

S&W Defense and Investigations Report

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WHEN DO PERQUISITES AMOUNT TO LOOTING?

In both civil and criminal cases, federal courts are struggling with the question of when to condemn perquisites, such as the personal use of corporate jets, that executives often enjoy. Criminal prosecutions of high-paid executives appear almost commonplace in the new millennium. Notwithstanding the elimination of mandatory federal sentencing guidelines, lengthy prison terms for white collar crimes are far from rare, in both federal and state court. Former Tyco CEO L. Dennis Kozlowski has been sentenced to up to 25 years' imprisonment, and Enron's Jeffrey Skilling received a sentence of 24 years. In a recent decision by the United States Court of Appeals for the Tenth Circuit, *United States v. Lake*, 472 F.3d 1247 (2007), the court reversed convictions of corporate executives whom the government claimed had engaged in a "far-reaching scheme to milk the company for all they could through a pattern of fraud and deceit." The *Lake* decision offers some guidance on the issue of when perquisites amount to criminal looting, while generating as many questions as it answers.

At the trial level, a jury convicted the *Lake* defendants of wire fraud, money laundering, circumvention of internal controls and conspiracy. A key issue in the case was whether the defendants acted with wrongful intent by failing to disclose their personal use of corporate jets. The trial court believed that the government introduced sufficient evidence of fraud based on, among other things, the defendants' failure to disclose their personal enjoyment of the corporate aircraft. When instructing the jury, the trial court rejected a defense request regarding the operation of SEC regulations.

The Tenth Circuit Court of Appeals reversed the trial court, explaining:

The government's sole challenge to the reports

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of defendants' compensation is that the reports failed to disclose the defendants' personal use of corporate aircraft. But the government did not show at trial that disclosure was required. Use of corporate aircraft is a "perquisite" governed by Regulation S-K Item 402(b)(2)(iii)(C)(1). ...Disclosure of perquisites is required only if their aggregate value for the year exceeds a threshold equal to the lesser of \$50,000 and 10% of the executive's annual salary and bonuses. ...There was no evidence that the value of personal travel ever exceeded the reporting threshold.

The *Lake* court explained why there was insufficient evidence in the particular case, while providing a roadmap for prosecutors in future matters:

[The government] computed the value of a flight by determining what a charter flight for the same trip would cost (including the costs of chartering a plane to fly from the corporate plane's base to the departure point for the trip and from the trip's destination point back to the base). This is not an unreasonable method of measuring the value of the trips to Mr. Wittig and Mr. Lake. But it is not the method required by the SEC. Regulation S-K states: "Perquisites and other personal benefits shall be valued on the basis of the aggregate incremental cost to the registrant and its subsidiaries." ...The natural interpretation of this language is that the value of a trip is to be computed solely on the basis of the actual additional cost incurred by the corporation in providing the transportation. Thus, for example, if the corporate airplane is flying to New York on business and a member of the Wittig family goes along for pleasure, the value is only the extra cost of adding a passenger. The extra cost may be as little as the cost of additional fuel to fly with the weight of one more passenger plus luggage. Even when the trip is solely for pleasure, the cost to the corporation may be modest. If the pilot is on a salary and is not working overtime, the extra cost might be limited to fuel and maintenance. Although no regulation explains how to determine "aggregate incremental cost," the interpretation above is the interpretation adopted by every treatment of the subject we have found, including a statement by an SEC official. ...Suffice it to say that the government did not introduce (or even offer) any evidence concerning the cost to [their company] of the alleged personal trips benefitting the defendants.

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The government attempted to circumvent this ruling by arguing that "even if the reports to the SEC were not false (because they contained all required information), they were fraudulent ... because, regardless of SEC requirements, investors and the public would have expected disclosures of personal travel in those reports." The Tenth Circuit rejected this argument, finding that the company was required to report the various items of compensation that it reported to the SEC, and there was no evidence that the public had been led to expect additional, voluntary disclosures.

An open issue after *Lake* is whether the convictions would have stood had the government proved the defendants' failure to pay income tax on the value of their perquisites. The trial court refused a defense request for the admission of the defendants' amended tax returns that reported income from the perquisites. When so doing, the court found that tax issues were irrelevant because the government had not charged the defendants with any counts of tax offenses. Personal use of corporate aircraft is, however, generally taxable, and the *Lake* defendants initially claimed no income from their use of corporate aircraft. It is unclear why the government chose not to charge specific counts of tax evasion in *Lake*. It is equally unclear whether proof of tax crimes would have helped uphold the convictions for fraud and conspiracy in *Lake*. Obviously those executives who receive taxable fringe benefits should report them and pay any tax due, and employers should comply with reporting and withholding obligations. Failure to do so may support a fraud charge even when a defendant has no obligation to disclose the existence of perquisites for the benefit of shareholders.

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In the civil context, courts have made similar rulings regarding limits on a company's duty to disclose perquisites, at least when they amount to unauthorized looting. Recently, in *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 2007 WL 8729 (D.Colo. Jan. 2, 2007), a trial court dismissed securities fraud claims based on an alleged failure to disclose perquisites received by executives. The court explained that, "taking all of Plaintiff's allegations as true, it involves a senior executive taking advantage of weak internal controls for his own personal gain," which it found not actionable by itself as a securities fraud claim. The *Andropolis* court reasoned that disclosures of excessive perquisites give rise to securities fraud claims only when part of "a scheme to artificially affect market activity," such as had occurred in the Tyco matter.

The *Lake* decision indicates how proper reporting of perquisites to shareholders and tax authorities may bear on a defense against criminal prosecution. In this regard, companies should be aware that last August the SEC reduced the threshold for disclosing perquisites to \$10,000 and clarified that "incremental cost" for purposes of the shareholder disclosure rules is not necessarily the value of perquisites for federal income tax purposes. Prosecutors, who may themselves enjoy no-frills employment benefits and be inclined to find certain large perquisites criminal in nature even if properly disclosed, may look not only to the adequacy of shareholder disclosure under these new rules but also to more traditional tax evasion charges to help prove fraud or money laundering charges.