outstanding," a key metric employed by analysts to measure the average number of days that a company takes to collect revenue after a sale has been made.[71] A high "days sales outstanding" number means the company is selling its product to customers on credit and taking longer to collect the money, possibly signaling liquidity and cash flow problems.[72] Second, ArthroCare resisted the establishment of a reserve against the large DiscoCare balance, because it would have a negative impact on its earnings.[73]

The solution to these accounting issues was to have ArthroCare acquire DiscoCare, effective December 31, 2017.[74] The large account receivable balance would disappear on the consolidated balance sheet, but the sales from ArthroCare to DiscoCare would remain in the consolidated income statement.[75] To sweeten the transaction, Raffle and Applegate shipped $1.5 million of spine wands to DiscoCare, even though surgeries for which they were purchased were not approved, and asked DiscoCare to delay selling the wands until after the acquisition closed to permit ArthroCare to book income on the same wands again when they were sold.[76]

---

[71] Baker complaint *supra* note 33, at ¶ 26; Raffle complaint *supra* note 33, at ¶ 22.

[72] *Days Sales Outstanding – DSO*, INVESTOPEDIA, http://www.investopedia.com/terms/d/dso.asp.

[73] Baker complaint *supra* note 33, at ¶ 26; Raffle complaint *supra* note 33, at ¶ 22.

[74] Baker complaint *supra* note 33, at ¶ 27; Raffle complaint *supra* note 33, at ¶ 23.

[75] *Id.*

[76] *Id.*

5. Overstating Earnings in SEC Reports

As a result of these transactions, ArthroCare materially overstated its revenues in its 2006 10-K report, its 2007 10-K report, and its 2008 Form 10-Q. The company would later issue restatements of those reports.[77] When suspicions about reported earnings surfaced, ArthroCare engaged in an internal review, conducted with the assistance of outside counsel, confirmed that the spine division engaged in improper practices, and announced it was under formal investigation by the SEC[78] ArthroCare subsequently disclosed that the DOJ initiated an investigation into the sales, accounting and billing practices related to its spinal surgery medical devices and its relationship with its subsidiary, DiscoCare, and said it was cooperating with the investigation.[79] As these investigations moved forward, the SEC and DOJ embarked on a series of civil and criminal actions against Baker and Gluk, Raffle and Applegate, and ArthroCare, the principal components of which are described below.

B. *SEC and DOJ Civil and Criminal Actions*

Having determined that fraudulent financial statements were included in the annual and quarterly report filed by ArthroCare, the SEC and DOJ initiated several actions against Raffle, Applegate and ArthroCare: (1) civil actions to recoup Raffle and Applegate's incentive compensation, (2) criminal actions against Raffle and Applegate charging them with wire and securities fraud, and (3) deferred prosecution against ArthroCare. Each of these actions is discussed in turn.

---

[77] Baker complaint *supra* note 33, at ¶ 32; Raffle complaint *supra* note 33, at ¶ 28.

[78] *ArthroCare investigation reveals impropriety; CEO steps down*, AUSTIN BUSINESS JOURNAL, (Feb. 18, 2009), http://www.bizjournals.com/austin/stories/2009/02/16/daily26.html.

[79] Stewart Bishop, *ArthroCare Faces DOJ Investigation Over Billing Practices*, LAW360, (May 8, 2013), http://www.law360.com/articles/439815/arthrocare-faces-doj-investigation-over-billing-practices.

1. SEC Disgorgement Action Against Raffle and Applegate

The SEC pursued civil actions against Raffle and Applegate, accusing them of improperly reporting shipments of spine products to distributors as sales to inflate ArthroCare's reported earnings and misleading ArthroCare's accountants and auditor. The SEC sought disgorgement of their compensation, including bonuses, incentive pay and profits from stock sales, paid during the period misstatements of earnings appeared in reports filed with the SEC. Raffle and Applegate reached a settlement agreement with the SEC resolving these civil claims on July 5, 2011. Without admitting or denying the SEC's allegations, Raffle and Applegate consented to a permanent injunction prohibiting them from violating Section 17(a) of the Securities Act of 1933[80] and Section 13(b)(5)[81] of the Securities Exchange Act of 1933, and agreed to pay $1.78 million and $621,754.60 in disgorgement respectively (reduced to $329,230 and $55,000

---

[80] 15 U.S.C.A. § 77q.

(a) Use of interstate commerce for purpose of fraud or deceit. It shall be unlawful for any person in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[81] 15 U.S.C.C. § 78m.

(b) Form of Report; Books, Records, and Internal Accounting; Directives. . . . (5) No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2).

respectively reflecting their inability to pay the larger amount).[82] The settlement also barred Raffle and Applegate from serving as officers or directors of public companies for five year.[83]

2. Raffle and Applegate are Arrested, Indicted and Plead Guilty

On August 22, 2012, federal agents arrested Raffle and Applegate on charges appearing in a sixteen-count indictment accusing them of wire and securities fraud. The indictment stated they inflated company earnings by tens of millions of dollars, hid sales terms and commission payment information, and caused a $400 million loss for investors. Raffle and Applegate accomplished this scheme, the indictment stated, by setting up a Florida warehouse for DiscoCare, shipping and storing ArthroCare inventory in the warehouse, falsely claiming those shipments were sales, paying distributors $4 million in commissions to accept extra product under reduced or extended payment terms, and hiding these fees in earnings reports as marketing expenses. Investors lost $400 million as a result of the scheme.[84]

Admitting he participated in a scheme to inflate earnings by tens of millions of dollars and hid sales terms and commission payment information, Applegate later pled guilty to one count of conspiracy to commit securities, mail and wire fraud and one count of making false statements on ArthroCare's Form 10-K.[85] Raffle followed suit, pleading guilty to the same

---

[82] SEC v. Raffle et al., SEC Litigation Release No. 22027 (July 5, 2011), *http://www.sec.gov/litigation/litreleases/2011/lr22027.htm*. ("The judgment also orders [Raffle] to pay $1,782,742.43 in disgorgement plus prejudgment interest of $329,230.44, but waives payment of all but $175,000 of this amount, and does not impose a civil penalty, based upon his sworn financial statements. . . . The judgment orders [Applegate] to pay $621,754.60 in disgorgement plus prejudgment interest of $106,469.70, but waives payment of all but $55,000 of this amount, and does not impose a civil penalty, based upon his sworn financial statements.").

[83] *Id.*

[84] Jess Krochtengel, *ArthroCare Execs Arrested Over $400M Stock Drop*, LAW360 (Aug. 22, 2012), http://www.law360.com/articles/372303/arthrocare-execs-arrested-over-400m-stock-drop.

[85] Jeremy Heallen, *ArthroCare Exec Cops to $400M Securities Fraud Scheme*, LAW360, (May 9, 2013), http://www.law360.com/articles/440442/arthrocare-exec-cops-to-400m-securities-fraud-scheme?article_related_content=1.

charges, plus an additional count of making false statements.[86] Raffle was subsequently sentenced to eighty months in prison followed by three years of supervised release, and ordered to pay a $25,000 fine; Applegate was sentenced to sixty months in prison, followed by three years of supervised release, and ordered to pay a fine of $25,000.[87]

3. ArthroCare's Deferred Prosecution Agreement

ArthroCare and the DOJ reached a settlement agreement on January 7, 2014. ArthroCare agreed to pay $30 million and enter into a deferred prosecution agreement, ending the DOJ's investigation into the senior executives' scheme to inflate company earnings. As part of the agreement, the DOJ filed a criminal information in Texas federal court charging ArthroCare with one count of conspiracy to commit securities fraud and wire fraud. ArthroCare agreed to participate in an "enhanced" compliance program and to report on its progress annually to the DOJ. Pursuant to the agreement, ArthroCare agreed to a cease-and-desist order containing findings of facts and obligating it to refrain from committing or causing any future violations of the Securities Exchange Act of 1934.[88]

---

[86] Lance Duroni, *Another Ex-ArthroCare Exec Cops to $400M Fraud Scheme*, LAW360 (July 23, 2013), http://www.law360.com/articles/459297/another-ex-arthrocare-exec-cops-to-400m-fraud-scheme?article_related_content=1.

[87] *See Pending Criminal Divisions Cases*, U.S. DEPARTMENT OF JUSTICE RELEASE, accessed on April 9, 2016, at https://www.justice.gov/criminal-vns/case/raffle-applegate.

[88] *See Order Instituting Cease-and Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order*, U.S. SECURITIES AND EXCHANGE COMMISSION, (Feb. 9, 2011), https://www.sec.gov/litigation/admin/2011/34-63883.pdf. *See also* Joe Carlson, *ArthroCare resolves fraud allegations, but must cooperate in case against execs*, MODERN HEALTHCARE, (Jan. 8, 2014), http://www.modernhealthcare.com/article/20140108/NEWS/301089972, and Michael Lipkin, *ArthroCare To Pay $30M To End $400M Securities Fraud Probe*, LAW360, (Jan. 7, 2014), http://www.law360.com/articles/499414/arthrocare-to-pay-30m-to-end-400m-securities-fraud-probe?article_related_content=1.

Having secured plea agreements with Raffle and Applegate, the DOJ turned its attention to Baker and Gluk. In ensuing criminal and civil proceedings the DOJ indicted and convicted them of wire and securities fraud, and pursued incentive compensation clawback proceedings.

4. Baker and Gluk are Indicted, Tried, Sentenced, and Awarded New Trials

Baker and Gluk, the CEO and CFO of ArthroCare, were each indicted on multiple counts of wire fraud, securities fraud, and conspiracy on July 17, 2013, for their actions in falsely stating ArthroCare's earnings.[89] A federal jury convicted both executives of those charges on June 2, 2014.[90] Baker was sentenced to twenty years in prison and Gluk to ten years in prison for perpetrating securities fraud. The court also ordered Baker and Gluk to forfeit approximately $22.5 million, representing their profits from the scheme.[91] Baker and Gluk filed motions for retrial,[92] and those motions were upheld by the Fifth Circuit Court of Appeals, which ruled the trial judge erred in excluding evidence suggesting other people committed the fraud or mislead

[89] Daniel Wilson, *Ex-ArthroCare CEO, CFO Indicted for $400M Earnings Fraud*, LAW360 (July 17, 2013), http://www.law360.com/articles/458100/ex-arthrocare-ceo-cfo-indicted-for-400m-earnings-fraud?article_related_content=1.

[90] Kat Greens, *Jury Convicts ArthroCare Execs in $400M Fraud Scheme*, LAW360 (June 2, 2014), http://www.law360.com/articles/543972/jury-convicts-arthrocare-execs-in-400m-fraud-scheme?article_related_content=1.

[91] Jeff Sistrunk, *Ex-ArthroCare CEO Gets 20 Years in $756M Fraud Case*, LAW360, (Aug. 29, 2014), http://www.law360.com/articles/572738/ex-arthrocare-ceo-gets-20-years-in-756m-fraud-case?article_related_content=1.

[92] Cara Salvatore, *Ex-ArthroCare CEO Wants Retrial over $756 Fraud Scheme*, LAW360 (Nov. 24, 2014), http://www.law360.com/articles/599104/ex-arthrocare-ceo-wants-retrial-over-756m-fraud-scheme?article_related_content=1; Kelly Knaub, *Ex-ArthroCare CFO Also Seeks Retrial in $756M Fraud Case*, LAW360 (Dec. 3, 2014), http://www.law360.com/articles/600961/ex-arthrocare-cfo-also-seeks-retrial-in-756m-fraud-case?article_related_content=1.

the executives, and remanded the case for retrial.[93] The Baker/Gluk case is now pending in federal district court in Austin, Texas.[94]

5. Clawback Actions Against Baker and Gluk

Because ArthroCare materially overstated its revenues in its 2006 10-K report[95], its 2007 10-K report, and its 2008 Form 10-Q,[96] and was required to, and in fact did, issue restatements of those reports, and because Baker and Gluk, as the CEO and CFO of ArthroCare, were ultimately responsible for ArthroCare's financial condition and proper and accurate reporting of that financial condition to the public, the SEC pursued a civil action to recoup their compensation in restricted ArthroCare common stock, pursuant to Sections 3(b)(1)[97] and 304(b)[98] of the

---

[93] United States v. Gluk, 811 F.3d 738, 742 (5th Cir. 2016). *See* Jonathan Stempel, *ArthroCare ex-CEO, ex-CFO win reversal of U.S. fraud convictions*, REUTERS (Jan. 25, 2016), http://www.reuters.com/article/us-usa-crime-arthrocare-idUSKCN0V32OR.

[94] E-mail from Linda D. Mizell, Judicial Assistant to the Hon. Sam Sparks, United States District Judge, to Edward J. Schoen (confirming that the Baker/Gluk case is now pending on Judge Sparks' docket as No. 1:13-cr-346-ss) (March 6, 2017) (on file with author).

[95] "A 10-K is a comprehensive summary report of a company's performance that must be submitted annually to the Securities and Exchange Commission. Typically, the 10-K contains much more detail than the annual report. It includes information such as company history, organizational structure, equity, holdings, earnings per share, subsidiaries, etc." *What is a 10-K*, INVESTOPEDIA, http://www.investopedia.com/terms/1/10-k.asp (last visited March 20, 2017).

[96] "The SEC form 10-Q is a comprehensive report of a company's performance that must be submitted quarterly by all public companies to the Securities and Exchange Commission. In the 10-Q, firms are required to disclose relevant information regarding their financial position. There is no filing after the fourth quarter, because that is when the 10-K is filed." *What is the SEC Form 10-Q*, INVESTOPEDIA http://www.investopedia.com/terms/1/10q.asp (last visited March 20, 2017).

[97] 15 U.S.C. § 78u(d).

> (1) In General. A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.

This provision empowered the SEC to enforce the clawback provision in the absence of efforts of ArthroCare to do so. *See* Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust ex rel. Fed. Nat'l Mortg. Ass'n v. Raines, 534 F.3d 779, 793 (D.C. Cir.2008) ("§ 304 of the Sarbanes–Oxley Act of 2002 . . . establishes that the SEC may sue the CEO and CFO of a company when the company has been required to restate its earnings due to noncompliance with securities laws.").

[98] 15 U.S.C. § 7243(a).

Sarbanes-Oxley Act of 2002. In its complaint against Baker and Gluk, the SEC did not allege they engaged in any conscious or intentional wrongdoing, but contended they were required to reimburse ArthroCare simply because they served and signed the erroneous annual and quarterly reports in their capacities as CEO and CFO and ArthroCare was compelled to file restatements for the periods in question to correct the earnings misrepresentations.[99] Baker and Gluk argued the reimbursement provisions of Section 304 cannot be enforced in the absence of misconduct constituting an independent violation of securities law on their part.[100] The court rejected Baker and Gluk's argument. The court determined the language of the clawback provision was unambiguous in requiring "CEOs and CFOs to reimburse the issuer for any qualifying compensation they receive within one year of a filing which the issuer is subsequently forced to restate due to misconduct by the issuer its agents," and that the handful of cases addressing the clawback provision "were devoid of any mention of a scienter requirement."[101] Hence the court concluded the CEO and CFO need not be personally aware of the misconduct leading to misstated financial statements; as long as they received additional compensation during the

---

Forfeiture of certain bonuses and profits.
(a) Additional compensation prior to noncompliance with Commission financial reporting requirements.
If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for –
(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
(2) any profits realized from the sale of securities of the issuer during that 12–month period. (b) Commission exemption authority. The Commission may exempt any person from the application of subsection (a) of this section, as it deems necessary and appropriate.

[99] SEC v. Baker, 2012 WL 5499497 at 1.

[100] *Id*. at 4.

[101] *Id*. at 5. *See* SEC v. Jenkins, 718 F. Supp.2d 1070, 1072 (D. Ariz .2010); Cohen v. Viray, 622 F.3d 188, 193 (2nd Cir. 2010); Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust ex rel. Fed. Nat'l Mortg. Ass'n v. Raines, 534 F.3d at 793.

period of the misconduct, their additional compensation was subject to recapture by the SEC.[102] According to the court, allowing recapture for compensation during a period of misstatement "ensures the integrity of the financial markets" by motivating CEOs and CFOs to ferret out misconduct of employees and preventing CEOs and CFOs from benefiting from misstatements of the company's financial statements.[103]

Finally, as further fallout from the ArthroCare fraud scheme, the Public Company Accounting Oversight Board (the Board) suspended the former PricewaterhouseCoopers (PwC) accountant who failed to detect the DiscoCare scheme when he audited ArthroCare's financial statements. The Board concluded that Randall Stone, who ran the 2007 audit of ArthroCare, "failed to properly evaluate numerous indicators that should have alerted him to the possibility that ArthroCare was improperly recognizing revenue on its 2007 sales of medical devices to DiscoCare." [104] The Board barred him from working for a registered public accounting firm for three years and fined him $50,000. Stone resigned from PwC on June 30, 2014. While the Board acknowledged Stone did not ignore anonymous allegations ArthroCare was engaged in "channel stuffing,"[105] the Board faulted him as "the engagement partner" for "failing to have obtained a detailed written response from management addressing the new allegations, prior to the re-issuance of PwC's audit report."[106]

---

[102] SEC v. Baker, 2012 WL 5499497 at 5.

[103] *Id*. at 6.

[104] Brad Perriello, *Board Suspends Ex-PricewaterhouseCoopers Accountant over ArthroCareSscandal*, THE MED. DEVICE BUS. J. (July 8, 2014), http://www.massdevice.com/board-suspends-ex-pricewaterhousecoopers-accountant-over-arthrocare-scandal/.

[105] *Id*. Investopedia defines "channel stuffing" as "a deceptive business practice used by a company to inflate its sales and earnings figures by deliberately sending retailers along its distribution channel more products than they are able to sell to the public" *Channel Stuffing*, INVESTOPEDIA, http://www.investopedia.com/terms/c/channelstuffing.asp (last visited March 20, 2017).

V. DISCUSSION QUESTIONS

(1) What provisions of the Sarbanes-Oxley Act impose personal liability on Baker and Gluk, the CEO and CFO, for the misstatements of earnings appearing in ArthroCare's financial statements?

Two provisions of the Sarbanes-Oxley Act impose personal liability on Baker and Gluk for the misstatements of earnings appearing in ArthroCare's financial statements. Under Section 302, the CEO and CFO are required to review the periodic report, to certify that the financial statements fairly present, in all material respects, the operations and financial condition of the issuer, and to establish, maintain, evaluate and certify the adequacy of internal controls.[107]

---

[106] David B. Hardison, *Spotlight on PCAOB's 2014 Enforcement Program*, LAW360 (March 9, 2015), http://www.law360.com/articles/628875/spotlight-on-pcaob-s-2014-enforcement-program.

[107] 15 U.S.C.A. § 7241.

(a) Regulations required. The Commission shall, by rule, require, for each company filing periodic reports under section 78m(a) or 78o(d) of this title, that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that--

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)--

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to

Under Section 404, management must annually assess the effectiveness of internal controls[108] for financial reporting, and the company's outside auditor must attest to management's assessment of internal controls.[109] If the CEO and CFO know the financial statements do not fairly present, and intentionally misrepresent, the operations and financial condition of the issuer, or if the CEO and CFO knowingly misrepresent the adequacy of internal controls in their assessment, they have personal liability for damages suffered by those who relied on the financial statements.

(2) Do the clawback provisions of Section 304 of the Sarbanes-Oxley Act require Baker and Gluk and Raffle and Applegate to return all compensation earned during the periods of time the financial statements contain material misstatements regardless of whether they were aware or should have been aware of those material misstatements?

The clawback provision in Section 304 of the Sarbanes-Oxley Act provides for a forfeiture of "certain bonuses and profits." Section 304 provides that "any bonus or other

---

the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

[108] "Internal controls are methods put in place by a company to ensure the integrity of financial and accounting information, meet operational and profitability targets, and transmit management policies throughout the organization. Internal controls work best when they are applied to multiple divisions and deal with the interactions between the various business departments. No two systems of internal controls are identical, but many core philosophies regarding financial integrity and accounting practices have become standard management practices." *Internal Controls*, INVESTOPEDIA, http://www.investopedia.com/terms/i/internalcontrols.asp (last visited March 20, 2017)

[109] 15 U.S.C.A. § 7262.

(a) Rules required. The Commission shall prescribe rules requiring each annual report required by section 78m(a) or 78*o*(d) of this title to contain an internal control report, which shall--

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) Internal control evaluation and reporting. With respect to the internal control assessment required by subsection (a) of this section, each registered public accounting firm that prepares or issues the audit report for the issuer, other than an issuer that is an emerging growth company (as defined in section 78c of this title), shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

incentive based or equity based compensation received by that person from the issuer during the 12 month period following the first public issuance will be forfeitable."[110] Base compensation is excluded from forfeiture;[111] therefore the defendants were not required to return *all* compensation received.

The defendants argued that Section 304 was, in effect, a statutory disgorgement provision and, as such, should be applied only in cases where the accused parties actually participated in the illegal acts. The SEC, on the other hand, took the position that "reimbursement," as per Section 304, is not dependent upon misconduct of the parties. The court agreed with the SEC, because reimbursement of their additional compensation motivates the CEO and CFO to investigate the misconduct of employees and prevents them from benefiting from misstatements of the company's financial statements. Furthermore, while Section 304 gives a cause of action to the SEC, no private cause of action is granted. A recent appellate case, *Cohen v. Viray*, 622 F.3rd 188, 194 (2nd Cir.2010), agrees with the interpretation of the court in *Baker* that the language of Section 304 did not create or provide a private right of action. The court examined the intent of Congress and noted that the language specifically gave the SEC permission to bring a Section 304 cause of action and did not identify other potential litigants.[112] The court buttressed its position by noting that other sections of Sarbanes-Oxley provide private causes of actions.[113] For example, Section 306 provides a cause of action when the officers or directors have engaged in and earned profits from insider trading while in a period of pension fund blackout.[114] Hence,

---

[110] 15 U.S.C. § 7243(a), *supra* note 98.

[111] *Id.*

[112] *Id.*

[113] *Id.*

[114] 15 U.S.C.A. § 7244 (a):

in *Cohen v. Viray*, the appellate court held that no private cause of action to recover equity based compensation exists, and only the SEC is authorized to grant exemptions from the reimbursement provisions of Section 304.[115] The appellate court therefore reversed the lower court's approval of a settlement agreement of a derivative shareholder lawsuit releasing and indemnifying the former CEO and CFO against liability imposed by Section 304 was erroneous.

(3) Has the enforcement of the incentive compensation clawback provision been effective in stemming securities fraud?

As the court noted in *SEC v. Baker*, "[f]or reasons best known to the SEC, the Commission has been historically reluctant to utilize Section 304 in the ten years since Sarbanes-Oxley was enacted."[116] One explanation for the reluctance of the SEC to proceed may be the subsequent passage of the whistleblowing and executive compensation provisions of the Dodd-

---

(1) In general
Except to the extent otherwise provided by rule of the Commission pursuant to paragraph (3), it shall be unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer.
(2) Remedy
(A) In general
Any profit realized by a director or executive officer referred to in paragraph (1) from any purchase, sale, or other acquisition or transfer in violation of this subsection shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such director or executive officer in entering into the transaction.
(B) Actions to recover profits
An action to recover profits in accordance with this subsection may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer fails or refuses to bring such action within 60 days after the date of request, or fails diligently to prosecute the action thereafter, except that no such suit shall be brought more than 2 years after the date on which such profit was realized.

[115] Cohen v. Viray, 622 F.3rd 188, 194-195 (2nd Cir.2010).

[116] SEC v. Baker, 2012 WL 5499497 at 3. *See* Alison List, *The Lax Enforcement of Section 304 of Sarbanes—Oxley: Why is the SEC Ignoring its Greatest Asset in the Fight Against Corporate Misconduct?*, 70 OHIO ST. L.J. 195, 216 (2009).

Frank Act.[117] The SEC may have chosen to wait until the implementation of new regulations defining those previsions.[118] Another explanation is that the SEC initially pursued actions against CEOs and CFOs when they were personally involved in financial misconduct, but delayed pursuing executives who were not personally responsibility for the misconduct until after the 2007-2009 financial crisis abated, because executives' incentive compensation presumably was sparse during the financial crisis.[119] Finally, the SEC's reluctance may simply be the result of cost benefit analysis:

> [The SEC] might feel that the market is self-regulating to correct this problem through contractual "clawback" provisions or reputation value, and that no additional government regulation is needed to root out misconduct. The SEC might have an economic disincentive to pursue these causes of action, finding it excessive and that the imposition of these causes of action will do significant harm to the companies and the market as a whole. Finally, the most likely explanation for the SEC's lack of action is that the SEC is signaling an increase in enforcement of Section 304 in the upcoming years. The SEC is likely conscious of the high costs of complying with many of the procedures required by Sarbanes-Oxley and has actively chosen to give the market a few years to set up these

---

[117] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), 12 U.S.C. §§ 5301-5641.

[118] Richard Gallagher, *The Rise and Growth of Whistleblowing and Executive Compensation Litigation*, NEW DEV. IN SEC. LITIG. 1 (2013).

[119] Katherine Blostein, *Clawbacks: Trends and Developments in Executive Compensation*, EXECUTIVE COMPENSATION SUBCOMMITTEE ERR MIDWINTER MEETING (Mar. 25, 2010), http://apps.americanbar.org/labor/errcomm/mw/Papers/2010/data/papers/014.pdf .

> procedures and find the past misconduct before imposing a harsh punishment.160 This theory best explains the sudden action in 2007, when no enforcement was previously seen. The SEC is signaling to the market that companies have had their chance to adjust to Sarbanes-Oxley; if they have not found the misconduct by now, the SEC is going to nail them for it.[120]

In any event, it appears that the "SEC is now increasingly focused on greater enforcement of the incentive compensation clawback provision of . . . Section 304(a)," even if the CEO and CFO of a company did not act wrongfully in triggering a restatement of the company's financial statements,[121] and it is likely that more enforcement actions in this area will be pursued by the SEC[122] When pursued, these provisions give the SEC "some very draconian powers" to combat the practice of publicly traded company to restate their financial statements.[123] Furthermore the

---

[120] List *supra* n. 116, at 223.

[121] Matthew J. O'Hara, *SEC Enforcement of the Sarbanes-Oxley Clawback Statute: Increased Enforcement Pressure in an Undeveloped Area of the Law*,SEC COMPLIANCE BEST PRACTICES,) 2015 WL 5565386 at 1; William R. Baker, III et al., *A Tale of Two Clawbacks: The Compensation Consequences of Misstated Financials*, LATHAM & WATKINS CLIENT ALERT 5 (Aug. 10, 2010), https://www.lw.com/upload/pubContent/_pdf/pub3662_1.pdf ("The SEC's recent aggressive use of its clawback authority under SOX 304 may presage a similarly aggressive interpretation of Dodd-Frank 954. US public companies would do well to consult promptly with counsel experienced in this area for advice on how to respond to these developments"); Marc J. Fagel, *2016 Year-End Securities Enforcement Update*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Feb. 2, 2017) at 10-11, https://corpgov.law.harvard.edu/2017/02/02/2016-year-end-securities-enforcement-update/ ("In a significant legal development for the Division of Enforcement, a federal court of appeals recently affirmed the authority of the SEC to obtain clawbacks of incentive-based compensation from CEOs and CFOs even where such executives are not themselves charged with misconduct. Under Sarbanes-Oxley, the SEC can compel these executives to return incentive-based compensation in the event of a restatement of the company financials due to corporate misconduct. While in the years following the 2002 passage of Sarbanes-Oxley the SEC typically sought clawbacks only from executives who were also charged with participating in the wrongdoing, the agency has increasingly brought stand-alone clawback actions against CFOs and CEOs even where it did not allege that the officer had him- or herself broken the law.").

[122] O'Hara *supra* n. 122, at 2 ("[W]e are currently seeing increased interest by the SEC in enforcing this statute, and therefore, we are likely to see more enforcement actions in this area."); Fagel *supra* n. 122, at 1 ("The SEC closed out the fiscal year by touting yet another record number of new enforcement actions and the $4 billion in disgorgement and penalties it had imposed on defendants.")

[123] O'Hara *supra* n. 122, at 1

incentive compensation clawback provision has given the company's auditors much more power to force senior management to comply with the auditors' views.[124] Nonetheless, the SEC's delay in aggressively pursuing the clawback claims has slowed the development of case law which clarifies the significant ambiguities inherent in Section 304(a).[125]

(4) Assess whether or not PricewaterhouseCoopers can be found liable to investors for their negligence, if any, in certifying ArthroCare's financial statements containing material overstatements of ArthroCare's earnings?

Courts employ four approaches in determining the liability of public accounting firms for negligently certifying financial statements containing material misstatements of earnings. The first approach, the *Ultramares* doctrine, is derived from *Ultramares Corp. v. Touche*,[126] in which the court decided that where there is no privity of contract between the accounting firm and the third party user of financial data, the accounting firm cannot be held liable for its negligence.[127] The second approach, the *Credit Alliance* doctrine, is derived from *Credit Alliance Corp. v. Arthur Andersen & Co.*[128]. *Credit Alliance* expanded the *Ultramares* doctrine by permitting an action for negligence against the accounting firm if the accountants were aware that the financial statement would be used for a particular purpose and that a known party or parties would rely on the financial statements.[129] The third approach is set forth in Section 552 of the Restatement

---

[124] *Id*..

[125] *Id*. at 3.

[126] 255 N.Y. 170 (N.Y. Ct. App. 1931).

[127] *Accord* Fehribach v. Ernst & Young LLP, 493 F.3d 905, 909 (7th Cir. 2007).

[128] 65 N.Y.2d 536, 551 (N.Y. Ct. App. 1985)

[129] *Accord* Marcus Bros. Textiles, Inc. v. Price Waterhouse, LLP, 513 S.E.2d 320, 324 (N.C. Sup. Ct. 1999).

(Second) of Torts,[130] which limits the liability of the accountant for negligence to cases in which the accountant manifests an intent to supply the information to a member of a group of persons for whose benefit the information is provided and who use the information for its intended purpose.[131] The fourth approach, exemplified by *H. Rosenblum Inc. v. Adler*,[132], is the reasonably foreseeable user approach, in which the accountant may be found liable for negligence by parties who are reasonably foreseeable recipients and users of the financial statements for business purposes and who relied on the financial statements for those business purposes.[133]

In *Ellis v. Grant Thornton LLP*,[134] the Court of Appeals for the Fourth Circuit, noting that West Virginia had adopted the Restatement (Second) of Torts Section 552 approach,[135] followed suit. Because there was no evidence that Grant Thornton knew a potential employee of its client

---

[130] Restatement (Second) of Torts § 552:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
> [T]he liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

[131] *See*, *e.g*., Marcus Bros. Textiles, Inc., v. Price Waterhouse, LLP, 513 S.E.2d at 324, (finding that a duty of care extends to specific parties if the auditor knows the parties will rely on the results of the audit).

[132] 93 N.J. 324, 332-339 (N.J. Sup. Ct. 1983).

[133] In 1994, the New Jersey lawmakers passed N.J.S.A. 2A:53A-25, which effectively overturned *Rosenblum*. It limits liability of accountants to cases in which the accountants knew at any time that a third party would rely on their statements. The liability of accountants to third parties in New Jersey was narrowed further in *Cast Art Industries v. KPMG*, 209 N.J. 208 (Sup. Ct. N.J. 2012), in which the court distinguished "knowing at any time during the audit" from "knowing at the time of engagement" that a third party would rely on the results. It found that the auditors must know at the time of the inception that the audited financial statements will be used by a third party.

[134] 530 F.3d 280, 287 (4th Cir. 2008).

[135] First National Bank of Bluefield v. Crawford, 182 W.Va. 107, 110 (Sup. Ct. App. W.Va. 1989).

would rely on the audit report, that Grant Thornton prepared the audit report to be used by potential employees, or that Grant Thornton intended a potential employee to use the audit report, the court found that Grant Thornton could not be held liable for negligence in preparing the audit report by a potential employee of the client who relied on the report in making a decision to accept an employment offer to work for the client. On the contrary, the audit report was delivered to the Board of Directors for its use, and stated it was to be used solely by its client, First National Bank of Keystone, and the Office of the Comptroller of the Currency, and was not intended for use by third parties.

Applying these principles to the ArthroCare audit, it is doubtful PwC would be found liable to investors for negligence in not detecting the scheme undertaken by Raffle and Applegate. There is no privity of contract between PwC and the investors, eliminating liability under the *Ultramares* doctrine. PwC was not apprised of a particular purpose or purposes for which the financial statements would be used, eliminating liability under the *Credit Alliance* approach. PwC did not undertake its auditing duties with the intention of benefiting specific investors in ArthroCare, and the investors in ArthroCare do not constitute a limited group of persons for whose benefit and guidance the information is supplied, eliminating liability under § 552 of the Restatement (Second) of Torts.[136] Finally, the reasonably foreseeable user approach has largely been abandoned, eliminating that route to making PwC liable.

---

[136] Because ArthroCare is headquartered in Texas and the Texas Supreme Court adopted § 552 of the Restatement (Second) of Torts as the standard for assessing the liability of accountants to third parties, this standard would likely be applied to PwC's audit of ArthroCare. *See* Ellis v. Grant Thornton LLP, 314 S.W.3d 913, 921 (Sup. Ct. Tex. 2010) ("Epic's bonds were sold on the open market: that only certain investors bought them does not make those investors a 'limited group.' As the United States Court of Appeals for the Fifth Circuit has explained, "to interpret the 'limited group' requirement as including all potential investors would render that requirement meaningless."). *See also* The Scottish Heritable Trust, PLC v. Peat Marwick Main & Co., 81 F.3d 606, 612 (5th Cir. 1996) ("the Texas courts have adopted the Restatement approach with respect to accountants' liability to third parties for negligent misrepresentation" and minority shareholders do not fall into the category of a "limited group" of investors justifiably able to rely on the financial statements.).

(5) Assess the liability of Baker and Gluk and Raffle and Applegate for violations of Section 10(b) and Section 18(a) of the 1934 Securities Exchange Act.

Section 10(b) of the Securities Exchange Act makes it

> unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange … [t]o use or employ, in connection with the purchase or sale of any security … any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[137]

Hence, in order to be successful in a Section 10(b) action, investors must prove that the defendant directly or indirectly participated in fraudulent or deceitful activities or made untrue statements in connection with the purchase or sale of a security, that those misstatements were material, and that the investors relied on the misstated financial statements when they purchased or sold their shares in ArthroCare.[138] As confirmed by their guilty pleas, it is clear Raffle and Applegate deliberately and knowingly overstated ArthroCare's sales of the SpineWand to DiscoCare and the revenues reported in ArthroCare's 2006 and 2007 10-K reports and its 2008

[137] 15 U.S.C.S. § 78j.

[138] Investors can establish reliance by showing they were aware of the company's misstatement at the time they bought or sold the securities. Investors may also use the "fraud-on-the-market" theory to demonstrate reliance on the falsified financial statements. The fraud on the market theory permits the court to presume an investor's reliance merely because the misrepresentation affects the information publicly available to the investor in the markets. In the absence of material misrepresentation, the actual value of the security is its market price. If false information is transmitted through the market and affects the price of the security, then the investor is misinformed about the true value of the investment. That presumption of reliance, however, is rebuttable. For example, the defendant may establish that an investor knew the market price was incorrect or that the misleading statements did not actually affect the value of the security. Basic Inc. v. Levinson, 485 U.S. 224, 246-247 (1988). The United States Supreme Court recently upheld the fraud-on-the-market theory in *Halliburton Co. v. Erica P. John Fund, Inc*., 134 S. Ct. 2398, 2408 (2014).

10-Q report, and hence can be found guilty of violating Section 10(b). In contrast, Baker and Gluk cannot be held liable for violating Section 10(b) in the absence of evidence they attested that the financial statements fairly presented the financial condition of ArthroCare and certified the adequacy of internal controls while knowing the financial statements overstated income and intentionally failed to disclose the misstatements in the financial statements. That they were found guilty of securities fraud in their criminal trial would appear to fulfill this element, but those verdicts were overturned on appeal.

An alternative approach to finding Baker and Gluk guilty of securities fraud under Section 10(b) as aiders and abettors to Raffle and Applegate's deliberate overstatement of revenues was vitiated by the U.S. Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). In *Central Bank*, the U.S. Supreme Court examined the text of 10(b), specifically that portion making it "unlawful for any person, directly or indirectly" to commit fraud in connection with the purchase of securities, and concluded that "there is no private aiding and abetting liability under § 10(b).[139] In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority (the Authority) issued $26 million in bonds to finance public improvements in Stetson Hills, a planned residential land commercial development in Colorado Springs. Central Bank of Denver (Central Bank) served as indenture trustee for the bond issues. The bonds were secured by landowner assessment liens, and the bond covenants

[139] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). "The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act. Then-SEC Chairman Arthur Levitt, testifying before the Senate Securities Subcommittee, cited *Central Bank* and recommended that aiding and abetting liability in private claims be established. Congress did not follow this course. Instead, in §104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress directed prosecution of aiders and abettors by the SEC." Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. 552 U.S. at 158. *See also* Sean G. Blackman, *Analysis of aider and abettor liability under Section 10(b) of the Securities Exchange Act of 1934*: Central Bank of Denver v. First Interstate Bank of Denver, 27 CONN. L. REV. 1323 (1995).

required the liens to be worth at least 160% of the bonds outstanding principal and interest. The covenants required AmWest Development (AmWest), the developer of Stetson Hills, to give Central Bank an annual report containing evidence that the 160% test was met. In January 1988, AmWest provided Central Bank with an updated appraisal which showed the land values almost unchanged from the 1986 appraisal. Realizing land values were declining in Colorado Springs and concerned Central Bank was relying on an outdated appraisal, the underwriter questioned whether the 160% test was met. Central Bank's in-house appraiser confirmed the underwriter's doubts about the reliability of the appraisal, and recommended an independent appraiser be engaged. After an exchange of letters between Central Bank and AmWest, Central Bank agreed to delay the independent review of the appraisal until after the June 1988 bond issue closed. Before the independent appraisal was completed, the Authority defaulted on the 1988 bonds. A private investor sued Central Bank for vicariously aiding and abetting an alleged fraud for delaying the independent appraisal of the value of the liens. Because Section 10(b) does not impose liability for aiding and abetting, claims by private investors are easily rejected. Hence the U.S. Supreme Court affirmed the district court's granting summary judgment in favor of Central Bank.[140]

Baker and Gluk and Raffle and Applegate may also be liable for the misstatements in ArthroCare's financial statements under Section 18(a) of the 1934 Securities Exchange Act.[141]

---

[140] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. at 191. *See also* Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135, 148 (2011) ("The statements in the Janus Investment Fund prospectuses were made by Janus Investment Fund, not by JCM. Accordingly, First Derivative has not stated a claim against JCM under Rule 10b-5.").

[141] 15 U.S.C.A. § 78r.

(a) Persons liable; persons entitled to recover; defense of good faith; suit at law or in equity; costs, etc. Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation . . .,which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was

Section 18(a) imposes liability on those persons responsible for false or misleading statements of material fact in any 10-K, 10-Q or proxy solicitation statements filed with the SEC. As is the case with Section 10(b), investors must prove they relied on the false statement in order to recover damages, but need not establish the defendant was at fault. If the defendants prove they acted in good faith and did not know that the statement was false or misleading, they have a complete defense to the investors' claim.[142]

Having pled guilty to conspiracy to commit securities fraud through their scheme to inflate earnings, Applegate and Raffle have no defense to the investors' claim and may be found liable under Section 18. Not having pled guilty and their convictions for security fraud having been overturned, Baker and Gluk have a much different posture in assessing their liability under Section 18(a). While the investors need not establish that Baker and Gluk were at fault, Baker and Gluk may escape liability under Section 18(a), if they can establish they were unaware of the scheme to falsely inflate sales.

(6) If ArthroCare had not acquired DiscoCare, could DiscoCare be held liable for its participation in the activities that permitted ArthroCare to overstate its income in its financial statements?

The United States Supreme Court addressed the question of whether a third party customer is liable under Section 10(b) for participating in the scheme to overstate earnings in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta Inc.*[143] Facing a shortfall in projected

---

> false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

[142] 15 U.S.C.A. § 78r.

[143] 552 U.S. 148 (2008).

earnings, Charter Communications, Inc. reached an agreement with two of its major customers, Scientific-Atlanta and Motorola, to overpay them $20 on each purchase of a set top box and to have Scientific-Atlanta and Motorola return the $20 to Charter Communications by purchasing advertising from Charter Communications. This arrangement enabled Charter Communications to record the advertising fees as revenues to assist it to meet projected revenue and cash flow expectations. In order to hide this scheme from its auditors, Charter Communications drafted documents to make it appear the transactions were independently conducted in the ordinary course of business. Scientific-Atlanta and Motorola, in turn, provided documents to Charter Communication explaining the increased price for the set top box was caused by increased production costs or liquidated damages triggered by a failure to purchase certain quantities of the set top boxes, and signed contracts with Charter Communications to purchase advertising time. The set top box purchase agreements were backdated to make it appear they preceded the advertising contracts. This scheme enabled Charter Communications to falsely inflate revenue and operating cash flow by approximately $17 million on the financial statements filed with the SEC and reported to the public. Even though Scientific-Atlantic and Motorola had no role in preparing or disseminating Charter Communications' financial statements, and recorded the transactions as a wash, consistent with generally accepted accounting principles, investors filed a securities fraud class action suit against Scientific-Atlanta and Motorola, claiming they knew Charter Communications intended to use the transactions to overstate its revenues and assisted it in doing so. The district court granted Scientific-Atlanta and Motorola's motion to dismiss for failure to state a claim on which relief can be granted. The court of appeals affirmed on the grounds that the allegations did not show that Scientific-Atlanta and Motorola made misstatements relied upon by the public or that they violated a duty to disclose, because at most

Scientific-Atlanta and Motorola had facilitated Charter's misstatement of its financial results, but, the circuit court noted, there is no private right of action for aiding and abetting a Section 10(b) violation. On appeal, the U.S. Supreme Court affirmed:

> Here respondents were acting in concert with Charter in the ordinary course as suppliers and, as matters then evolved in the not so ordinary course, as customers. Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. In these circumstances the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action.[144]

Under *Stoneridge,* then, it is doubtful that DiscoCare could have be found liable for its participation in the activities that permitted ArthroCare to overstate its income in its financial statements, because investors did not rely upon DiscoCare's reporting of the transactions in its financial statements.[145]

(7) Assess the liability of PricewaterhouseCooper for violations of Section 10(b) of the 1934 Securities Exchange Act.

---

[144] Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. 552 U.S. at 166-167.

[145] The instructor using this case may want to ask the students whether they think DiscoCare should be held liable and, if so, why.

In order to hold PwC liable for violations of Section 10(b) a plaintiff must prove: (1) that PwC knowingly made untrue statements or omitted facts, both of which rise to the level of being material, (2) that the injured party justifiably relied on PwC's statements of fact, (3) that the injured party suffered damages as a result of relying on said statements or facts, and (4) that there was actual intent to deceive or defraud.[146] Because there is no evidence in the case indicating PwC certified ArthroCare's financial statements knowing they were misstated and with the intention to deceive investors, PwC cannot be found liable for violating Section 10(b) of the 1934 Securities Exchange Act. This conclusion is compelled by *Ernst & Ernst v. Hochfelder*, in which the Supreme Court determined that Section 10(b) "cannot be read to impose liability for negligent conduct alone."[147] Rather Section 10(b) liability arises from "knowing or intentional misconduct," in the absence of which there is no right of recovery. In *Hochfelder*, customers of a brokerage firm filed suit against Ernst & Ernst, because it failed to detect a stock scheme perpetrated by the firm's president and owner in performing its audit. Since there was no allegation Ernst & Ernst acted with the intent to deceive, manipulate or defraud in performing its auditing engagement, the Court found that the claim pursued by the brokerage firm customers was properly dismissed.

(8) What accounting rules or principles did the accounting scheme implemented by Raffle and Applegate violate?

Generally Accepted Accounting Principles, commonly referred to as GAAP, proscribe rules and standards for recording transactions and reporting financial data. The Financial Accounting Standards Board (FASB) issues standards and pronouncements and as of July, 1,

---

[146] Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 842 (7th Cir. 2007); Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F3d. 851, 854 (8th Cir.2005).

[147] 425 U.S. 185, 197, 201 (1976).

2009, became the sole official source of GAAP. There are various principles relevant to this case, among which is the revenue recognition principle. This principle determines what and when revenue should be recorded. FASB ASC 605 sets out guidelines in recognizing revenue and other revenue related detailed information. In the most simplistic sense, there are two bases of recording revenue and expenses – the case basis and the accrual basis. If a company is employing the cash basis, then revenue is recognized or recorded when the cash is actually received. In the accrual basis of accounting, revenue is recognized when it is earned, for example, once the service has been completed. In this case, ArthroCare continued to ship products to DiscoCare despite the fact that DiscoCare did not need them in an effort to meet revenue projections. The parties had previously agreed that ArthroCare would delay recognition of revenue until the surgeries were performed and the price was certain, and this agreement is inconsistent with revenue recognition under both the cash basis of accounting (income is recognized when payment is received) and the accrual basis of accounting (income is recognized when earned).

ArthroCare also departed from other GAAP standards. In November 1, 2006, ArthroCare agreed to pay a monthly service fee to DiscoCare to cover DiscoCare's distribution expenses with one-half being crediting to the account receivable and the other half paid to DiscoCare so that it had cash flow to pay its accounts payable to ArthroCare. This arrangement altered ArthroCare's revenue recognition and thus violated GAAP. Unless cash is actually received simultaneously when the surgery is performed, the cash basis method of accounting for revenue was incorrectly utilized. In the alternative, revenue could have been recognized when shipped, as was done previously. Instead, the parties agreed to a scheme wherein revenue was to be recognized based on performed surgeries, events normally irrelevant when employing either the cash or accrual bases. GAAP provides that revenue is to be recognized when there is a sale of goods or when the products are delivered, as noted in SEC Staff Accounting Bulletin No. 101, which clearly delineates when revenue should be recognized: "the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)."[148] Hence it is difficult to reconcile waiting for the product to be used, *i.e.*, when the surgery was performed with SAB 101.

Second, at the end of 2006, Raffle and Applegate "persuaded" the accounting department to record additional sales to DiscoCare even though the surgeries were not complete, thus were not yet earned, according to accounting standards. Third, in 2007, ArthroCare shipped $2.1 million of SpineWands despite the fact that DiscoCare had only $900,000 of approved surgical cases, thereby violating their agreement regarding recognition of revenue. Fourth, ArthroCare double counted revenues. It shipped $15 million to DiscoCare and asked DiscoCare to delay selling the wands, which allowed ArthroCare to record revenue earned on the wands for a second time when they were actually sold. Obviously, revenue is earned only once and thus should so be recorded. Finally, ArthroCare engaged in "channel stuffing," or sending more products than a distributor is able to sell in an effort to distort and inflate its own revenues.

ArthroCare's actions are quite similar to the SEC's accounting fraud charges against Lucent Technologies for violating the GAAP revenue recognition principle by engaging in channel stuffing.[149] Among other actions, some high level Lucent employees were charged with

---

[148] SEC Staff Accounting Bulletin: No. 101 – Revenue Recognition in Financial Statements, 17 CFR Part 211 (Release No. SAB 101), December 3, 1999, accessed on March 25, 2017, at https://www.sec.gov/interps/account/sab101.htm

[149] *See* S.E.C. v. Lucent Technologies, Inc., 610 F. Supp.2d 342 (D. N.J. 2006). Lucent and several of the individual defendants reached out-of-court settlements with the SEC and were dismissed from the case.

sending products to customers that were not needed and promising an easy return policy in an effort to inflate revenues. In 2004, Lucent agreed to settle the SEC charges by consenting to a judgment enjoining it from violations of anti-fraud provisions of federal securities law and paying a $25 million penalty.[150]

(9) Assess the morality of the actions of Raffle and Applegate and Baker and Gluk in crafting the scheme to misstate ArthroCare's financial statements.

As their guilty plea clearly demonstrates, Raffle and Applegate deliberately and knowingly executed the scheme to vastly overstate ArthroCare's earnings. The facts of the case also show that more harmful damages were inflicted on those affected by their actions, including themselves, than beneficial results. The losses to investors in ArthroCare, estimated to be $400 million, clearly outweigh any financial benefit to Raffle and Applegate (approximately $2.4 million), which was disgorged in any event. Hence Raffle and Applegate's fraudulent actions must be deemed to be immoral under the theory of Act Utilitarianism.[151] Likewise, following a rule of conduct that business executives should falsely overstate earnings in order to meet earnings projections clearly produces more harm than benefit to those affected. The damage to

---

[150] SEC v. Lucent Tech. et al. ,Litigation Release No. 08715, *SEC Charges Lucent Technologies, Inc. and Ten Defendants for a $1.1 Billion Accounting Fraud*, U.S. SECURITIES AND EXCHANGE COMMISSION (May 17, 2004), https://www.sec.gov/litigation/litreleases/lr18715.htm.

[151] "Act utilitarians believe that whenever we are deciding what to do, we should perform the action that will create the greatest net utility. In their view, the principle of utility—do whatever will produce the best overall results—should be applied on a case by case basis. The right action in any situation is the one that yields more utility (i.e. creates more well-being) than other available actions." *How Act Utilitarianism and Rule Utilitarianism Differ*, INTERNET ENCYCLOPEDIA OF PHILOSOPHY, para 2, accessed on March 22, 2017, at http://www.iep.utm.edu/util-a-r/#H2. *See also* John M. Kline, ETHICS FOR INTERNATIONAL BUSINESS: DECISION MAKING IN A GLOBAL POLITICAL ECONOMY 9 (2d Ed. 2010) ("[Utilitarianism] focuses on the consequences, seeking the greatest good for the greatest number. The related decision rule argues that an action is "right" if and only if it produces as great a value/disvalue function as any available alternative action."); Laura P. Hartman, PERSPECTIVES IN BUSINESS ETHICS, 6 (2004) ("[U]tilitarianism] . . . directs us to make decisions bases on the greatest "good" (or utility) for the greatest number as the end result. . . . The most basic form of utilitarian analysis is cost-benefit analysis where you tally the costs and benefits of a given decision and follow the decision that provides for the greatest overall gain.").

the integrity of the financial system and ensuing collapse of investor confidence in financial institutions dwarfs any financial benefit that flows to executives who falsely inflate their company's earnings. Hence Raffle and Applegate's fraudulent actions must be deemed to be immoral under the theories of Rule Utilitarianism.[152] Furthermore, Raffle and Applegate's fraudulent actions are deemed immoral under Kant's Categorical Imperative, which requires the actor to be willing that all other individuals may act in the same manner, *i.e.*, the actor must be willing to have others act the same way toward the actor.[153] It is highly doubtful Raffle and Applegate would permit all other business executives to fraudulently misstate their company's financial statements. Finally, Rawls' Veil of Ignorance theory[154] likely renders Raffle and Applegate's conduct unethical. Not knowing what position they might occupy in society, they certainly would not permit fraudulently misrepresented financial statements to be included in

---

[152] INTERNET ENCYCLOPEDIA OF PHILOSOPHY, surpa n. 151 ("Rule utilitarians adopt a two part view that stresses the importance of moral rules. According to rule utilitarians, a) a specific action is morally justified if it conforms to a justified moral rule; and b) a moral rule is justified if its inclusion into our moral code would create more utility than other possible rules (or no rule at all). According to this perspective, we should judge the morality of individual actions by reference to general moral rules, and we should judge particular moral rules by seeing whether their acceptance into our moral code would produce more well-being than other possible rules.") Kline, *supra* note 151, at 10 ("[R]ule utilitarianism . . . maintains the emphasis on consequences but acknowledges the difficulty of knowing the outcome of each individual action. Therefore, rules are accepted as appropriate for certain types of actions in the expectation that abiding by the rules will yield the greatest good for the greatest number in the long run.").

[153] Kline *supra* note 151, at 10 ("[A] decision rule was considered ethical if all rational beings, thinking rationally, would accept the rule whether they were the giver or receiver of the action."); Hartman, *supra* note 151, at 8 ("Kant propounded the *categorical imperative*, the notion that every person should act on only those principles that she or he, as a rational person, would prescribe as universal laws to be applied to the whole of mankind. (This approach has also been called *universalism*.) Universalism suggests that, in reaching a decision, we should consider whether it would be acceptable if everyone in every situation made the same decision.").

[154] Kline, *supra* note 151, at 10 ("John Rawls adapted [the concept of universalism] to a theory of justice in his famous "veil of ignorance" test, asking what principles we would call fair if we did not know our place in a society (and therefore could not anticipate how the principles might impact us.)); Hartman, *supra* note 151 at 7 ("Rawls argues that under a veil of ignorance we would build a cooperative system in which benefits (e.g., income) would be distributed unequally only where doing so would be to the benefit of all, particularly the least advantaged. All those behind the veil would agree to that unequal standard because they could not know whether they would be among the advantaged or the disadvantaged. From this system of distributive economic justice, it follows that ethical justice is measured by the capacity of the act in question to enhance cooperation among members of society. That which is determined from behind the veil of ignorance is deemed ethical through the fairness of the end result.").

reports filed with the SEC, because they might be the investors who relied on the fraudulently stated earnings and lost substantial sums of money.

Although their conviction of the crimes of wire and securities fraud belie their contentions, Baker and Gluk claim they were unaware of the scheme concocted by Raffle and Applegate to misrepresent ArthroCare's earnings, a matter that will likely be resolved when they are retried for wire and securities fraud. Assuming they were unaware of Raffle and Applegate's actions, they nonetheless acted immorally by failing to meet their responsibilities to assess the adequacy of ArthroCare's internal controls and to investigate the legitimacy of the incestuous relationship and extraordinary sales transactions between ArthroCare and DiscoCare. Their failure to meet these responsibilities clearly caused more harm than good to all of those affected, and following a rule of conduct that executives should not investigate the adequacy of internal controls or highly suspicious business transactions clearly produces more harm than good to all of those affected. Hence Baker and Gluk's failure to meet their managerial responsibilities must be deemed immoral under Act and Rule Utilitarianism. Likewise, Baker and Gluk's failure to meet their managerial responsibilities does not constitute a universal practice that they would be willing to have every person engage in, and hence flunks Kant's universalism principle. Similarly, the failure of Baker and Gluk to meet their managerial responsibilities cannot pass muster under Rawls' Veil of Ignorance theory. Not knowing what position they might occupy in society and what advantages or disadvantages they might possess, individuals would not accept Baker and Gluk's failure to meet their managerial responsibilities. Hence their action or inactions must be deemed immoral under Kant's Categorical Imperatives and Rawls' Theory of Justice.

(10) Assuming (a) that Baker and Gluk were not aware of the fraudulent scheme undertaken by Raffle and Applegate to fraudulently overstate ArthroCare's income and (b) that Baker and Gluk did not engage in any conscious or intentional wrongdoing, assess the morality of applying the clawback provisions to Baker and Gluk and making them return all incentive compensation they received during the period of time the financial statements were misstated.

Assuming Baker and Gluk did not engage in any conscious or intentional wrongdoing, applying the clawback provisions of Section 304(b) of the Sarbanes-Oxley Act of 2002 to recapture all of the incentive compensation paid to Raffle and Applegate may be deemed moral under Act Utilitarianism, if the good consequences flowing from the clawback outweigh the bad consequences to all those affected. The recapture of their incentive compensation discourages business executives from engaging in conduct that denigrates the integrity of the financial markets and prevents CEOs and CFOs from benefiting from misstated financial statements. These benefits presumably outweigh the negative financial consequence inflicted on Baker and Gluk. Further, pursuing a rule of conduct that recaptures incentive compensation received as a consequence of misstatements of financial statements regardless of their intention to engage in misconduct likely produces more beneficial results than negative consequences to those affected. Hence applying the clawback provisions regardless of the complicity or culpability of the CEO and CFO is likely moral under both Act and Rule Utilitarianism.

Further, clawbacks of incentive compensation paid to CEOs and CFOs because of misstated financial statements may constitute a universal practice that all executives would accept to insure the integrity of the financial markets, and hence would be deemed moral under Kant's Categorical Imperatives. Likewise, the forfeiture of incentive compensation paid to

CEOs and CFOs because of misstated financial statements appears to pass muster under Rawls' Veil of Ignorance theory. Not knowing what position we might occupy in society, individuals likely would choose to have incentive compensation recaptured to discourage executives from issuing fraudulent financial statements. Hence enforcing the clawbacks regardless of the CEO's and CFO's awareness of the fraudulent financial statements or whether they engaged in intentional wrongdoing may be moral under Kant's and Rawls ethical theories.

VI. CONCLUSION

In creating this case study, the authors hoped not only to facilitate their students' understanding of generally accepted accounting principles and the major antifraud provisions of securities law, but also to help them appreciate the interconnectedness of materials covered in Legal Environment of Business and Principles of Accounting I. By delving deeply into the civil pleadings and examining in detail the specific schemes undertaken by the executive officers of ArthroCare to misstate earnings and defraud investors over a three year period, the case study provides a clear example of how violations of generally accepted accounting principles fit within the fraud provisions of the Sarbanes-Oxley Act and the 1934 Securities Exchange Act. Hopefully seeing those interconnections will encourage students to see similar interconnections in their other business courses. Likewise, by describing the multiple legal actions taken against the ArthroCare executives by the DOJ and SEC and the significant penalties imposed on those executives and ArthroCare, the case alerts students to the significant investigatory and enforcement powers of the DOJ and SEC to combat securities fraud. Perhaps these materials will also make the students more hesitant to construct such schemes in their careers and to be more vigilant in their business dealings. Finally, by specifically examining the GAAP violated by the executive officers of ArthroCare in recording its sales of SpineWands to DiscoCare, students are more clearly apprised of the application of those principles not only in preparing financial statements but also in establishing a securities fraud case.