

Sarbanes-Oxley Prohibition on Loans to Executives May Conflict with Compensation Practices

August 30, 2002 Brian Barnard, W. Scott Wallace

As we discussed in our Alerts dated July 31 and August 9, 2002, Section 402 of the Sarbanes-Oxley Act of 2002 (the "Act") makes it unlawful for public companies to directly or indirectly extend or maintain credit, or arrange for the extension of credit to their executive officers or directors.

The scope of the Act's prohibition on personal loans to executive officers and directors is not clear at this time, as there is little legislative history about Section 402, and the SEC has not yet issued any interpretive guidance concerning Section 402. Its broad language could prohibit not only direct loans, but also a number of common compensation practices such as "cashless exercise" of options and split-dollar life insurance policies. We expect the SEC to issue rules to clarify the Act's prohibition on these practices, but prudence may dictate a cautious approach concerning the use of these practices pending further guidance from the SEC.

Who is Covered; Definition of Directors and Executive Officers

The Act does not clearly define to whom loans are prohibited. The term director will likely be defined by reference to Section 3(a)(7) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and would include any director of a corporation or any person performing similar functions with respect to the corporation. A person who is a director of a subsidiary of a corporation (and not of the corporation itself) would not be covered by Section 402 of the Act with respect to the parent corporation, unless the director is otherwise an "executive officer" of the parent corporation. The term "executive officer" presumably will be defined similar to the term "executive officer" under Rule 3b-7 of the Exchange Act. This would include the issuer's president, vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the issuer. It could also include executive officers of a subsidiary if they perform policy making functions for the parent.

Cashless Exercise of Stock Options

Many public companies maintain "cashless exercise" programs, which allow executives and other employees a simple way to exercise stock options without any cash payment by the employee. These "cashless exercise" programs are offered by many major brokerage firms, and are one of the most common methods used by employees to exercise options for stock of public companies. Although the terms and operation of these option exercise programs may vary, many allow employees to exercise options by merely delivering an exercise notice. The exercise price of stock options is then paid to the issuer from the proceeds of a same-day sale of the underlying stock, or through a loan from the broker. These programs must be carefully examined to determine whether the company could be viewed for purposes of Section 402 of the Act as either extending credit, or arranging for the extension of credit through the broker.

It seems unlikely that Congress intended to prohibit this customary method of exercising stock options. It is arguable that under Regulation T adopted by the Board of Governors of the Federal Reserve Board, a cashless exercise is not an extension of credit, and should not be considered an

extension of credit for purposes of Section 402 of the Act, if the conditions of Regulation T are met with respect to such exercise. However, we believe that, in the absence of further guidance from the SEC, companies should consider excluding executive officers from engaging in a cashless exercise program. One alternative to the cashless exercise is the use of a "stock-for-stock" exercise, but the company should consult with its auditors and tax advisors to ensure this would not result in adverse accounting or tax consequences. If an executive can arrange for the extension of credit by a broker with no involvement by the company, then arguably there is no "arranging" of credit by the company. However, we believe that any such arrangements of credit for the "cashless" exercise of stock options should be carefully evaluated on an individual basis.

Split-Dollar Life Insurance

We believe that premiums on split-dollar life insurance policies covering executive officers and directors could be considered personal loans prohibited by Section 402 of the Act if the director or executive officer is designated as the owner of the policy. These policies could be considered loans because the company, which pays the premiums on the policies, is eventually reimbursed. Under such a split-dollar policy, the company typically pays the premiums while the employee owns the policy. The policies are generally set up so that when the executive retires, the company is repaid (usually without interest) from the cash value of the policy. For purposes of the Act, it is likely that under such an arrangement the employee would be deemed to have received a loan. In addition, other split-dollar arrangements could be considered a loan depending on the particular arrangement. Accordingly, each company should review its split-dollar life insurance policies carefully.

The "grandfathering" provisions of the Act, which allow extensions of credit outstanding on the date of enactment, may not apply to pre-existing split-dollar policies, since the payment of premiums could be viewed as a new extension of credit, because the amount of the "loan" is arguably increased. Accordingly, ceasing or deferring payment of further premiums on pre-enactment policies may be prudent, until further guidance on these issues is received from the SEC.

Other Arrangements

Public companies should review all arrangements with their directors and executive officers to determine if any could fall within the scope of a "personal" loan. Presumably, business travel, corporate credit cards, and other cash advances used for business purposes of the corporation will not be considered personal loans if such advances do not exceed acceptable per diem rates (in the case of business travel) or the reasonable cost of the anticipated business expense and are re-paid timely and promptly. The company should establish a clear policy that prohibits directors and executive officers from using advances, corporate credit cards, and other business loans for personal purposes.

Many other arrangements raise concerns under Section 402 or may require interpretive guidance. These arrangements include re-location assistance, the right to purchase stock with a note, leveraged co-investment plans, and any other personal credit arrangement such as guarantees and installment sales. Moreover, loans or other credit arrangements to the executive officer's family members or other persons or entities in which the director or executive officer has an interest should be reviewed carefully to determine whether they are personal loans "for" the director or executive officer. Other arrangements that may require interpretative guidance include indemnification arrangements, discounted stock options, and loans from the corporation's

retirement plans.

Promoted Individuals May Need to Repay Loans

Public companies should also review arrangements with personnel who may become a director or executive officer in the near future. Because the Act prohibits the issuer from "maintaining" credit with an executive officer, any person who becomes a director or executive officer will apparently be required to repay all personal loans prior to the time of the person's election to the board or promotion to the position of an executive officer.

Further Information

This Alert summarizes certain key points of the Act, but does not cover all of the provisions of this very complex legislation. For a more detailed discussion of reporting issues and other items raised by this Act, please see the Haynes Boone client alerts *Sarbanes-Oxley Act of 2002 Promises Far-Reaching Implications for Public Companies*, and *Sarbanes-Oxley Act of 2002; Suggestions for Compliance*. Implementation of the Act will require resolution of ambiguities and further rulemaking by the SEC.

If you would like to learn more about the Act and the rules and regulations relating to the Act, please feel free to contact your regular Haynes Boone attorney or any member of our Corporate Governance Practice Group.