

Legal Alert:

Prohibition on Personal Loans to Directors and Executive Officers of Public Companies

October 8, 2002

This memorandum supplements our prior Legal Alerts addressing the Sarbanes-Oxley Act of 2002 and related guidance; please click [HERE](#) to see those previous Legal Alerts.

Executive Summary

In a broadly worded provision, Section 402 of the Sarbanes-Oxley Act of 2002 (the “Act”) prohibits U.S. and non-U.S. public companies from making or arranging for a personal loan to any director or executive officer of the company on or after July 30, 2002. Loans maintained on July 30, 2002 are “grandfathered,” provided that they are not renewed or materially modified on or after that date. Violations of this prohibition are subject to the civil penalties and, for willful violations, the criminal penalties of the Securities Exchange Act of 1934 (the “Exchange Act”).

Caution is needed in interpreting the rule as it may apply to a number of common transactions involving executive officer and director compensation and benefits. These transactions include cashless exercise of stock options, split dollar life insurance programs, employee relocation policies, and advances to pay taxes on deferred compensation or option exercise. The need for caution arises from the broad wording of Section 402, as well as the ambiguities in that wording, the limited legislative history, and the lack of guidance to date from the SEC. In addition, while arguments are being advanced that the ban should not apply to certain of these arrangements and the SEC is being urged by companies to exempt programs fitting certain parameters, Senators Susan Collins and Carl Levin have reacted to media reports of these actions by writing to the SEC, encouraging the SEC to resist efforts to “weaken” the ban.

Overview of Section 402 Prohibition

Section 402 of the Act amends Section 13 of the Exchange Act to prohibit U.S. and non-U.S. public companies from directly or indirectly extending or arranging for an extension of credit in the form of a personal loan to a director or executive officer (or the equivalent thereof) on or after July 30, 2002. The ban is not limited to loans extended within the U.S. or to persons resident within the U.S. Accordingly, pending the issuance of guidance by the SEC, public

companies should carefully evaluate whether to include directors and executive officers in arrangements that may give rise to personal loans. Public companies should also consider the implications of Section 402 of the Act before amending or modifying any arrangements that were in effect on or before July 30, 2002 that, if entered into on or after that date, would actually or potentially be subject to the ban on personal loans.

While we think that reasoned arguments can be made that the prohibition should not apply to certain arrangements, the letter Senators Collins and Levin wrote to the SEC specifically referenced loans “to purchase company stock, exercise stock options, obtain insurance, relocate for work or pay taxes.” The letter opined that there is no basis in the legislative history for exemptions for these arrangements and that financing of the arrangements should be provided by third parties in the ordinary course of business, rather than through personal financing using company funds.

Scope of the Prohibition

In relevant part, the Act makes it “unlawful for any issuer..., directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.” The elements of this prohibition are discussed below.

1. *Issuer.* The section applies to loans made or arranged by an “issuer.” This term includes any company or other entity that –

- has a class of securities listed on a national securities exchange in the United States;
- otherwise has securities registered under Section 12 of the Exchange Act;
- is required to file reports under Section 15(d) of the Exchange Act; or
- has a registration statement pending under the Securities Act of 1933.

The loan prohibition thus applies to companies with publicly traded stock or other securities (including debt issues), including both U.S. and non-U.S. companies, and companies that, although not yet publicly traded, have filed a registration statement seeking to become a public company. If a company files a registration statement and later withdraws it, Section 402’s ban on personal loans would cease to apply when the registration statement is withdrawn.

2. *Directors and Executive Officers.* The prohibition applies to extensions of credit to an issuer’s directors and executive officers or the “equivalent thereof.” Although the Act does not define “executive officer,” we believe that companies should apply Exchange Act Rule 3b-7, in

determining who is an “executive officer” for purposes of Section 402. That rule defines an “executive officer” as the company’s president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance) or any other officer or person who performs policy-making functions for the company. Under the rule, executive officers of the company’s subsidiaries are also treated as executive officers of the company if they perform policy-making functions for the company.

The Exchange Act defines a “director” as “any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.” This definition should not include directors of a subsidiary who are not also acting as directors of the company.

These rules present at least three issues –

- As indicated above, executive officers and directors are defined under current law as including persons who, respectively, perform policy-making functions, even though they are not officers, or perform functions similar to those of a director. It is unclear whether the parenthetical portion of the phrase in Section 402 referring to “any director or executive officer (or equivalent thereof)” is intended to make additional individuals subject to the ban on personal loans.
- Because the prohibition on loans applies to direct and indirect extensions of credit, it is likely that loans to (a) an executive officer’s or a director’s spouse, children, or trust, (b) a business controlled by the executive officer or director, or (c) similar related parties, will be subject to the new rule if they can be characterized as personal loans.
- It appears that if an individual has any personal loans from the company outstanding at the time he or she becomes an executive officer or director of the company, the loans would immediately be subject to the prohibitions of Section 402 (assuming that they were not pre-effective date “grandfathered” loans).

3. *Personal Loans.* Section 402 prohibits extensions of credit “in the form of a personal loan,” a phrase not defined in the Act. There are very limited statutory exceptions for loans in the form of certain “consumer credit” provided in the ordinary course of the company’s consumer credit business or certain extensions of credit by U.S. broker-dealers. Logically, bona fide business advances, such as travel advances or the use of company credit cards, if made and used in the ordinary course of business for valid business expenses and expended or repaid promptly, should not be regarded as personal loans, but even this is not entirely clear. However, any advances

used for personal purposes or use of a company credit card for personal purchases would likely be deemed to be personal loans within the meaning of Section 402 of the Act. Similarly, potentially unreasonable terms, such as allowing advances in excess of the amount reasonably expected to be incurred or allowing delayed repayment of advances not spent for business purposes may violate Section 402's prohibition with respect to the excess amounts.

4. *Arranging.* Section 402 prohibits not only making personal loans, but also "arranging" such loans. In other contexts under the securities laws, such as the margin lending rules under Federal Reserve Regulation T, the term "arranging" has been construed very broadly to include activities as remote as introducing an executive officer to a lending institution or recommending a particular lending institution to an executive officer. Although there are policy arguments against applying such a broad construction of the term "arranging" in Section 402, until further guidance is published, it is prudent to assume that the term may be subjected to a broad construction.

Specific Compensation and Benefit Practices Potentially Affected by Section 402

Because of the breadth and ambiguity of the statutory language, a number of compensation and benefit practices may potentially be affected by Section 402. These include:

1. *Cashless Exercise of Stock Options.* These programs typically involve the receipt by the broker of a copy of the participant's notice to the company of exercise of the option, giving instructions to the company to deliver shares of common stock issuable upon exercise of the option to the broker, who is to sell the shares for the participant and use the proceeds to pay the option price to the company and to satisfy any tax withholding obligation. Arguably, an agreement by the company to defer payment of the exercise price for the option until the broker receives the proceeds of a sale of the securities would be a prohibited extension of credit. Moreover, if the broker itself provides the temporary financing through a margin loan or otherwise (as by paying the option price to the company before settlement of the sale of the shares), the company may be regarded as having "arranged" for the financing if it played a role in identifying the broker or structuring a program with a particular broker to facilitate cashless exercises of company stock options. Since these types of transactions, which can take many different forms, typically involve some sort of extension of credit to the participant by the company or the broker, there is concern that all or some forms of these transactions may be subject to Section 402.

There are alternative arguments that such transactions, when viewed in the overall context of the company's stock option program (a) should not be regarded as extensions of credit, (b) that any extension of credit is not in the form of a personal loan, or (c) that the company's involvement is sufficiently remote to conclude that the company did not arrange the credit. However, until further guidance is issued by the SEC, companies may want to consider

whether to exclude directors and executive officers from such cashless exercise arrangements. A company also may well wish to consider the feasibility of other alternatives, such as allowing use of “mature” shares already owned by optionees to effect stock-for-stock exercises and to cover tax withholding; having the executive officer or director make arrangements with his own broker for a loan to pay the exercise price and tax withholding, without any involvement by the company; or the use of stock appreciation rights rather than stock options.

2. *Split Dollar Life Insurance Arrangements.* These arrangements typically involve a structure in which the company pays the premium for a whole life insurance policy on the life of the employee but arranges to be repaid from the policy proceeds at death an amount at least equal to the premium paid. Since these arrangements involve some form of direct or indirect employer financing of the premium payments, questions arise as to whether they are subject to Section 402. Moreover, recently proposed Treasury regulations would expressly treat the form of split dollar arrangement known as a “collateral assignment,” in which the policy is owned by the employee and the company receives an assignment of the right to a portion of the policy proceeds, as a loan to the employee.

Although there are arguments that these arrangements should not be subject to Section 402, companies may want to avoid entering into any new arrangements until the application of Section 402 to the various forms of split dollar arrangements has been clarified by SEC guidance. Also, companies with existing arrangements will need to consider whether those existing arrangements will be adequately protected by the grandfather provisions discussed below. The prudent course of action at this time may be to seek to defer payment of additional premiums, pending further guidance. In some cases, restructuring the insurance arrangement may be appropriate.

3. *Loans from 401(k) and Similar Plans.* Questions have been raised as to whether there are any circumstances in which loans to executive officers from 401(k) or other qualified retirement plans would be affected by Section 402 of the Act. Even though the loan is made by the plan and not by the company, it has been suggested that by establishing the loan program as part of the plan, the company could be found to be arranging the loan to the executive. We do not believe loans from such plans should be considered to fall within the scope of the Act because the executive officer or director is effectively borrowing from himself or herself and not the company. We are not aware of any serious suggestions to the contrary by SEC officials or members of Congress, including in the letter from Senators Collins and Levin.

There is a technical argument that 401(k) and similar plans that give participants a choice whether to invest 401(k) or employee after-tax contributions in employer securities may be considered separate issuers for the plan interests registered on Form S-8 where the plan files a separate Form 11-K, rather than reporting information on the employer’s Form 10-K. Conceivably employees who are not executive officers of the employer but play a policy-making

role with respect to such a plan, for example, by sitting on the plan's investment committee, would be considered the equivalent of executive officers of the plan who are prohibited from taking personal loans from the plan.

4. Advances of Litigation Expenses or Indemnification. Corporate by-laws, charters, employment contracts, or other agreements frequently provide that executive officers and directors are entitled to be indemnified for litigation expenses or similar liabilities subject to a requirement that the amounts be repaid if the individual is found to be sufficiently culpable or to have acted without due care. Questions have been raised as to whether the possibility that the executive officer or director may be required to repay such amounts should result in the payments being considered impermissible loans under Section 402. Arguably an indemnification payment subject to a condition subsequent that the amount be repaid is not an extension of credit. It is also arguable that the indemnification payments are being made for business, rather than personal, reasons and that they are supported by public policy.

5. Other Compensation-Related Arrangements. Each of the following types of loans or arrangements may fall within the ambit of Section 402 –

- Any form of direct or indirect loan under a stock option, restricted stock award or similar equity-based compensation program for executive officers or directors. Company loans to pay the exercise price for options, for example, appear to be clearly covered by the prohibition.
- Employee-relocation loans, arrangements made by a company with a lending institution for favorable mortgage or other lending terms for executive officers or directors, and other loans by a company to purchase homes, personal computers, or other personal assets.
- So-called leveraged co-investment programs under which the company makes or arranges for a loan on behalf of executive officers or directors to a private equity partnership in which the company's executive officers or directors have invested.
- Any company guarantee of a loan made by a third-party to an executive officer or director.
- Advances of employment taxes owed by an executive officer, for example, in connection with option exercises, the vesting of restricted stock, bonus stock awards, or payments or funding of deferred compensation. (There should not be an issue if the executive officer surrenders shares to the company in exchange for the company's payment to the IRS.)

- Signing bonuses that must be repaid upon termination of employment or the occurrence of some other event. (As for indemnification payments, however, it can be argued that the contingent nature of the obligation to repay a signing bonus should not convert the bonus to a personal loan.)

Arrangements in Existence Before July 30, 2002

Under Section 402, a grandfather rule exempts extensions of credit maintained by a company on July 30, 2002 as long as there is no “material modification” or renewal of the arrangement. Although it is not clear from the statute, we believe that there are arguments that binding commitments made before July 30 should be exempt, even though not funded until after that date. Similarly, demand loans where all arrangements were made and were binding before July 30 should be included within the protection of the grandfather provision. In view of the strong position advocated by Senators Collins and Levin, however, companies may wish to consider the individual facts of such arrangements, including the reason for the loan, and whether there are any viable alternatives.

It is not clear what constitutes a “material modification” of a grandfathered loan. A full forgiveness of the loan would constitute a material modification, but it would result in elimination of the loan, so it should not result in a violation of Section 402. It is far less clear how a partial forgiveness would be treated, however. Companies should carefully review their existing loans and other extensions of credit, including transactions that are potentially subject to Section 402 (such as split dollar life insurance arrangements), to evaluate whether they are protected under the grandfather rule or whether these arrangements should be eliminated.

As noted above, there is a related issue for an individual who first becomes an executive officer or director of a company on or after July 30. Loans made or arranged for the individual before July 30, 2002 should be grandfathered, but other loans entered into on or after July 30 may not be grandfathered, even if the individual was not an executive officer or director at the time the loans were made. The statute’s application in these situations will need to be clarified in future guidance.

Future Guidance

The SEC has authority to issue guidance and exemptive orders under the Act. However, because the SEC is required by the Act to provide guidance on other provisions of the Act by express statutory deadlines, the staff of the SEC has indicated that guidance on the provisions of Section 402 will not be given priority, and for that reason may be delayed until after guidance on the other provisions has been completed.

For more information regarding Section 402 of the Act, or if you have any questions concerning these issues, please feel free to contact one of the members of our Corporate Governance or Employee Benefits and Executive Compensation Practices. Please click [HERE](#) to obtain contact information for members of our Corporate Governance and [HERE](#) for our Employee Benefits and Executive Compensation Practices.