

Mind your T&E's: Anticipating the Next Problem in Executive Compensation Practices and Disclosures.

Whenever a new regulatory system is introduced, behaviors must change. That certainly is the case with the SEC's 2006 amendments to its rules regarding executive compensation. Executives and directors who had grown accustomed to receiving perquisites and having other personal expenses paid by their companies with little oversight or disclosure now must operate in the sunshine. This change may be embraced by most executives and directors, given the extensive publicity surrounding these new rules and the embarrassing newspaper articles (not to mention prosecutions and enforcement actions) describing in detail some of the more extreme expense reimbursement practices in recent years. But the sunshine of disclosure occasionally inspires a different sort of behavior that can result in new problems for companies. The SEC placed a spotlight on this possibility by referencing just two enforcement cases in its 436-page executive compensation release. Companies should be alert for perquisites and other personal expenses that are incorrectly classified for disclosure purposes as "travel and entertainment expenses." It also would be prudent to review, and perhaps enhance, controls on T&E approvals. After briefly describing the new requirements for disclosure of perquisites and other personal expenses, we provide highlights of the two enforcement cases, and their implications, below.

The New Disclosure Regime for Perquisites and Personal Benefits. The SEC's 2006 amendments to the rules regarding executive compensation bring substantial changes to the way that perquisites and other personal benefits ("perks") must be disclosed. No definition of these terms appears in the amendments. Instead, the SEC suggests a two-prong test for determining what must be counted as a perk. First, an item is not a perk if the executive needs it to do the job (and thus it is "integrally and directly related to the performance of the executive's duties"). But otherwise, the item is a perk if it "confers a direct or indirect benefit that has a personal aspect" upon the executive unless the item is

"generally available on a non-discriminatory basis to all employees." The company's convenience is not relevant to the question of whether the item conveys a direct or indirect benefit.

Previously with respect to named executives, perks could be omitted from disclosure if the aggregate amount of these benefits was the lesser of 10% of total annual salary and bonus, or \$50,000. The new rules, however, require disclosure of these items if they aggregate to \$10,000 or more. The new rules also require much greater identification of perks. The old rules required that individual benefits be disclosed by type and amount only if they exceeded 25% of

the total perquisites and personal benefits of the named executive. The new rules, in stark contrast, require that *all* perks be identified, so long as the aggregate perks meet or exceed the \$10,000 threshold. Further, if the value of any single perk equals or exceeds the greater of \$25,000 or 10% of the total, the value of that perk must be quantified and disclosed.

The new rules also require that directors' perks must be disclosed. The release does not distinguish between directors and executives for purposes of the applying the rules regarding perks disclosure. Nevertheless, significant practical differences may exist between the duties required of directors and those required of

executives, and non-employee directors are situated differently from employees of the company. These factors may be relevant to whether a particular item is a perk within the two-prong test set forth in the SEC release.

“Travel and Entertainment” Is Not a Catch-All. The new rules dramatically increase the pressure on companies to disclose minute details of their executive compensation policies. Anticipating that this might increase pressure to categorize items as travel and entertainment expenses, the SEC stressed that perks identified pursuant to the new rule must be described specifically, not generally, and that the “particular nature of the benefit received” must be evident from the description. Specifically, the SEC noted that the description “travel and entertainment” does not sufficiently identify perks such as “clothing, jewelry, artwork, theater tickets and housekeeping services.” Companies would be wise to review carefully any perks categorized as “travel and entertainment” to ensure that the category is not being used to avoid disclosure of individual benefits.

The Enforcement Warning. The SEC’s sternest warning in the entire executive compensation release comes in the section regarding disclosure of perks. The release states, “all participants should approach the subject of perquisites and personal benefits thoughtfully,” and then says in a footnote, “[t]he Commission has taken action in circumstances where perquisites were not properly disclosed,” citing *SEC v. Tyson Foods, Inc. and Donald Tyson*, Civil Action No. 05 0841, *In the Matter of Tyson Foods, Inc. and Donald Tyson*, Admin Proc. File No. 3-11917, Litigation Release No. 19208 (Apr. 28, 2005), and *SEC v. Greg A. Gadel and Daniel J. Skrypek*, Litigation Release No. 19720 (June 7, 2006).

SEC v. Tyson Foods, Inc. and Donald Tyson. In April 2005, the SEC issued a cease and desist order charging Tyson Foods, Inc. and former Chairman and CEO Donald Tyson for having made and caused misleading disclosures of perks and personal benefits provided to Mr. Tyson both before and after his retirement in 2001. They were also charged with

failing to maintain adequate internal controls over Mr. Tyson’s personal use of company assets. Without admitting or denying the allegations, both the company and Mr. Tyson settled and were required to pay \$1.5 million and \$700,000 in penalties respectively.

The SEC alleged, among other things, that Mr. Tyson’s responses to D&O questionnaires were “inadequate,” that many perks had not been raised with or authorized by the compensation committee, and that many perks were not disclosed or were mischaracterized. According to the complaint, Mr. Tyson received approximately \$3 million in perks including: \$20,000 for oriental rugs; \$18,000 for antiques; \$15,000 for a London vacation; \$8,000 for a horse; \$464,132 in personal use of homes, chauffeur, cook, housekeeper and a crewed boat; \$426,086 in personal use of company-owned aircraft including trips when Mr. Tyson was not on board; \$203,675 in housekeeping expenses at homes or vacation homes; \$46,110 to maintain nine automobiles owned and used by Mr. Tyson and his family and friends; clothing, jewelry, art work, theater tickets, Christmas gift certificates; and over \$1 million in personal income tax liability associated with Mr. Tyson’s receipt of these benefits.

The SEC’s order alleged that over \$1 million of those perks were not disclosed or were mischaracterized as “performance-based bonuses” in order to “preserve the company’s tax deduction for Mr. Tyson’s compensation.” The SEC also found that the company used the “misleading terms” of “travel and entertainment costs” to describe perks that were neither travel nor entertainment. The misuse of the term “travel and entertainment” allegedly continued after Mr. Tyson’s retirement, when the company used those terms to describe the continuation of Mr. Tyson’s personal benefits pursuant to his retirement agreement.

SEC v. Gadel and Skrypek. In June 2006, the SEC filed a complaint against the former CFO and Controller of Buca, Inc., a Minneapolis-based restaurant company, alleging that the former officers caused various misstatements and

omissions in the company’s filings including understating the CEO’s and CFO’s compensation and failing to disclose related party transactions. The SEC is seeking permanent injunctions, disgorgement, civil penalties, and officer/director bars.

While part of the allegation involves earnings management using improper capitalization of expenses, the headlines for this case involve reporting of executive compensation. The SEC alleged that Gadel received at least \$96,630 in undisclosed compensation from 2000-2003, including “reimbursements for family vacations and visits to strip clubs.” Gadel and Skrypek allegedly “routinely approved” the CEO’s “inappropriate requests for reimbursement of a wide variety of personal and non-business expenses” resulting in undisclosed compensation to the CEO of almost \$850,000.

Gadel and Skrypek also allegedly knew about, but failed to ensure disclosure of, related party transactions totaling more than \$1 million between the company and an information technology company of which Gadel was a director and shareholder. The SEC alleges that they also failed to ensure disclosure of a transaction relating to the purchase of an Italian villa for the CEO using company funds.

Notably, the SEC alleged that Buca, Inc. had very few policies regarding how travel and entertainment expenses were to be billed to the company. This allegedly resulted in a “lax culture” in which the CFO, the Controller, and their subordinates received and approved improper requests for reimbursement of personal expenses.

Upgrading Procedures. Often, the SEC gives companies a bit of time to grow accustomed to complicated new rules before it begins enforcing them. It seems clear, however, that the SEC intends to act quickly to enforce the new rules regarding perquisites and other personal benefits. Travel and entertainment expenses for officers and directors will be scrutinized carefully in enforcement investigations, so companies would be prudent to embark on

such a review themselves. Gone are the days when executive secretaries and low-level accounting staff were sufficient to safeguard the corporate coffers while satisfying reimbursement requests made by the corporate executives they served. As *Gadel and Skrypek* illustrates, the SEC will now expect companies to impose oversight over the process. It may be time

to consider adding a disclosure lawyer's influence through enhanced reimbursement procedures or additional approval processes for certain executives. It would be unfortunate if the increased disclosure of perks prompted corporate personnel to attempt to mask perks as mere travel and entertainment expenses in the ordinary course of business. After

all the effort companies are devoting to implementing the new rules, adding a few extra steps to the travel and entertainment expense reimbursement process may avoid unfortunate distractions down the road.

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