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"Airing Out the Denny Crane Room": Recent SEC Action Emphasizes Need for Effective Disclosure Controls and Procedures for Executive Perquisites

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Last month, Energy XXI, Ltd. ("EXXI"), a publicly-traded oil and gas exploration company, saw its former Chief Executive Officer charged with various securities law violations by the Securities and Exchange Commission ("SEC"). The SEC seeks to have the CEO pay civil money penalties and be barred from any officer or director role with any issuer of registered securities.

From 2012 to 2016, "[the CEO] obtained undisclosed compensation and perquisites by submitting business expenses for payment that he knew or should have known were personal in nature and/or lacked documentation sufficient to establish a business purpose."[1] This resulted in a failure by EXXI to disclose more than $1 million in compensation and perquisites in its executive compensation disclosures.[2]

Part of the CEO's problematic practices included charging to his corporate credit card over $1 million in expenses that were either personal in nature and/or lacked documentation sufficient to establish a business purpose. Among the $1 million, expenses included:

- $40,000 toward a $160,000 bottle of wine purchased at a charity auction;
- $36,000 on a shopping trip to a designer shoe boutique;
- a $15,000 birthday party for a friend at the CEO's home;
- $43,000 for use of the company aircraft to attend college football games;
- a $15,000 donation to the private school attended by the CEO's daughter;
- $17,000 in personal legal fees;
- $323,000 to keep a company cigar and liquor lounge (the "Denny Crane Room"); and
- $18,000 for first class tickets for the CEO and his family to fly to London to attend a board meeting.[3]

Other perquisites that EXXI provided to the CEO included club memberships, automobile leases, health insurance, and reimbursement of business and health care expenses.[4] These facts serve as a cautionary tale for reporting companies and highlight the importance of effective disclosure controls and procedures for disclosing executive benefits, also known as perquisites.

Effective disclosure controls and procedures are important to ensure that information that needs to be disclosed under the rules of the Securities Exchange Act of 1934 (the "Exchange Act"), including information regarding executive compensation, is appropriately disclosed. The rule is straightforward – reporting companies are required to maintain disclosure controls and procedures designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, all within the time periods specified in the SEC's rules and forms. The disclosure controls and procedures must also be designed to ensure that information required to be disclosed is accumulated and communicated to the issuer's management, as appropriate, to allow timely decisions regarding required disclosure. In other words, effective disclosure controls and procedures provide those who need to know with the bundle of information that they need to evaluate, and with enough time to appropriately evaluate whether or not disclosure is required.

So what should a director or corporate executive look for when evaluating, or developing for the first time, effective disclosure controls and procedures with respect to perquisites? There is no one-size-fits-all approach to effective disclosure controls and procedures, and the rules allow for flexibility in formulating the disclosure controls and procedures, but here are a few suggested practices:

First, it is important to identify benefits that could be considered perquisites. The factors to be considered when determining whether a benefit is a perquisite are:

1. An item is <u>not</u> a perquisite if it is integrally and directly related to the performance of the executive's duties.
2. Otherwise, an item is a perquisite if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.

The analysis begins with what is not a perquisite. The SEC uses this negative analysis because if an item is directly related and integral to the performance of an executive's duties, then the analysis ends – the item is not a perquisite. For example, a company phone or laptop computer is not a perquisite if the company believes that it is essential that the executive be accessible when out of the office.

However, the SEC does not intend to make the set of items that are integrally and directly related to the performance of the executive's duties broad. The concept of a benefit that is integrally and directly related to job performance is a narrow one. Thus, providing the use of a private aircraft for security purposes may provide a benefit to the company because it keeps management safe; however, any such personal use of the private aircraft will still generally be considered a perquisite.

Some things are commonly understood to be perquisites, such as personal use of a corporate jet and car allowances for personal usage. The categorization of some benefits is less clear, such as spousal attendance at a business dinner. An argument can be made that, under certain circumstances, a spouse's attendance is integrally and directly related to the performance of an executive's duties, which would prevent the expense from being categorized as a perquisite. On the other hand, there is an argument that the executive is at least receiving a benefit in the amount of the incremental cost of the spouse's attendance. The SEC intended not to make the analysis a bright-line test, for fear that it would be easily manipulated, but understanding the analysis above should allow management to correctly identify whether items are perquisites. Legal advisors will often have much more experience with perquisite disclosure, so it would be prudent for management to reach out to the company's legal advisors when there is doubt.

Second, director and officer questionnaires ("D&O questionnaires") should be provided to company management to assist with identification and appropriate disclosure of perquisites. D&O questionnaires are packets of questions used to query directors and officers about a wide variety of subjects that must be disclosed in periodic reports and other publicly filed documents, such as proxy statements. Among the subjects covered is executive compensation and perquisites. An effective questionnaire will ask the director or officer if he or she has received any benefit from the company, and will give examples to refresh his or her memory as to what benefits will qualify as perquisites. Each director and officer will submit his or her questionnaire to a designated reviewer, likely the company's general counsel or external counsel, for review. The D&O questionnaires should be provided to directors and officers well before the deadline for disclosure in order to give ample time to both the directors and officers to carefully consider and provide their answers, and also leave time for the reviewers to analyze the responses and prepare the appropriate disclosures.

Third, there are a number of other important considerations to remember when thinking about perquisites, besides disclosing them under securities laws. A company should consider that the value of perquisites is taken into account when determining "Named Executive Officer" ("NEO") status. Accordingly, the company should consider providing D&O questionnaires to officers that are just outside the most highly paid executives and educate these officers on perquisites. A company should also remember that the income tax rules for deductibility of benefits (or imposition of tax on the perquisite) are different than the determination of whether benefits must be disclosed in filings with the SEC. A company may be able to deduct all or part of a benefit provided to an executive as an "ordinary" or "necessary" business expense for income tax purposes, but still be required to disclose the benefit in a report pursuant to the Exchange Act. In any case, a company should consult their tax advisors.

With effective disclosure controls and procedures, a company will save themselves from unnecessary investigation and fines, but more importantly, keep the confidence of public investors.

Disclaimer

The information provided by this client memorandum is intended to give a general understanding of the changes to the federal securities laws, and should not be relied upon to comply with the law and regulations. Please contact the authors if you seek further clarification or advice.

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[1] *S.E.C. v. Schiller*, Case 4:18-cv-02433, p. 14 (filed on July 16, 2018).

[2] *Id.*

[3] *Id.* at 16.

[4] *Id.* at 15.