

Client Alert

Corporate Practice Group

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SEC Takes Action: Results of Under-Disclosing Executive Perks

The Securities Exchange Commission (SEC) investigation of and the action taken against MDC Partners Inc. (“*MDC*”) and its former Chief Executive Officer, Miles S. Nadal (“*Nadal*”), underscore the importance of proper disclosure of executive compensation. Between 2009 and 2014, MDC disclosed in its proxy statements some, but not all, of the perquisites paid on Nadal’s behalf. The estimated \$11.285M worth of perquisites that MDC failed to disclose included private aircraft usage, club memberships, cosmetic surgery, yacht and sports car related expenses, jewelry, charitable donations, pet care and personal travel expenses.

On January 18, 2017, the SEC issued a press release describing the terms of the settlement related to MDC’s problematic disclosure practices, in which MDC agreed to pay a \$1.5M penalty in settlement for various disclosure violations, including the failure to disclose Nadal’s compensation.¹ In settling the matter with MDC, the SEC took into consideration the remedial actions that MDC promptly undertook, including adding three new independent directors to its Board of Directors, creating a role of a SVP of Internal Controls and Compliance, replacing its Chief Accounting Officer, and implementing new internal controls and compliance policies and procedures, in addition to training programs for its executives concerning expense reimbursements.

On May 11, 2017 in a separate settlement related to the same matter, the SEC announced that Nadal agreed to pay \$5.5M to settle charges for failure to properly disclose his compensation, and the related SEC order indicated that Nadal was prohibited from acting as an officer or director of a public company for a five-year period. Preceding his settlement with the SEC, Nadal had resigned as the company’s Chief Executive Officer and Nadal returned to MDC the unreported \$11.285M, along with \$10.582M in cash bonus awards.

The SEC’s proxy disclosure rules require that the compensation received by each of a company’s named executive officers (NEO), which typically includes the chief executive officer, be set forth in the issuer’s proxy statement. NEO compensation is summarized in the proxy’s summary compensation table, which discloses perquisites and other personal benefits or property provided to an NEO, the aggregate value of which is equal to or greater than \$10,000. If the aggregate amount of the perquisites is at least

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\$10,000, then regardless of the amount each perquisite must be identified by type, and any specific type of perquisite or personal benefit that exceeds the greater of \$25,000 or 10% of the aggregate value of the perquisites must be quantified and disclosed in a footnote. MDC neither identified the types of perquisites that Nadal received, nor quantified in a footnote specific perquisites above the \$25,000/10% threshold. MDC had determined that the unreported items at issue were business expenses, rather than properly identifying them as personal expenses and benefits treated as compensation.

The SEC penalties may not be MDC's or Nadal's only legal problem. Perquisites, as compensation, are generally deductible business expenses by a corporate taxpayer. The IRS, however, may question MDC's deduction of Nadal's perquisites on the grounds that some or all of his perquisites were not "ordinary and necessary" or otherwise were unreasonable, and therefore not deductible. Furthermore, the amounts treated as a reimbursable business expense, and not compensation, may result in the IRS imposing penalties on MDC for the failure to withhold employment taxes. Additionally, if Nadal did not include the perquisites that constitute compensation in his tax return, he likely would be subject to U.S. federal income tax, interest, and penalties with respect to the prerequisites, assuming the relevant tax year or years are not barred by the statute of limitations. The relevant statute of limitations is either three years or six years from the due date of the return of the implicated tax year, unless the reporting omission constitutes civil tax fraud for which case there is no statute of limitation. Moreover, his income omission could lead to criminal sanctions. State and local income tax, interest and penalties could also be implicated. Nadal would not be entitled to deduct the amount paid to the SEC to settle the matter if it constituted a fine or a penalty. Finally, whether Nadal could deduct the amount he returned to MDC, and whether he could use the deductions to offset income, are unclear absent more facts.

The two matters demonstrate that the SEC will not only bring enforcement against the issuer who fails to disclose perquisites and personal benefits provided to a named executive officer, but may also pursue enforcement against the named executive officer. In addition to the enforcement action against Nadal for the failure to disclose, the SEC also could have sought penalties under the Sarbanes-Oxley Act, as Nadal signed certifications covering each annual report that incorporated the fiscal year's proxy statement.

We recommend that each company regularly review and update internal control and compliance policies and procedures, and ensure that the legal, finance and tax departments have appropriate participation in the updating of such policies and procedures. Training should be provided to executives, as well as accounting personnel, as to the difference between, and treatment of, a business expense and personal expense/benefit. Finally, prior to preparing the proxy statement, legal and tax personnel should carefully review each NEO's perquisites and business expense reimbursements for the fiscal year to ensure that perquisites are properly disclosed.

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¹ The \$1.5M payment includes settlement for a separate disclosure violation regarding non-GAAP financial measures, which violation is not addressed in this article.