Milbank

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CONTACT

Manan (Mike) Shah
Partner
212-530-5501
mdshah@milbank.com

Joel I. Krasnow
Partner
212-530-5681
jkrasnow@milbank.com

Kelly P. Bartley
Associate
212-530-5012
kbartley@milbank.com

# Executive Compensation Client Alert: Recent SEC Enforcement Actions Underscore the Need to Carefully Monitor & Review Certain Executive Compensation Practices

Two recent Securities and Exchange Commission (SEC) enforcement actions highlight the importance of maintaining adequate internal procedures and controls relating to executive compensation, and ensuring that SEC disclosure rules and guidance in this area are being carefully followed by registrants.

***Dow Chemical's Failure to Properly Disclose Perquisites***

On July 2, 2018, the SEC imposed a cease-and-desist order against The Dow Chemical Company ("Dow Chemical"), and, in response, Dow Chemical submitted a settlement offer that was accepted by the SEC. In its cease-and-desist order, the SEC alleged that, from 2011-2015, Dow Chemical failed to adequately evaluate and disclose approximately $3 million in executive perquisites.

The SEC found that Dow Chemical had failed to properly follow the SEC's standards regarding disclosure of perquisites, which provide that:

- *An item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties.*
- *Otherwise, an item is a perquisite or personal benefit 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.*

Instead, Dow Chemical incorrectly applied a standard whereby "a" business purpose "related" to the executive's job was sufficient to determine that a benefit was not a perquisite requiring disclosure. By applying this incorrect standard, the SEC found that Dow Chemical had failed to identify the following types

of benefits as disclosable perquisites: payment for travel to outside board meetings, sporting events, club memberships, limited use of personal assistant office time, and membership fees to sit on the board of a charitable organization.

The SEC found that Dow Chemical not only had "inadequate processes and procedures" in place to ensure proper reporting of perquisites, but that it had also inadequately trained employees who were tasked with drafting the CD&A section of the proxy statement and compiling the executive compensation tables. The SEC fined Dow Chemical $1.75 million and ordered it to retain an independent consultant for a period of one year to conduct a review of Dow Chemical's policies, procedures and training relating to the evaluation of payments and other expense reimbursements in the context of securities laws related to executive compensation.

***Former Energy XXI CEO's Failure to Disclose Loans and Perquisites***

On July 16, 2018, the SEC charged the former CEO ("Schiller") of Energy XXI Ltd. ("EXXI") with failing to disclose over $10 million in personal loans provided to him by outside company vendors as well as a candidate for EXXI's board of directors. Specifically, the SEC alleged that Schiller received more than $7.5 million in personal loans from three outside vendors in exchange for business promises, and received a $3 million loan from a portfolio manager at EXXI's largest shareholder, who, at the time the loan was made, was a prospective candidate for EXXI's board of directors. EXXI was not charged in this action.

The complaint also alleged that during certain years of his tenure, Schiller submitted reimbursements for expenses that were "unreasonable, personal in nature, and/or not supported by sufficient documentation", including (i) Schiller's share of a $160,000 bottle of wine that he purchased with other oil and gas industry executives at a charity auction; (ii) a charitable donation to his daughter's private school; (iii) amounts paid to keep a private bar located in EXXI's executive officer suite stocked primarily with liquor and cigars, and (iv) first class tickets for his wife and daughter to travel to London to attend an EXXI board meeting to which board member spouses were invited. The SEC's complaint stated that Schiller failed to disclose these items for the years in question.

The SEC charged Schiller with various securities law violations stemming from his alleged failure to disclose the above arrangements in EXXI's public filings. Specifically, the SEC claims that Schiller failed to properly disclose the personal loans as "related party transactions" under Item 404(a) of Regulation S-K (and,

in the case of the loan from the prospective director, failed to disclose the loan in the 8-K filing related to the board member's appointment), and failed to disclose certain of the expenses listed above as perquisites under Item 402 of Regulation S-K.

***Practical Considerations***

In recent years, the SEC has sporadically initiated enforcement actions such as the ones described above, and while it remains unclear whether these actions signify the beginning of an emerging trend toward more active enforcement, it is important for issuers to take note of the serious consequences that can arise as a result of failed control measures and inadequate disclosure in this area of law. Clearly, the SEC continues to closely monitor public companies' handling of executive compensation-related disclosure matters.

To help safeguard against SEC scrutiny and minimize the risk of an SEC enforcement action, issuers should consider taking the following steps as they progress toward next year's proxy season:

- Review D&O questionnaires carefully to ensure that questions are drafted broadly enough to prompt the person completing the questionnaire to list any payment/arrangement that could arguably be a disclosable perk or related party transaction.
    - For example, avoid using the word "perquisite" in the question itself; responders are likely to construe this term more narrowly than the SEC does, resulting in payments/other forms of compensation being left out of questionnaire responses.
- Adopt a more conservative approach when reviewing payments and reimbursements made to executive officers and directors, taking into account the SEC's narrow interpretation of whether something is "integrally and directly related to the performance of the executive's duties".
    - Keep in mind that simply identifying "a" business purpose for providing a particular benefit does not answer the question of whether or not such benefit is a disclosable perquisite.
- Implement board or committee policies that would require pre-approval of certain payments/transactions to directors and executive officers, and/or adopt a company policy that clearly lays out what kinds of payments/arrangements will be considered disclosable perquisites in the company's public filings in order to eliminate any ambiguity surrounding what arrangements will need to be disclosed.

- Encourage communication between internal working groups tasked with compiling information for annual proxy disclosures so that information is properly making its way from the departments that have knowledge of payment arrangements to those that are in charge of drafting the proxy itself (e.g., ensure that the necessary information is flowing from your finance/payroll team to your legal team).

- Develop annual training programs for internal working groups (including directors and executive officers) in order to provide more context and understanding as to how the SEC disclosure rules are intended to work.

EXECUTIVE COMPENSATION AND EMPLOYEE BENEFITS

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Executive Compensation and Employee Benefits Group.



**NEW YORK**
28 Liberty Street, New York, NY 10005

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| Manan (Mike) Shah | mdshah@milbank.com | +1-212-530-5501 |
| Joel Krasnow | jkrasnow@milbank.com | +1-212-530-5681 |
| Kelly Bartley | kbartley@milbank.com | +1-212-530-5012 |