

Case Study – Le-Nature’s Inc.

What happened and why – highlights from the case study:

- Executive management “tone at the top”
- Reliance on “junk bonds” for financing
- Errors on accounting records
- Material internal control weaknesses
- Fraud
- Others?



MD

Le-Nature’s Inc – Discussion Questions



- Discuss of fraud triangle: factors and examples
 - Which risk factors are evident in the Le-Nature case?
 - Impact on accounting and financial reporting and how PCAOB views risk factors relating to misstatements from fraudulent financial reporting
 - Use COSO framework to identify deficiencies in Le-Nature’s system of internal controls
 - Impact on stakeholders
 - Management accountant roles: impact on internal control, fraud prevention, corporate ethics/good governance
 - Comments on individual ethics and “prison tally?”

Le-Nature's Inc. Fraud: What Happened and Why?

Michael C. Knapp

*McLaughlin Chair in Business Ethics and
Professor of Accounting
University of Oklahoma*

Carol A. Knapp

*Assistant Professor
University of Oklahoma*

INTRODUCTION

After graduating from West Virginia University in 1984 with a degree in accounting and finance, Gregory Podlucky decided to work with his father Gabriel, who had a small business empire in western Pennsylvania that included a chain of auto parts stores, an ethanol fuel company, several real estate properties, and the Jones Brewing Company, best known for its line of Stoney's beers.

In 1989 Gregory Podlucky decided to strike out on his own. Using the funds he obtained from cashing out his ownership interest in his father's businesses, Podlucky established a water bottling venture in Latrobe, Pa., the hometown of golfing great Arnold Palmer. In 1992, entrepreneur and former CPA Podlucky expanded his product line to include a wide range of flavored water, fruit, and tea drinks.

Despite being in the hypercompetitive beverage industry, Podlucky's company, which he ultimately named Le-Nature's Inc., grew rapidly. By 2006, the company was the 33rd largest beverage producer in the United States, with annual reported sales approaching \$290 million and a workforce of several hundred employees. One year earlier, Podlucky had rejected a \$1.2 billion offer to sell Le-Nature's. Instead of selling, Podlucky decided to take his company public. Unfortunately for him, his fellow investors, and his company's many creditors, that dream was never realized.

STRATEGIC FINANCING

Podlucky served as Le-Nature's chief executive officer (CEO) and relied principally on his family and wide circle of friends and business associates to staff the company's other key positions as it expanded over the years. He hired his brother Jonathan to serve as Le-Nature's chief operating officer (COO) and placed his 22-year-old son Jesse in charge of the day-to-day accounting for Le-Nature's large subsidiary that produced bottled tea products. Among the friends that he appointed to management positions at Le-Nature's was Robert Lynn, who held different titles during his years with the company, including executive vice president of sales.

Despite serving as Le-Nature's CEO, Gregory Podlucky was also heavily involved in the company's routine accounting functions.¹ Tammy Andreycak, another close friend of Podlucky, held the title of director of accounting, and was the organization's chief accountant. But Andreycak was a single mother who did not have a college degree or formal training in accounting. According to company insiders, her primary role within Le-Nature's was serving as Podlucky's confidante. When dealing with third parties, Podlucky often referred to Andreycak as his secretary.²

A shortage of capital is a common problem for rapidly growing small companies. Therefore, Podlucky relied on a variety of different strategies to finance his company's expanding operations. During the 14 years that he served as Le-Nature's CEO, the articulate and outgoing Podlucky raised almost \$1 billion of debt and equity capital for the company.

In 1999, Podlucky retained a financial consulting firm to identify potential investors for Le-Nature's. In 2000 and 2002, that consulting firm arranged for two investment funds to collectively purchase eight million shares of Le-Nature's preferred stock, which they had the right to convert into the company's common stock. If the two funds had exercised the convertibility option, they would have controlled 45% of Le-Nature's outstanding common stock. Instead, Podlucky owned all of his company's outstanding common stock throughout its existence.

The sales of preferred stock raised nearly \$30 million for Le-Nature's. Those transactions directly affected Le-Nature's corporate governance structure because each of the investment funds that purchased the preferred stock had the right to appoint an individual to the company's board of directors. The majority of the board consisted of "inside" directors including Podlucky, his brother Jonathan, and other senior company executives.

Podlucky also used long-term equipment leasing as a financing technique. In one such transaction, Podlucky retained a North Carolina leasing agent to contract with a Wisconsin-based company that was a subsidiary of a German manufacturing firm. The German firm manufactured equipment Le-Nature's used in its bottling operations. With the North Carolina leasing agent serving as an intermediary, Le-Nature's leased the equipment from the Wisconsin subsidiary of the German firm. The leasing agreement required Le-Nature's to make a large escrow deposit with the leasing agent; Le-Nature's borrowed the funds to make that deposit from a U.S. lender. In total, Podlucky financed the acquisition of approximately \$300 million of equipment in this manner.

Podlucky used conventional long-term borrowing arrangements as the primary method for raising funds for his company. Wachovia, a diversified financial services firm based in North Carolina, arranged or underwrote approximately \$500 million of long-term debt for Le-Nature's.³ In 2005, for example, Wachovia marketed a \$150 million bond issue for the company. The high-yield or "junk" bonds were sold primarily to pension and retirement funds such as CalPERS (California Public Employees Retirement System), the nation's largest pension fund.

Podlucky relied heavily on Le-Nature's audited financial statements to borrow funds for his company. For example, in the case of the \$150 million bond issue, Wachovia included Le-Nature's audited financial statements with the promotional materials for those bonds. Likewise, Moody's Investors Services accessed and relied on Le-Nature's financial statements to assign credit ratings to those bonds—and the company's other outstanding debt obligations.

SUSPICIONS AND RESIGNATIONS SPARK INVESTIGATION

In August 2003 Le-Nature's independent audit firm, Ernst & Young (EY) was completing its review of the company's financial statements for the second quarter of fiscal 2003. During the EY quarterly review, a standard procedure was to ask a client's senior executives whether they suspected or were aware of any fraudulent activity within the organization. When Richard Lipovich, the EY audit engagement partner, posed that question to John Higbee, Le-Nature's CFO at the time, Higbee candidly replied that he had significant doubts about the reliability of his company's recorded sales figures. Lipovich received similar responses from Le-Nature's chief administrative officer (CAO) and its vice president of administration (VPA). The day after communicating their concerns to Lipovich, the three company officials submitted letters of resignation to Gregory Podlucky.

In their resignation letters, the three former executives suggested that Podlucky was "engaging in improper conduct with Le-Nature's tea suppliers, equipment vendors, and certain customers."⁴ Higbee—who had served for 20 years as an audit partner with Arthur Andersen & Co., including 16 years heading up the audit practice for that firm's Pittsburgh office—reported that Podlucky had repeatedly refused to provide him with documentation supporting key transactions reflected in Le-Nature's accounting records. He considered Podlucky's failure to provide such documentation "an astonishing and extremely improper restriction for any executive officer to impose upon a company's chief financial officer."⁵ Those restrictions made it impossible for Higbee to satisfy his CFO-related corporate governance responsibilities.

Higbee also identified what he considered to be several material weaknesses in Le-Nature's internal controls. Those weaknesses included Podlucky's "absolute control" over the company's "detailed financial records" and the lack of "checks and balances" for key assets of the company, such as the large escrow deposits for its long-term equipment leases and its product inventories.⁶

The startling statements by Higbee and his two former colleagues in their resignation letters prompted Lipovich to write a letter to Le-Nature's board of directors. In that letter, Lipovich requested that Le-Nature's retain an independent law firm to investigate and file a report regarding the allegations made by the three former company executives. Lipovich informed Le-Nature's board that EY would not be associated with any of the company's financial statements until the law firm completed its investigation, EY reviewed

the report, and EY determined if it had to undertake any other investigative procedures.

Le-Nature's board responded to Lipovich's letter by creating a Special Committee to investigate the allegations made by the three former executives. That committee was made up of the outside members of the company's board, which included the directors appointed by the investment funds that had purchased Le-Nature's preferred stock. The Special Committee retained an independent law firm, K & L Gates (one of the 10 largest legal firms in the United States) to supervise that investigation. In turn, K & L Gates hired an independent accounting firm, Pascarella & Wiker, to assist in the investigation.

In late November 2003, K & L Gates submitted a draft copy of its report to Podlucky, who was not a member of the Special Committee. The CEO provided feedback regarding the report to the law firm. One week later, K & L Gates provided a revised copy of the report to the members of the Special Committee. The report "found no evidence of fraud or malfeasance,"⁷ although it did identify multiple internal control weaknesses. Among the suggestions made to remedy those internal control weaknesses were strengthening the segregation of duties for key transactions such as equipment leases and inventory purchases, adopting more rigorous documentation standards for those transactions, and establishing an audit committee consisting of outside directors.

The outside directors on the Special Committee accepted the findings of the investigative report and indicated that they would work with the other members of Le-Nature's board of directors to address the identified internal control problems. Shortly thereafter, Le-Nature's dismissed EY as its independent audit firm and retained BDO Seidman, which would ultimately audit the company's 2003 through 2005 financial statements.

FRAUD ALLEGATIONS RESURFACE

Following the 2003 investigation, Gregory Podlucky rededicated himself to enhancing his company's stature and size in the beverage industry. Le-Nature's impressive financial data caught the attention of several private equity funds in 2005 when Wachovia prepared and distributed a confidential memorandum to sell the company to the highest bidder. The initial bid received for the company was \$1.2 billion. To the disappointment of the company's preferred stockholders, Podlucky rejected that offer. The preferred stockholders claimed that Podlucky intentionally sabotaged the sale of Le-Nature's by refusing to allow the potential buyer access to the company's accounting records. Podlucky

dismissed that allegation and instead maintained that he had rejected the buyout offer because the price had been too low.

In May 2006, the preferred stockholders filed a lawsuit against Le-Nature's, Podlucky, and other top executives to force an outright sale of the company. Despite that lawsuit, Podlucky began preparing an initial public offering (IPO) for Le-Nature's with the assistance of K & L Gates. At the same time, Wachovia was in the process of arranging more than \$300 million of additional long-term loans for Le-Nature's.

Podlucky's plans for his company were disrupted when allegations of an accounting fraud within Le-Nature's resurfaced. The CEO responded to those allegations by pointing to the fact that his company's financial statements had received an unqualified audit opinion each year from Le-Nature's independent auditors. Podlucky also insisted that "the financial stability of Le-Nature's has never been stronger"⁸ and boldly predicted that Le-Nature's sales would nearly quadruple over the next four years from approximately \$290 million to more than \$1 billion annually. In October 2006, Le-Nature's preferred stockholders requested a restraining order against the company in a petition they filed with a Delaware court. In the petition, the preferred stockholders referred the court to a fraudulent equipment leasing transaction arranged by Le-Nature's. One of the lenders that provided the financing for the company's long-term leases had determined, with the assistance of a handwriting expert, that certain documents for the given transaction had been forged. The forged documents had resulted in \$20 million of the lease escrow deposit financed by the lender being improperly transferred to Le-Nature's.

The Delaware court issued the requested restraining order, evicted Podlucky from the company's corporate headquarters, and appointed Steven Panagos of Kroll Zolfo Cooper (a consulting firm specializing in corporate turnarounds and restructuring) to serve as the custodian of Le-Nature's assets and operations. Less than one week later, Panagos filed an affidavit with the court that presented evidence of a massive accounting fraud within the company. He also reported that he had found evidence that Podlucky had "frantically shredded company documents"⁹ before he was forced to leave Le-Nature's corporate headquarters. Even more troubling was the custodian's discovery that the company had been maintaining two sets of accounting records.

Panagos' affidavit spurred Le-Nature's creditors to file a petition to initiate involuntary bankruptcy proceedings against the company. A federal bankruptcy judge approved that petition and appointed a bankruptcy trustee to take control of Le-Nature's for the purpose of liquidating it and pursuing any viable legal claims against individuals or entities involved in undermining the company.

FRAUD ON A GRAND SCALE

Investigations of Le-Nature's accounting records by the company's court-appointed custodian, bankruptcy trustee, and law enforcement authorities revealed the sordid details of the brazen accounting hoax Podlucky initiated in the late 1990s. The individual who would prove to be most helpful in unraveling the fraudulent scheme was Andreycak, Le-Nature's director of accounting and Podlucky's most trusted associate. After pleading guilty to multiple criminal charges, Andreycak agreed to cooperate with law enforcement authorities investigating the Le-Nature's scandal. A federal judge would subsequently note that Andreycak and Podlucky were the only "two people aware of the magnitude of the [Le-Nature's] fraud."¹⁰

James Garrett, a federal prosecutor with the U.S. Department of Justice assigned to the Le-Nature's case, characterized the fraud masterminded by Podlucky as a "financial mirage" the likes of which he would not even dream could be created."¹¹ In 2002, the company had reported sales of more than \$135 million when the company's actual sales were less than \$2 million. Three years later, in 2005 (the fiscal year before the fraud was uncovered) Le-Nature's audited financial statements reported revenues of \$287 million when the company's actual revenues were less than \$40 million. A large portion of the bogus revenues booked by Le-Nature's was cycled through its tea subsidiary. From 2000 through 2006, that subsidiary reported sales of \$240 million while its actual sales during that period were less than \$100,000.¹²

Podlucky and his co-conspirators used Le-Nature's graphics department to prepare a slew of bogus purchase orders, sales invoices, and other fake documents to sustain the accounting fraud. The bogus documents allowed the conspirators to conceal Le-Nature's enormous volume of fictitious revenues from the company's lenders, independent auditors, and regulatory authorities. As determined by one of Le-Nature's lenders, the conspirators also used forged documents to improperly transfer deposits held in escrow by a leasing agent to Le-Nature's. In turn, that leasing agent provided confirmations to Le-Nature's independent auditors that intentionally overstated the dollar amount of deposits being held by his firm on behalf of the company.

Le-Nature's maintained two completely separate accounting systems during the course of the massive accounting fraud. One system accumulated the company's actual transaction data but only Podlucky and Andreycak could access this system. The other accounting system contained primarily fraudulent financial data. The company's independent auditors were never aware of the accounting

system that had actual transaction data. Podlucky was also successful in concealing that accounting system from law firm K & L Gates and accounting firm Pascarella & Wiker, that were involved in the Special Committee fraud investigation of 2003.

Podlucky used Le-Nature's phony financial statements to convince third parties to loan funds to the company. He then siphoned off large amounts of those borrowed funds for his personal use. Because the stolen funds had to be repaid, it was necessary for Podlucky to continually borrow additional amounts. This cycle of repaying stolen funds with new loans caused law enforcement authorities to characterize his fraud as a Ponzi scheme.

As pointed out by Le-Nature's court-appointed bankruptcy trustee, the 2003 Special Committee investigation tragically backfired on the company's preferred stockholders and creditors, who were the primary victims of Podlucky's scam. The "no fraud" conclusion of the investigative report submitted to the Special Committee allowed Podlucky and his co-conspirators to continue "looting" the company "and wasting corporate funds on avoidable transactions" for three more years.¹³

Federal law enforcement authorities placed a final price tag of nearly \$700 million on Podlucky's long-running scam. U.S. District Judge Alan Bloch, in a decision that was largely symbolic, imposed a \$661 million restitution order on Podlucky. That figure included the huge losses suffered by Le-Nature's enormously unprofitable business operations and the funds embezzled and squandered by Podlucky and his family members.

Podlucky used the embezzled funds to finance a lavish and ostentatious lifestyle. An audit of Podlucky's personal finances revealed that in one year he spent \$45,000 on shoes; his corporate salary at the time was \$50,000. When he lost control of Le-Nature's, Podlucky was building a palatial, 25,000-square-foot home near the company's headquarters that had a price tag approaching \$20 million. Investigators discovered nearly \$30 million of jewelry (purchased with Le-Nature's funds) in a secret room within the company's corporate headquarters. Years later, authorities recovered additional jewelry worth millions of dollars, when members of the Podlucky family attempted to sell it through Sotheby's auction house. Law enforcement authorities seized other extravagant Podlucky personal assets, including a small fleet of luxury automobiles and an immense model train collection that he had acquired at a cost of \$1 million.

The lynchpin of the Le-Nature's fraud was the fatal flaw in the company's corporate governance system that allowed Podlucky to single-handedly manipulate and distort the company's reported financial results. Outside of the company,

Podlucky was perceived as a gregarious, well-meaning individual who was heavily involved in charitable, religious, and political organizations and activities. Internally, Podlucky (a very large man) was known for his overbearing and volatile disposition. Podlucky used his domineering personality to control his subordinates.

During their testimony in various court proceedings, Podlucky's former colleagues alluded to his "foul-mouthed, dictatorial style" that he used to "bully" them into submission.¹⁴ In one particularly revealing anecdote that they reported, Podlucky forced a fellow executive to take off his (Podlucky's) shoes, shine them, and then put them back on his feet. The executive was also forced to tie the shoes and adjust Podlucky's socks.

Podlucky's son Jesse also eventually faced criminal charges for his role in the Le-Nature's fraud. A principal element of his attorneys' defense strategy was the fact that the young accountant had been controlled and manipulated by his tyrannical father throughout his life, which allegedly reduced Jesse's responsibility for his misdeeds. Jesse's attorneys reported that because of Podlucky's "erratic" and "uncontrollable temper," his children had lived under a "reign of terror" in the Podlucky household.¹⁵ Jesse recalled one scene in which his father hurled his own birthday cake against a wall and referred to his children with a derogatory epithet. In another incident, Jesse recalled that he was beaten so badly by his father that his face was "almost unrecognizable."¹⁶

JUDGMENT DAY

In October 2011, Podlucky appeared before federal Judge Alan Bloch during his sentencing hearing after pleading guilty to mail fraud, income tax evasion, and conspiracy to commit money laundering. While addressing Judge Bloch, Podlucky stated, "I am appalled by my actions, Lord, I mean, Your Honor."¹⁷ Later in the hearing, Podlucky referred to himself as a "filthy rag" and pleaded with the judge to give him a noncustodial sentence so that he could create a charity to cater to the needs of federal prison inmates. Judge Bloch ignored Podlucky's tearful contrition and sentenced him to 20 years in federal prison for his egregious crimes.

Seven of Podlucky's relatives and business associates also received prison sentences for their roles in the Le-Nature's fraud. Despite his attorneys' efforts to blame his criminal behavior on his overbearing father, Jesse received a nine-year prison sentence after being convicted of money laundering. A similar conviction for Karla Podlucky, who was Podlucky's wife and Jesse's mother, resulted in a four-year prison sentence. The money laundering charges against Jesse and Karla stemmed from their involvement in covertly selling

jewelry that had been purchased with Le-Nature's corporate funds. The two had used the proceeds from the sale of the jewelry for a variety of improper expenditures, including the payment of Podlucky's legal bills and the purchase of an \$80,000 Mercedes-Benz automobile for Jesse.

Podlucky's close associate Andreycak received a five-year prison term despite her extensive cooperation with law enforcement authorities investigating the Le-Nature's fraud. After pleading guilty to one count of bank fraud, Podlucky's brother Jonathan, Le-Nature's former COO, received a sentence of five years. Like Jesse and Karla, Lynn (Le-Nature's former executive vice president of sales) opted for a jury trial rather than pleading guilty to the criminal charges filed against him. Following his conviction on 10 fraud charges, Lynn received a 15-year prison sentence. Another former Le-Nature's executive, Andrew Murin, received a prison sentence of ten years after pleading guilty to bank fraud, while a similar plea by one of Le-Nature's former leasing agents, Donald Pollinger, resulted in a five-year prison sentence.

DISCUSSION QUESTIONS

1. The fraud triangle identifies conditions or circumstances that are often precursors to financial fraud. Define the three categories of fraud risk factors that are included in the fraud triangle and provide specific examples of each.
2. Using the fraud triangle, identify fraud risk factors that were present in the Le-Nature's case. What implications did these factors have for the reliability of Le-Nature's accounting and financial reporting process?
3. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) internal control framework identifies the five principal components that should be present in an organization's system of internal control. Name and briefly describe each of those components.
4. Relying on the COSO framework, identify specific flaws that were present in Le-Nature's internal control. How were principles of COSO's internal control framework violated by Podlucky and his co-conspirators? How did the deficiencies in Le-Nature's internal controls contribute to the failure of third parties (including Wachovia, leasing companies, and the company's independent auditors) to uncover the Le-Nature's fraud?
5. What stakeholders were negatively affected by Le-Nature's lack of internal controls and its leaders' criminal behavior? How so?

6. Identify specific work roles assumed by management accountants in business organizations and explain how the individuals occupying those roles contribute to internal controls, fraud prevention, an ethical climate and thus to good overall corporate governance.
7. Several accountants or individuals with accounting backgrounds were involved in the Le-Nature's debacle. These individuals included Higbee, Lipovich, Andreycak, Podlucky, Podlucky's son Jesse, and the individuals assigned to the Pasarella & Wiker investigative team. Evaluate the overall professionalism of each of those individuals by applying the four standards discussed in the IMA Statement of Ethical Professional Practice that can be found at www.imanet.org/docs/default-source/press_releases/statement-of-ethical-professional-practice_2-2-12.pdf?sfvrsn=2.

ABOUT IMA® (Institute of Management Accountants)

IMA®, the association of accountants and financial professionals in business, is one of the largest and most respected associations focused exclusively on advancing the management accounting profession. Globally, IMA supports the profession through research, the CMA® (Certified Management Accountant) program, continuing education, networking and advocacy of the highest ethical business practices. IMA has a global network of more than 75,000 members in 140 countries and 300 professional and student chapters. Headquartered in Montvale, N.J., USA, IMA provides localized services through its four global regions: The Americas, Asia/Pacific, Europe, and Middle East/Africa. For more information about IMA, please visit www.imanet.org

ENDNOTES

- ¹Richard Gazarik, "Lawsuit Alleges Fraud in LeNature's Dealings," TribLIVE, May 1, 2008, http://triblive.com/x/pittsburghtrib/news/westmoreland/s_565150.html#axzz3sQEQUsIS.
- ²Joe Mandak, "Witness in Pa. Soft Drink Fraud Case Gets 5 Years," Associated Press, 3 January 2012, <http://news.yahoo.com/witness-pa-soft-drink-case-gets-5-185137723.html>.
- ³Wachovia was acquired by Wells Fargo in late 2008 during the height of the 2008-2009 financial crisis that gripped the U.S. economy.
- ⁴*Mark Kirschner v. K & L Gates LLP, et al*, Superior Court of Pennsylvania, 46 a.3d 737 (2012), 2012 PA Super 102, July 19, 2012.
- ⁵*Ibid.*
- ⁶*Ibid.*
- ⁷*Ibid.*
- ⁸Richard Gazarik, "Greg Podlucky Had Visions of Taking Le-Nature's's to the Top," TribLIVE, November 19, 2006, http://triblive.com/x/pittsburghtrib/news/westmoreland/s_480492.html#axzz3sQEQUsIS.
- ⁹*Ibid.*
- ¹⁰Joe Mandak, Joe Mandak, "Robert Lynn, Former Chief Revenue Officer of Le-Nature's, Sentenced to 15 Years in Prison for Massive Accounting Fraud," Huff Post, January 3, 2012, http://huffingtonpost.com/2012/01/03/robert-lynn-le-nature_n_1181909.html.
- ¹¹Joe Mandak, CNS News, "Ex-Pa. Soft-drink CEO Gets 20 Years in Prison," CNSNews.com, October 23, 2011, <http://www.cnsnews.com/news/article/ex-pa-soft-drink-ceo-gets-20-years-prison>.
- ¹²*USA v. Karla Podlucky*, U.S. Court of Appeals for the Third Circuit, Docket No. 12-2469, May 27, 2014.
- ¹³*Mark Kirschner v. K. & L Gates LLP, et al.*, 2012.
- ¹⁴Joe Mandak, CNS News, 2011.
- ¹⁵*USA v. G. Jesse Podlucky*, U.S. District Court for the Western District of Pennsylvania, Case 2:11-cr-00047-ANB, Document 201, April 19, 2012.
- ¹⁶*Ibid.*
- ¹⁷Joe Mandak, CNS News, 2011.