ROPES & GRAY

THE SEC STRIKES AGAIN:
UNDISCLOSED EXECUTIVE PERKS & RELATED PERSON TRANSACTIONS

Two recent SEC enforcement actions involving executive perks and related person transactions are a reminder that disclosure deficiencies in these areas can attract SEC scrutiny. The extent to which this represents a new trend or merely the carryover of investigations started under the prior leadership remains to be seen, but the recent activities warrant renewed attention to these matters.

Recent Perk-Related Enforcement

Over the last few years, a growing list of companies have found themselves on the wrong side of an SEC enforcement action for failing to disclose in their public filings perquisites ("perks") provided to their executives. In general, the actions have alleged either misconduct by executives who practiced deception to obtain unwarranted benefits or the absence of effective corporate controls. The companies targeted were generally (sometimes very) small, growth-oriented companies.

THE DOW CHEMICAL SETTLEMENT

Enter the SEC's settlement with The Dow Chemical Company ("Dow") on July 2, 2018. Dow is a household name with tens of thousands of employees and roots dating back to the 19th century. After its 2017 merger with DuPont, DowDuPont Inc. is among the 30 companies currently making up the Dow Jones Industrial Average. As such, it stands out among companies that have recently seen SEC enforcement action over perk disclosure.

Dow's SEC order does not allege executive misconduct. While it does allege insufficient procedures for complying with the SEC's executive compensation disclosure rules, those deficiencies seem, at least at first blush, surprisingly mundane. The SEC says that Dow inappropriately applied a "business purpose" standard to determine whether a benefit would be disclosed as a perk rather than the SEC's more stringent "integrally and directly related to [job] performance" standard. In the eyes of the SEC, Dow also did not adequately train its employees in the art of proper perquisite disclosure. But the order gives no indication of how the alleged breakdown in Dow's processes occurred and therefore does little to help steer other companies toward the right side of the perk line.

The amount Dow agreed to pay as a fine to the SEC, $1.75 million, is among the highest paid by any company in a perk-related enforcement action since 2015 (though not relative to its resources, clearly). The order further requires Dow to hire (and pay for) an independent consultant to review its policies, procedures and controls for complying with the SEC's perk disclosure rules. Dow must implement recommended changes (negotiating for any changes, but with the consultant ultimately calling the shots) and then subject itself to compliance monitoring for two years.

The SEC says approximately $3 million in executive perquisites for Dow's CEO, Andrew Liveris, were not "adequately evaluated and disclosed." The order provides only a high level list of the types of undisclosed perks, which were "among other things, travel to outside board meetings, sporting events and personal activities; club memberships; limited use of personal assistant office time; and membership fees to sit on the board of a charitable organization." The list itself raises more questions than it answers. What, for example, constitutes "limited use of personal assistant office time" and how would it be monitored and valued? Are there any types of sporting events attendance at which would be integrally and directly related to one's job performance? While the magnitude of the unreported expenditures catches the eye, also notable is the fine ($1.75 million) relative to the total undisclosed amount ($3 million). The order hints at the considerable flexibility the SEC has in construing how many acts or omissions may lead to separate penalties (generally each capped at the higher of $775,000, adjusted for inflation, or the amount of pecuniary gain) against a company, giving it leverage in negotiated settlements.

COMPLAINT AGAINST ENERGY XXI, LTD.'S FORMER CEO

Two weeks after the Dow settlement, the SEC's enforcement division filed a complaint against John D. Schiller, the former CEO of oil and gas company Energy XXI, Ltd. ("EXXI"), for perk nondisclosure violations, among other things. Mr. Schiller is reported to have settled that case with the SEC.[1] According to the SEC, Mr. Schiller obtained over $1 million in perquisites over a five-year period that were "unreasonable, personal in nature, and/or not supported by sufficient documentation." Mr. Schiller's expenses allegedly included, among other things:

- $323,000 to keep a private bar for certain senior EXXI executives and their guests stocked with liquor and cigars over a five-year period;
- $43,000 for use of EXXI's company aircraft to attend his alma mater's college football game with other industry executives;
- A combined $54,000 for a New York shopping trip for Mr. Schiller's wife and the spouses of other board members and members of senior management and first-class plane tickets for Mr. Schiller's wife and daughter to travel to London, in each case, in connection with EXXI board meetings; and
- $15,000 as a charitable donation to the private school for Mr. Schiller's daughter.

The SEC's list combines items that appear purely personal in nature with others that seem to have at least some business purpose, once again reinforcing the exacting nature of the SEC perk disclosure standard. The $323,000 bar provisions charge, to which "only a dozen or so persons had keycard access," is a noteworthy reminder that access to executive-only facilities and their trappings may constitute perks subject to public disclosure. By apparently ascribing the full value of the restocking costs to Mr. Schiller (rather than some measure of his proportionate share), the complaint sidesteps, but hints at, some of the thornier disclosure issues that can arise in valuing executive-facility perks. The charitable contribution item underlines the potential risks associated with corporate charitable contributions to institutions attended by an executive's (or director's) family member.

A TRIP BACK IN TIME

To understand the narrowness of the SEC's current perk disclosure standard, we need to travel back to the late 1990s and early 2000s. At that time, providing extensive executive perks was not uncommon, and many companies had developed a practice of disclosing them in a minimalist fashion.

While the SEC had by then been issuing guidance on perk disclosure for decades, it was a 2002 divorce filing by the wife of legendary former General Electric chairman and CEO Jack Welch that caught the attention of the media and the SEC.[2] Mr. Welch had by then retired from his CEO day job but had signed on to consult for the company. The company had disclosed in its proxy statements that he was making merely $86,000 in cash compensation but would also receive "lifetime access to Company facilities and services comparable to those which are currently made available to him by the Company."[3] A seemingly inconsequential "extra" was later revealed to be an oblique reference to a lavish set of perks that far outstripped the value of the modest cash compensation. Among other things, Mr. Welch was provided with use of a $50,000 per month furnished Manhattan apartment, unlimited use of GE's planes, unrestricted access to a chauffeured limousine and a bodyguard for various speaking engagements, including Mr. Welch's book tour. In the first year following his retirement these perks reportedly had a total value of approximately $2.5 million (approximately $3.56 million in today's dollars).

The SEC was not pleased. In September 2004, the SEC announced a settlement with GE over its failure to "fully and accurately describe the retirement benefits Welch was entitled to receive from the company."

UNPACKING THE SEC'S PERK DISCLOSURE STANDARD

With the ink on the GE settlement barely dry, the SEC set out over the next two years on an ambitious and sweeping rewrite of the executive compensation disclosure rules. Along with adopting other rules that reduced the de minimis threshold for omitting perk disclosure altogether or not separately identifying perks, in August 2006 the SEC finalized a stricter standard for required perk disclosure.

The SEC specified that unless an item is "integrally and directly related to the performance of the executive's duties," it must be disclosed as a perk if it confers a direct or indirect benefit on the executive that has a personal aspect, regardless of whether there is a business purpose. An exception is for personal benefits that are made generally available on a nondiscriminatory basis to all employees. If an item is integrally and directly related to the performance of the executive's duties, the inquiry is complete. For example, companies need not disclose the incremental value associated with a luxury car over an economy car if the purpose of the rental is integrally and directly related to a business purpose. Despite some commenters' objections that "business purpose" should be considered in determining whether an item should be considered to be a perk, the SEC did not change its proposed standard when finalizing the current rules.

The SEC acknowledges that its standard may be stricter than rules related to tax deductions or determining whether an item constitutes proper use of corporate assets under state law. Purposefully, the SEC adopted a principles-based approach to identifying perks, rather than a bright line, to discourage avoidance and facilitate evolution of disclosure along with corporate perk practices. However, the SEC's releases for the proposed and final rules did give certain specific examples:

Perks Under SEC Rules	Not Perks Under SEC Rules
Company-provided aircraft, yachts or other watercraft	Office space at a company business location
Commuter transportation services	A reserved parking space that is closer but not otherwise preferential
Commuting expenses (whether or not for the company's convenience or benefit)	Additional clerical or secretarial services devoted to company matters
Additional clerical or secretarial services devoted to personal matters[4]	Travel to and from business meetings
Investment management services	Other business travel
Club memberships not exclusively for business entertainment purposes	Business entertainment
Personal financial or tax advice	Security during business travel
Personal travel using vehicles owned or leased by the company	Itemized expense accounts the use of which is limited to business purposes
Personal travel otherwise financed by the company	
Personal use of other property owned or leased by the company	
Housing and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence)	
Security provided at a personal residence or during personal travel	
Discounts on the company's products or services not generally available to employees on a nondiscriminatory basis	

EMERGING PATTERNS IN RECENT PERK-RELATED ENFORCEMENT ACTIONS

Since 2015, there has been a stream of perk-related SEC enforcement actions. Taken together, these actions indicate that the SEC continues to construe the current rules strictly and will hold companies accountable for even inadvertent failures to disclose perks if the SEC determines the failure is the result of lax corporate controls.

While the number of cases is limited, the settlements suggest some patterns:

- **Monetary settlements have ranged from ~0% to ~7,000% (~400% putting aside the Marrone Bio Innovations, Inc. matter described below) of the total undisclosed amounts, with the dollar settlements ranging from $0 to $1.75 million. In some cases, however, the SEC has made multiple claims against the subject company (some unrelated to perks), so the settlement amount reflects a mixed penalty (including in the Marrone Bio Innovations, Inc. matter, which was largely focused on other issues).**
- **Where the executives are alleged to have engaged in deceptive practices, such as submitting falsified receipts or making exceptional, undocumented claims for reimbursements, the SEC has acknowledged leniency for companies that obtain reimbursements from executives for inappropriate corporate disbursements and pursue other appropriate remedial actions (including discipline/termination of executives in certain cases).**
- **Where disclosure failures are due to failures of corporate controls, the SEC will require the appointment of an independent consultant to review and oversee the implementation of stricter corporate policies and procedures.**

The chart below summarizes certain recent perk-related SEC enforcement actions.[5]

Company	Date	Approximate Amount of Undisclosed Perks	Other Allegations Unrelated to Perks?	Monetary Settlement	Independent Consultant Requirement?	Allegations of Executive Deception?
The Dow Chemical Company	July 2, 2018	$3 million over 5 years*	No	$1.75 million	Yes	No
Provectus Biopharmaceuticals, Inc.	December 12, 2017	$3.4 million over 5 years	No	$0**	Yes	Yes
MDC Partners Inc.	January 18, 2017	$11.3 million over 6 years*	Yes	$1.5 million**	No	Yes
Marrone Bio Innovations, Inc.	February 17, 2016	$25,000 over 2 years	Yes	$1.75 million	No	Yes
MusclePharm Corporation	September 8, 2015	$482,000 over 4.5 years	Yes	$700,000 plus interest	Yes	No
PolyCom, Inc.	March 31, 2015	$190,000 over 4 years	No	$750,000**	No	Yes

** Amount was reported to have been partially reimbursed to the company by the executive.*

*** In the enforcement order, the SEC favorably cited the company's remedial efforts after disclosure deficiencies were identified.*

PUTTING THE DOW SETTLEMENT IN CONTEXT

The SEC's enforcement action against Dow could suggest a new, stricter stance toward perk nondisclosure infractions. If Dow, with all its resources, can't get these things right without the SEC slapping it down, what chance do the little guys stand?

However, there are some factors operating outside the four corners of the SEC's enforcement order that may cast it in a different light. In August 2014, a former Dow fraud investigator filed a lawsuit against Dow claiming that Dow had unlawfully terminated her employment in October 2013 after she raised concerns about potential financial statement fraud, including as a result of certain unreported executive perquisites. The complaint cites $719,000 worth of unreported personal expenses for Mr. Liveris, including a $218,938 trip for him and his family to the 2010 Super Bowl, as well as a 2010 World Cup trip, a safari in Africa and trip to the 2010 Masters golf tournament. It also alleges payments, falsely identified as routine business expenses, to charities closely linked to Mr. Liveris. After losing a motion to dismiss in December 2014, Dow settled the whistleblower retaliation suit in early 2015.

While the allegations in the complaint offer plausible, though unverified, details to fill out the generalities used in the SEC's order ("travel to outside board meetings, sporting events and personal activities" and "membership fees to sit on the board of a charitable organization"), the settlement order leaves us wanting additional facts to assess the nature of the undisclosed compensation and the procedural deficiencies that allowed for it.

Prior to the SEC's announcement of the settlement, Dow had not disclosed in its public filings the existence of the SEC's inquiry. The SEC was undoubtedly aware of allegations in the whistleblower complaint, which likely precipitated its involvement in the case. The language in a settlement order is the subject of negotiation between the defendant and the SEC enforcement staff. It would not be surprising if Dow preferred not to have the details of its alleged transgressions spelled out in the order. The lack of specificity, however, leaves others who would like to learn from these mistakes scratching their heads.

Related Person and Form 8-K Allegations Involving EXXI

Beyond the perk disclosure deficiencies noted above, the SEC took aim at several other activities related to EXXI by Mr. Schiller, EXXI director Norman M.K. Louie and Mount Kellett Capital Management LP ("Mount Kellett"), EXXI's then-largest shareholder, for whom Mr. Louie worked as a portfolio manager.[6]

Among other things, the SEC accuses Mr. Schiller of financing an "extravagant lifestyle" by entangling his personal finances with those of EXXI, leading to a failure to report related person transactions. The SEC's related person rules[7] require disclosure of any transaction (i) that occurred during a given fiscal year, or that is currently proposed, (ii) in which a subject company was or is to be a participant, (iii) with an amount involved of at least $120,000 and (iv) in which a related person had or will have a direct or indirect material interest.

The arrangement allegedly worked as follows: Mr. Schiller had pledged a stock portfolio largely consisting of EXXI stock in order to secure over $23 million in loans. When EXXI's stock dropped in value, Mr. Schiller was facing a series of margin calls, which drove him to obtain $7.5 million in personal loans from the three company vendors.[8] EXXI then awarded the vendors new business or improved the vendors' business terms with EXXI. The SEC contends that this constituted a related person transaction because Mr. Schiller had a material interest in the vendors' business with EXXI as a result of the personal loans he received in exchange for future EXXI business. Despite the fact that the new business arrangements followed the loans (which could arguably undercut Mr. Schiller's interest in them), the SEC also alleges that two of the vendors threatened to call the loans after they were made if the promised business did not materialize.

The SEC further claims that Mr. Schiller allegedly obtained a $3 million loan from Mr. Louie at a time when Mr. Louie was a candidate to join EXXI's board. The failure of Mr. Louie and Mr. Schiller to disclose the arrangement to EXXI led EXXI to file an incorrect Form 8-K upon Mr. Louie later joining the board that failed to mention the loan. Mr. Schiller, after allegedly failing to disclose the loan, voted in favor of Mr. Louie's appointment to the board.

While the complaint and settlement cast EXXI as unaware of Mr. Schiller's loans from the vendors and Mr. Louie, the SEC does not hold EXXI out as completely blameless. On one hand, the SEC faults Mr. Schiller for omitting information on one of the vendor loans on a director and officer ("D&O") questionnaire that expressly asked about related person transactions, and says that EXXI's senior legal officer repeatedly solicited a D&O questionnaire from Mr. Louie. However, the documents also make clear that EXXI personnel did not insist that Mr. Louie actually complete the D&O questionnaire prior to the board vote on Mr. Louie's appointment (although the full board was apparently unaware of that fact). It was not until ten months after the D&O questionnaire was first solicited, and seven months after Mr. Louie supposedly became aware of the SEC's investigation, that he filled out a D&O questionnaire, which disclosed the $3 million loan.

Actions for the Proxy Offseason

What is clear is that the SEC continues to demand that perk disclosure adhere to a high standard compared to other areas of law and that ignoring, whether intentionally or not, that standard presents some peril. As a threshold matter, individuals responsible for preparing executive compensation disclosure need to be familiar with the SEC's perk disclosure standard. Those individuals must be empowered to find the information within the company to provide accurate disclosure. While that may seem obvious, in our experience, internal "silo-ing" of human resources, finance, legal and other functions often serves as a barrier. Assigning one person responsibility to quarterback these issues is often useful. Further, we recommend that companies review reimbursement policies and procedures with the SEC's disclosure standard in mind, and make sure they both conform to high standards of verification and recordkeeping and are in fact followed.

There is only so much that can be done to guard against a director or officer affirmatively concealing information from a company about related party transactions, but the EXXI-related enforcement actions do suggest some actions for companies to take. Of course, companies should make sure their D&O questionnaires comprehensively cover related person transactions and are timely completed. A failure to adequately learn about related person transactions and other potential conflicts of interest may have implications not only for required public disclosures, but also for stock exchange listing requirements and independence standards under a company's own governance policies or state law (e.g., special board committee membership).

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Accordingly, in some cases, companies may wish to supplement basic, broad questions on D&O questionnaires about related person transactions and potential conflicts of interest with specific prompts. Companies should also make sure directors and officers are aware of the need to provide timely updates to the company if related person transactions or potential conflicts of interest arise between D&O questionnaire cycles.

Finally, the complaint against Mr. Schiller also indirectly demonstrates the risk of director and officer stock pledging. If a company does not yet have an anti-pledging policy, it should strongly consider adopting one, and if it does, it should review the policy's adequacy.

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney.

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ENDNOTES

[1] The SEC's public announcement indicated that Mr. Schiller consented to a $180,000 fine and a five-year bar from serving as a public company director or officer.

[2] The SEC also pursued perk-related enforcement against Tyson Foods in 2005.

[3] GE had also filed the retirement and consulting agreement itself, which added that the "facilities and services" to which Mr. Welch would have access included "aircraft, cars, office, apartments, and financial planning services."

[4] This enumerated item may explain the reference to "limited use of personal assistant office time" in the Dow settlement, although the facts in the Dow case around that item remain elusive.

[5] EXXI was not named in the complaint against Mr. Schiller or the separate settlement, also filed on July 16, 2018, with an EXXI director and EXXI's largest shareholder. However, EXXI filed for Chapter 11 bankruptcy in 2016 and its assets were sold to a successor at the end of 2016.

[6] Mount Kellett was accused by the SEC of failing to disclose that it had taken substantial steps to actively participate in the governance of EXXI by filing a timely Schedule 13D.

[7] Item 404 of Regulation S-K defines a "related person" to include a company's executive officers, directors (including nominees), certain significant shareholders, and their immediate family members.

[8] Section 402 of the Sarbanes-Oxley Act, which prohibits loans from the company to directors and officers, foreclosed Schiller's turning to the company to help out with the margin calls.