ROPES & GRAY

CLIENT ALERT

August 2, 2002

SARBANES-OXLEY ACT:
PROHIBITION ON PERSONAL LOANS TO EXECUTIVES

One of the self-implementing and immediately effective provisions of the Sarbanes-Oxley Act is the Section 402 prohibition on personal loans to executives. This provision is sure to be one of the most debated provisions of the new law, in that it may have far-reaching and unintended consequences with respect to corporate compensation and benefits practices. As it is not possible at the present time to resolve, or even identify, all of the interpretive issues, public companies are well advised to review their current arrangements with executive officers and directors in light of the law in order to identify those questions that should be addressed in future rulemaking, SEC no-action letters or other interpretations. In the meantime, caution should be exercised with respect to the structuring of new arrangements with executive officers and directors, and to the modification or renewal of existing "personal loans." Here is a sampling of some of the issues:

- "Personal loan" is not defined, aside from the enumerated exceptions to the term. In this regard, can standard benefit arrangements be considered "personal loans"? For example, does the recently proposed tax treatment of certain collateral-assignment equity split-dollar insurance arrangements as loans bear on their possible status as "personal loans"? Is it a "personal loan" when a company accepts the undertaking of a third-party broker to pay an option exercise price in connection with a cashless exercise?

- The law applies to a personal loan to "any director or executive officer (or the equivalent thereof)." Does the language of equivalency, which is unusual in the SEC lexicon, push beyond the ordinary definition of "executive officer," which already requires a factual inquiry into the function of parent and subsidiary officers?

- The prohibition relates to direct or indirect "extensions of credit." The language is reminiscent of the margin rules under the 1934 Act. For those purposes, an "extension of credit" generally includes a guaranty. Given this fact and the background and purpose of the loan prohibition, companies should assume that guaranties are included within the prohibition.

- Also prohibited are direct or indirect activities to "arrange" personal loans for executives. This is also a term found in the margin rules, where it has a broad meaning. Does arranging relate only to situations in which the company provides some consideration to the third-party lender for loans to company executives? Or does it also cover such actions as securing a single broker as the third-party lender in a cashless exercise program or introducing executives to personal lending officers at a bank which may or may not be a participant in the company's credit? Does a company "arrange" when it works with a new third-party lender to transfer an executive's credit, in light of the problems of maintaining "grandfathered" loans as noted below?

- Personal loans outstanding on the date of enactment of the Act are "grandfathered," provided that there is no subsequent "material modification" or "renewal." Does a "material modification" include the company's action to shorten the maturity or take additional collateral? For the time being, caution suggests the answer is "yes." This being the case, the dynamics of many outstanding loans to executives to acquire company stock will change. Often these loans are provided on a demand, secured basis. If the value of the collateral falls, it is no longer possible for the company to maintain its position by taking additional collateral or otherwise restructuring the loan with required amortization under a term structure. In many situations this will put pressure on companies to collect on their loans to executives sooner than they would have otherwise done so. To be sure, this particular result is probably intended by the new law.

The above issues are simply illustrative. It is important to note that a wide variety of benefit arrangements can be analyzed as including personal loans. It is also important to note that the rigid grandfathering of existing loans is an imperfect solution, and companies may be well-advised to consider satisfactory ways of eliminating those loans now in favor of third-party credits.

If you have questions regarding the impact of the new prohibition on personal loans to executives, please call your regular Ropes & Gray contact, David Fine, Christopher Klem, Keith Higgins or Laurie Churchill.