

SARBANES-OXLEY'S NEW BAN ON LOANS TO DIRECTORS AND EXECUTIVE OFFICERS: WHAT YOU NEED TO KNOW NOW

Effective July 30, 2002, Section 402 of the Sarbanes-Oxley Act of 2002 amended the Securities Exchange Act of 1934 to prohibit U.S. and foreign companies with securities traded in the United States from making, or arranging for third parties to make, nearly any type of personal loan to their directors and executive officers. Although loans outstanding on July 30, 2002 were "grandfathered," the new prohibition prevents any material modifications (even those benefiting the company) or extensions of existing loans. Exceptions to the prohibition in Section 402 are very narrow, generally covering only loans made in the ordinary course of business and at market rates by issuers that are financial institutions or otherwise in the business of consumer lending.

Violations of the Sarbanes-Oxley loan prohibition are subject to the civil and criminal penalties applicable to violations of the Exchange Act.

The Sarbanes-Oxley loan prohibition is extremely broad and poses many interpretive problems. It is not clear when, if ever, the Securities and Exchange Commission will clarify the scope of the ban through rulemaking. Until the courts or the SEC provide guidance, public companies have little choice but to adjust existing policies and procedures in line with the full potential reach of the prohibition.

Broad Prohibition

Extending, maintaining or arranging credit. Section 402 adds a new Section 13(k) to the Exchange Act making it unlawful for any issuer, "directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an 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 ban covers not only traditional loans by the issuer, but also appears to cover guarantees by an issuer (or by a subsidiary) of third-party loans. The ban on "arranging" credit, directly or indirectly, also appears to prohibit a wide variety of transactions in which an issuer (or a subsidiary) facilitates or sets up personal loans or loan programs by third parties for the benefit of directors and executive officers, even where the issuer's involvement in arranging the credit may be minimal. The ban could clearly be interpreted to prohibit:

- **Broker-assisted cashless option exercises by directors or executive officers** in which an issuer has had involvement arranging the credit extended by the broker-dealer. If a director or executive officer arranges his or her own credit to fund an option exercise through an independent broker-dealer without issuer involvement, the loan ban should not apply. However, issuers will need to review carefully whether their level of involvement in such transactions might be deemed to constitute "arranging" the loan. (Cashless exercise by surrender of stock owned by a director or executive officer in payment of the option exercise price, where permitted under the terms of options, should *not* be affected by the loan ban.)

- **Any stock issuance to directors or executive officers in which the issuer itself extends credit** by permitting installment or other delayed payment of the purchase price.
- **Home mortgage or relocation loans** made by the issuer or by any third-party lender through any arrangement by or with the issuer.
- **Tax loans or advances** made by issuers or by any third-party lender through arrangement by or with the issuer to permit payment of taxes.
- **401(k) plan loans** made by the plan but which could be deemed arranged by the issuer sponsoring the plan.
- **Other arrangements, including equity split-dollar life insurance**, leveraged ESOPs and leveraged investment programs.

Issuer. Issuers covered by the prohibition include any company that is required to file reports with the SEC under Section 13 or 15(d) of the Exchange Act or that has a registration statement pending with the SEC under the Securities Act of 1933. Section 402 does not distinguish between U.S. and foreign private issuers subject to SEC reporting requirements. Since it also applies to private companies filing a registration statement in connection with their IPO, companies seeking to go public will be required to unwind loan arrangements within the scope of the prohibition *before* filing their registration statement.

Loans, guarantees or arrangements made by subsidiaries of covered issuers are also explicitly covered by the ban.

Executive officers and directors. The ban applies to “any director or executive officer (or equivalent thereof).” The term “executive officer” is not defined in Sarbanes-Oxley. However, Rule 3b-7 under the Exchange Act defines “executive officer” of an issuer to include:

“its president, any 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]. Executive officers of subsidiaries may be deemed executive officers of the [issuer] if they perform such policy making functions for the [issuer].”

Until the SEC provides further clarification (if it does), the ban on loans should therefore be viewed as extending to executive officers of subsidiaries. The term “or the equivalent thereof” in Section 402 is not defined, but appears to extend the ban to individuals performing functions similar to directors and executive officers for issuers that are not corporations (such as publicly traded partnerships).

Because the prohibition applies to any extension of credit or arrangement of credit “directly or indirectly . . . to or for” a director or executive officer, it appears also to extend to loans or other arrangements made to immediate family members of directors or executive officers (particularly if the family member resides with the director or executive officer) as well

as to corporations or other entities controlled by the director or executive officer, so long as the credit or arrangement could be deemed to be a “personal loan.”

In the form of a personal loan. The Sarbanes-Oxley loan prohibition prohibits only extensions of credit “in the form of a personal loan.” The term “personal loan” is not defined. It is difficult to predict how the courts or the SEC will interpret the term. However, travel and other types of cash advances for payment of business-related expenses as well as borrowing for business-related purposes under company credit cards should not be viewed as “personal loans” and, consequently, not be prohibited. Issuers should re-examine policies restricting the use of advances and company-sponsored credit cards by directors and executive officers to make sure use is strictly limited to business purposes.

Grandfathered Loans

Section 402 contains a “grandfather” clause exempting from the ban any extension of credit “maintained by the issuer” on July 30, 2002 (the date of enactment of Sarbanes-Oxley) “so long as there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date.” On its face, the grandfather clause appears to cover only loans “maintained by the issuer” and not loans by third parties arranged by the issuer.

Until further clarification is made by courts or the SEC, any change in any term of grandfathered arrangements (even one benefiting the issuer) could be deemed to be a modification or renewal bringing the arrangement within the ban. It is possible that forgiveness of an outstanding loan may be considered a prohibited “material modification” of the loan. Until further clarification by courts or the SEC, grandfathered loans should not be forgiven.

It is possible that the grandfather clause will be interpreted as exempting legally binding credit arrangements in place with the issuer before July 30 even if loans were not yet actually drawn down on that date under such arrangements.

The grandfather clause is tied, however, to the July 30, 2002 date. It does *not* exempt loans or arrangements simply because they were in place before an issuer or an individual first became subject to the prohibition. Consequently, private companies seeking to go public will be required to unwind existing loans with directors or executive officers (unless such arrangements existed on July 30, 2002) before filing a registration statement with the SEC. In addition, an individual becoming a director or executive officer of a covered issuer for the first time will be required to unwind existing arrangements with that issuer (unless they existed on July 30, 2002).

Explicit Exemptions

The Sarbanes-Oxley loan prohibition contains two categories of exempt loans and arrangements that will be available only for issuers that are financial institutions or otherwise engaged in the business of consumer lending.

Ordinary course of business loans by consumer lenders. Section 402 exempts the following types of loans made in the ordinary course of consumer credit business of the issuer if

they are of a type generally made available by the issuer to the public and are made on market terms or terms no more favorable than those offered to the general public:

- margin loans by SEC-registered broker-dealers to their employees for the purpose of buying, trading and carrying securities (other than the issuer's securities);
- open-ended credit plans, consumer credit and charge cards; and
- home improvement and manufactured home loans.

The exemption for margin loans by broker-dealers is especially narrow. It does not apply to loans for purchase of the broker-dealer's own securities. It does not appear to apply to loans to anyone other than employees of the broker-dealer, thereby excluding executive officers or directors of the broker-dealer's parent, subsidiaries or affiliates unless they are also employees of the broker-dealer. Furthermore, the exemption only applies to broker-dealers registered with the SEC, thereby excluding most non-U.S. broker-dealers.

FDIC-insured institutions. Section 402 also exempts loans by banks and thrifts that are insured by the U.S. Federal Deposit Insurance Corporation if the loans are subject to the insider lending restrictions of the Federal Reserve Board. Such restrictions apply to officers and directors of the bank or thrift as well as officers and directors of its parent, subsidiaries or affiliates. Non-U.S. banks (and their U.S. branches) are not generally insured by the FDIC. This exemption will not, therefore, generally apply to foreign banks.

The Need for Guidance and Exemptions

The loan prohibition in Section 402 reaches far beyond the scope of abusive loans to directors and officers that exemplified the corporate scandals leading to enactment of Sarbanes-Oxley. It is unclear whether the SEC will adopt rules that clarify the scope of the prohibition or draw exemptions for loans and arrangements with low potential for abuse. The SEC has no required timetable or obligation to make such rules or create such exemptions. Early indications from the SEC staff indicate that rules and exemptions may not be forthcoming.

For the time being, covered issuers have little choice but to examine and adjust policies and practices in line with the full potential reach of Section 402.

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