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Day 1
Dealing with Complexities of Perks
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Liz Dunshee: Hi everyone. We talk about perks almost every year at this conference and that's because there are always new developments and that's the case again this year. So I will welcome Mark Borges of Compensia, and Mark also blogs and answers questions for us on CompensationStandards.com and he's one of the authors of our executive compensation disclosure treatise that we just printed. Also welcome our very own Alan Dye of Hogan Lovells and Section16.net. Welcome to you both and I'm going to turn it quickly over to Alan to talk about how the pandemic has changed perks practices. Alan?

Alan Dye: All right. Thank you, Liz. As Liz mentioned Mark and I are going to discuss developments and issues that relate to disclosure or perquisites under Item 402. In past years we've generally started by trying to identify new or unusual perks that the compliance community needs to be aware of. We're changing things a little bit this year because of the COVID pandemic which has made some of the old issues seem new again. So we're going to discuss first how the pandemic might affect companies' perquisites disclosure or their upcoming proxy statements, and just to help frame the discussion I'll remind all of us how the SEC has defined a perquisite. The SEC said in the 2006 adopting release for Item 402 that an item is not a perk if it's integrally and directly related to the performance of the executive's duties. If the item isn't integrally and directly related to the performance of the executive's duties and the item provides a benefit that has a personal aspect then it's considered to be a perk for purposes of Item 402 even if it has a business purpose, not unless, of course, it's provided to all employees on substantially the same basis.

So during the pandemic we've seen some forms of personal benefit that are typically considered to be a perk that may warrant a different analysis this year. It may not, but they may warrant a different analysis this year to determine if they are in fact perks or if instead they might be deemed integrally and directly related to the executive's performance of the executive's duties. Now, for example, generally a company's payment of the expenses for setting up a home office for an executive is considered to be a perk. Paying for high-speed internet access, sophisticated computer equipment, a printer, a fax machine, separate phone lines and other things associated with establishing a home office are generally considered to be a perk.

Today, though, a lot of executives are working remotely. Usually they're working from home. They might be working from a vacation home to get away from a high-density urban area and in some cases companies have tried to facilitate that remote working by installing or upgrading home office equipment, making it easier and more efficient for the executive to work remotely and perform executive functions, and in some of those circumstances it might at least be a fair question whether the executive's home office has effectively become the executive's office for purposes of a perks analysis, and the premise underlying that possibility is that because the executive's headquarters office is unavailable then setting up a home office from which the executive can work might be deemed integrally and directly related to the executive's performance of his or her duties. If a company decides to pursue that analysis, whether the expenses are a perk, as is usually the case, depend on the facts and circumstances of the individual company or the individual executive, but I would think that in this context the most important factors would likely be whether the executive's old office is inaccessible, or even if accessible no one is going into the office, and also whether the executive spends virtually all business hours in a home office or instead splits time between the two offices. The more time the executive spends in the headquarters office it seems to me to be more likely that the company's expenses in establishing or enhancing the home office are not to be deemed a business expense but instead to be a perk, and a similar issue arises respect to other issues that arise relating to executives' home offices. It's generally considered to be a perquisite if the company establishes a home security system for an executive, but again, if as a result of the pandemic in the company circumstance the insider is working almost exclusively from home there's at least a possibility that an analysis might support a conclusion that enhancing home security systems while the executive is working from home might not be considered a perk. Mark, before I turn to another potential perk item maybe I'll turn it over to you to see if you have any thoughts on that issue.

Mark Borges: Well, I think what you've said is exactly right, which is it's going to depend upon the specific facts and circumstances, and it's probably something that companies ought to be considering now as they look at the patterns of behavior and what the work routines have been of their executives, particularly their named executive officers, over the past 6 or 9 months. I can think of a number of different scenarios where the CEO may have moved permanently, for all intents and purposes, to their home office to conduct business because their actual headquarters have been closed or are just no longer practical to go to, but other situations come up where the office has been closed for a short period of time and now it's being reopened. Who's going back to the office? How much is it being used? I think that every company is probably going to face its own special situation in trying to determine where they fall on what side of the line in terms of whether or not the business office has moved to the home office, whether or not the security that is provided to the executive as part of their normal business routine has now been shifted over to their home, particularly where you've got situations where people have security both at home and at business and what percentage represents personal and what represents business use. I think it's going to be one of those years where we're going to have to dig deep into each particular situation in order to see where the facts are in order to come up with a determination as to what's reasonable.

Alan Dye: Right. Another pandemic-related issue involves personal use of corporate aircraft. Due to the reductions in the number of commercial flights during the pandemic and concerns about potential exposure or increased exposure to the virus from flying commercially, some executives have made more frequent use of corporate aircraft for their personal travel. Some of that personal travel involves flying to a second home where the executive's family might be holed up and away from an urban area, you know, while a spouse works remotely and children attend school remotely but the executive has a need to fly, you know, back and forth to the main house and to the second home. At the same time and on the other hand some companies are seeing reduced personal use of the corporate aircraft because the executives have fewer places to go or fewer places they want to go or can go, and so there's a reduction in use. I think in either circumstance, you know, the personal use of corporate aircraft is going to be unquestionably a perk so it's not really a new issue, it's just one to be mindful of to make sure that companies are doing the things that they're usually expected to do and that the SEC tends to pay attention to, and that's having a system in place for monitoring that personal use, making sure that it's being appropriately accounted for as personal use, and also that the company has a reasonable methodology for valuing the perk.

Mark Borges: Yeah, that's something that has been high on the minds of the SEC particularly over the past 2 or 3 years, and I would imagine that given the circumstances that we're seeing now that this is something that's going to be looked at fairly closely going forward, particularly where they start to see a decrease in the amount of personal use perhaps relative to prior years based on what the activities and the routines of the executives are going to be.

Alan Dye: All right. Well, Mark, maybe that's a good segue to your discussion of the recent enforcement action relating to perks, so why don't I turn it over to you?

Mark Borges: Sure. A couple years ago, as you recall we had a couple of high-profile enforcement proceedings brought against Dow Chemical and Energy XXI which sort of were a reminder that the SEC does monitor perks fairly closely, and particularly in situations where there are significant amounts that are being characterized as personal benefits but what are not being reported. I think many of us thought that this was one of those things that the SEC did every few years and we probably would see it recede into the background again for a few more years, but lo and behold in June there was another high-profile enforcement proceeding against Argo Group International Holdings for failure to report disclosable perks, and what was interesting about this particular action was that it wasn't a situation where the company wasn't reporting perks. In fact, over a

5-year period they reported about a million dollars in items that were considered personal benefits paid to the former CEO, but what was discovered was that that was only about 20% of the amounts that were actually being made use of by the executive of corporate property and which was being characterized as a business expense rather than as a personal expense. So you had typically the kinds of things that we tend to see in these cases, personal use of corporate aircraft, rent and housing costs including a housekeeper and furniture for a Bermuda residence where the company was headquartered, personal use of corporate automobiles, helicopter trips and other personal travel costs, a car service, personal services being performed by the Argo employees for the personal benefit of the CEO. So a lot of items that were being mischaracterized from a status standpoint and which the SEC ultimately determined were personal benefits for the CEO and which should have been reported as perquisites.

I think what's most important about this proceeding is the same thing that we saw a couple years ago in the Dow and the Energy XXI matters, and that is that the company didn't have a process in place with adequate internal controls in order to identify and properly record the items that were under consideration as compensation rather than as business expenses. So, for example, they were reimbursing the CEO for items without an adequate record of what the business purpose of the item was, they allowed the CEO to approve his own expense reimbursements, which probably is never a good idea in a situation like this, and didn't have in place any mechanism for determining whether or not the CEO paid for his personal use of corporate aircraft, so the absence of these things really, I think, contributed to the problem that the company had, and ultimately they were forced to pay a penalty of $900,000 for the failure to report. What probably made the amount only $900,000 was the remedial efforts that the company undertook almost immediately when these items were brought to its attention in order to rectify the situation, including hiring a consultant to come in who could help them come up with a process for being able to identify, record and track these particular items. They also brought in a forensic accountant to look at things in order to make sure that their books and records were accurate, and perhaps most disturbingly they agreed to change the membership of the board of directors. So the court in noting the cooperation of the company in this particular action cited all of those things as being to the company's benefit as to why the penalty wasn't even greater for what was a significant nondisclosure over a lengthy period of time, and to me it's a reminder again that it's important to have someone in the organization who is in charge of monitoring executive activity when it comes to items that could potentially be personal benefits and reportable as perks, certainly anything that has to do with travel is probably going to be in that category, and that if you don't do something like that and you're simply waiting until the end of the year and hoping that your executives will self-report the items that they used for personal purposes, that you're running the risk of having something like this happen and you're certainly going to be found to not have the kind of controls that the SEC expects from a reporting standpoint to deal with this and other related reporting issues.

Alan Dye: Yeah. Mark, you make an important point that I think is worth emphasizing. These cases where there have been lavish perks that aren't disclosed tend to result in significant consequences for the company beyond just a simple cease and desist order or a "go forth and sin no more." When you look at what the remedial efforts were at Argo, they were just dramatic and disruptive and hugely expensive. A change in the composition of the board, termination of the chief executive officer, independent investigations to come up with remedial recordkeeping requirements and monitoring by the company, it's a significant consequence, and that investigation went on with Argo for the longest time. So again as you've said it's an important point to bear in mind, to make sure you have systems in place up front to catch perquisites.

Mark Borges: Yeah, I don't know to what extent this made a difference, but one thing I did notice was that this enforcement proceeding was brought out of the SEC's Philadelphia office, and over the course of the last year I've heard of a couple of situations where they have sent letters of inquiry to companies asking questions related to disclosure about items that might be considered perquisites. So while it may not be the commission as a whole or the enforcement staff as a whole that's keeping this as a high priority issue, there are certainly people within the SEC who are aware that this is an area where companies can tend to get lax and they're making it their effort to sort of monitor what's going on in this area in order to look for cases like this, where perhaps companies didn't have the kind of procedures in place that they needed to in order to be effectively overseeing what was being disclosed and what was being reported.

Alan Dye: Yes. There are now perks experts in the enforcement division working out of the Philadelphia office. Mark, in the couple of minutes we have left you mentioned the Dow Chemical enforcement action, and I'm sure you recall that one of the issues in the Dow Chemical enforcement action was that the director had been using company aircraft to travel to the meetings of a board of directors where the CEO of the company was an outside director, which gave rise to a lot of questions at the time as to whether it's ever appropriate for a chief executive officer of a company to use company aircraft or other company resources to attend board meetings of another company, and I think there's still room to conclude that board service by the chief executive officer of the company isn't necessarily personal service to that company, and any expense incurred by the company in supporting it's CEO's service on that other company's board might be integrally and directly related to the performance of the executive's functions, and I think to take an example where the company wants its CEO to serve on another board for the purpose of learning what the board experience is like, to help the CEO understand the board's thinking at the company where the executive is. The chief executive officer retains a search firm at the company's expense to try to locate board opportunities for the CEO and then assist the CEO in getting that representation on the board. There's at least a chance that that could appropriately be considered not to be a perk, the expenses associated with the company's efforts on the CEO's behalf might not be considered a perk and instead might be deemed integrally and directly related.

Mark Borges: Yeah, that doesn't seem too far away for my perspective from the situations which we more typically see where the CEO is sitting on the board of another company at the behest of his own board because of a business relationship or because of some similarities in their business industries or operations. So it is something worth keeping in mind and I agree with you that the facts, again, it all comes down to the facts and circumstances, but there could be situations where training somebody for service as a director is integrally and directly related to their role as an executive of the company, particularly when you're looking at succession planning and companies are reaching deeper into the executive team in order to find qualified director candidates, trying to get people seasoned so that they have the experience, not only of managing the company, but also of being able to understand the perspective from that of a director.

Alan Dye: Agreed. Did you have any other issues, Mark, that you wanted to cover? I see Liz is here to give us the hook.

Mark Borges: Yup, I think that last one was a good one to raise because it's starting to come up a little bit more frequently. I hadn't seen it before but I think in the last year a couple of times people have asked that question, and service on another board and the travel to and from those board meetings is a common item that comes up with some frequency.

Liz Dunshee: Yeah, that's a good point to raise and also good intel on the enforcement. Thank you for sharing that, Mark. So thank you both, Mark and Alan, this was informative as always, and now as mentioned this morning at 3 p.m. Eastern Time and also at 4 p.m. Eastern Time we are offering 30-minute interactive roundtables in which you can discuss hot topics with other practitioners who are attending this conference. There are still spots at many of the roundtables, and so what you need to do if you are interested in attending is click on the little seats icon next to the session that you want to attend. Better to do that sooner rather than later just in case you have any connection issues, our tech folks can help you get that sorted out, so if you're interested go ahead and head on over to one of those round tables click on the seats icon and then you can enter the join session and be put into the room. All right, thank you again, Mark and Alan, and thank you everyone for joining us today and thank you, again, as well to our sponsors, please visit the exhibit hall to learn more about them, and thank you to all of our speakers and everyone who turned in. I will see everyone back here tomorrow morning at 9:30 a.m. Eastern Time. Thanks.

Mark Borges: Thanks.

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