

**Lending to Corporate Insiders in Light of Section 402 of the  
Sarbanes-Oxley Act of 2002**

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# Lending to Corporate Insiders in Light of Section 402 of the Sarbanes-Oxley Act

## 1. Overview

- (a) **The Section 402 Prohibition.** Sarbanes-Oxley amended the Securities Exchange Act of 1934 (the “1934 Act”) by adding a new Section 13(k), which provides in pertinent part:

It shall be unlawful for any issuer (as defined in Section 2 of the Sarbanes-Oxley Act), 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 full text of Section 402 is reproduced in Appendix A.)**

- (b) **Issuers Subject to the Prohibition.** The prohibition applies to all issuers that (i) have securities registered under Section 12(b) or (g) of the 1934 Act, (ii) file periodic reports pursuant to Section 15(d) of the 1934 Act or (iii) have filed a registration statement under the Securities Act of 1933 which is awaiting effectiveness.
- (c) **Consumer Credit Exception.** The prohibition does not apply to the following categories of credit provided that the credit is (i) made or provided in the ordinary course of the consumer credit business of such issuer, (ii) of a type that is generally made available by such issuer to the public and (iii) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit:
- home improvement and manufactured home loans (each as defined in the Home Owners' Loan Act),
  - consumer credit, credit under an open end credit plan or a charge card (each as defined in the Truth-in-Lending Act), and
  - an extension of credit by a registered broker or dealer to one of its employees to buy, trade or carry securities that is permitted under applicable Federal Reserve regulations (other than an extension of credit that would be used to purchase the stock of that broker or dealer).
- (d) **Insured Bank Exception.** The prohibition does not apply to financial institutions that are FDIC-insured and therefore already subject to insider lending restrictions. See Federal Reserve Regulation O. Note that Regulation O does not apply to

bank holding companies or their non-bank subsidiaries, or to non-U.S. banks and their subsidiaries.

- (e) **Grandfathered Loans.** An extension of credit maintained by the issuer on July 30, 2002 is not subject to the prohibition, provided that there is (i) no material modification to any term of the credit or (ii) any renewal thereof after July 30, 2002. A key interpretive question here is whether extensions of credit after July 30, 2002 will be grandfathered so long as they are made pursuant to a binding commitment in place on or before July 30, 2002.
- (f) **Effective Date of Prohibition.** The prohibition under Section 402 has been in effect since July 30, 2002.

## 2. **Individuals Covered by the Prohibition**

- (a) **Directors.** Defined in Section 3(a)(7) of the 1934 Act as “any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or not.”
- (b) **Executive Officers.** Pending any future guidance from the SEC, the same definition used for purposes of a company's annual reports and proxy statements (1934 Act Rule 3b-7) should apply here. This definition would include:
  - the president,
  - vice presidents in charge of a principal business unit,
  - any other officer who performs a policy making function (including executive officers of subsidiaries if they perform policy making functions for the issuer)

Note that the SEC has taken a somewhat more expansive view of the term “executive officer” in interpreting the blackout restrictions of Section 306(a) of Sarbanes-Oxley. See Regulation BTR, §100(h). Under Regulation BTR, the term “executive officer” has the same meaning as the term “officer” under the Section 16 short-swing profit rules. Use of the Section 16 definition in this context appears to be more appropriate than under Section 402 of Sarbanes-Oxley. Section 16 and the blackout trading restrictions of 306(a) of Sarbanes-Oxley are highly similar in their purpose and scope, and applying both sets of rules to the same persons permits issuers to more easily monitor compliance. See Release No. 34-47225 (1/22/03).

- (c) **Related Parties.** Section 402 prohibits issuers from “directly or indirectly” making loans “to or for” any director or executive officer. The prohibition may therefore apply to:
  - loans to family members of the insider,

- loans to entities owned or controlled by the insider, and
  - issuer guarantees of loans from an unrelated third-party
- (d) **Application to New Insiders.** Section 402 applies to “maintaining,” as well as “extending” credit. The prohibition therefore could apply to continuing a loan made to an insider before he or she became such.

### 3. What is a “Personal Loan”?

- (a) **Lack of Guidance.** Neither the term “extension of credit” nor “personal loan” is defined in the Sarbanes-Oxley Act. It is possible that the SEC may look to Federal Reserve regulations and interpretations of the term “extension of credit” for guidance in the interpretation of Section 402.
- Regulation O. Under Regulation O, the term “extension of credit” is defined broadly (but subject to a number of exceptions) to include “an extending of credit in any manner whatsoever” and “any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, ... or by any means whatsoever.”
  - Narrower Interpretation. A narrower interpretation of the scope of the Sarbanes-Oxley Act to extensions of credit, and from the standpoint of statutory construction a more logical interpretation, is that the prohibitions apply only to extensions of credit that are “in the form of a personal loan.” Credit arrangements that are in the form of a loan are much narrower than arrangements that are extensions of credit. For example, an indemnity from the issuer to its executive officer would not customarily be considered a loan but would be considered an extension of credit.
- (b) **Personal vs. Business Loans.** Although nothing will be certain until the SEC issues guidance in this area, “loans” that further the issuer's business should not be regarded as “personal loans” and it is therefore reasonable to expect that they will be permitted. Such loans should include, for example, advances for payment of authorized travel or other expenses incurred or to be incurred on behalf of the issuer.
- (c) **Split Dollar Life Insurance Arrangements.** Under the typical structure for such arrangements, the issuer pays the policy premiums and is entitled to recover, from the proceeds of the insurance policy or from the policy's cash surrender value, an amount usually equal to its premium payments.
- Loan or Not? The application of Section 402 to such arrangements is unclear. Under existing Federal Reserve staff interpretations of Regulation O (the rules restricting loans to bank insiders), such arrangements are not treated as loans so long as (i) the employee's

obligation to repay the premium amounts is not independent of the lender's assigned interest in the value of the policy and (ii) the arrangement is not treated by the employee as a loan for federal income tax purposes. However, under currently proposed tax regulations, many of these arrangements may soon be treated as loans for federal income tax purposes.

- Split-Dollar Arrangements in Place on July 30, 2002. If split dollar arrangements are deemed to constitute personal loans, it is possible that each premium payment by the issuer could be deemed to constitute a new “extension of credit” subject to the prohibition. However, if there is no material modification to the arrangement after July 30, 2002, it is possible (but by no means certain) that the grandfathering exemption will be interpreted to apply to such payments.

- (d) **Indemnification Advances.** Under applicable state law (and in most cases pursuant to express charter and/or bylaw provisions), directors and executive officers may be entitled to mandatory or discretionary advances from the issuer for their expenses in connection with a claim or proceeding against them in their capacity as such. The status of such advances under Section 402 is unclear, although there are arguments that such advances should not be treated as “personal loans.”
- (e) **Cashless Exercise of Stock Options.** If the issuer delivers shares to the broker before it receives the purchase price and related tax withholding amount, the issuer may be deemed to have made a direct personal loan to the insider exercising the option. A number of arguments have been proposed for why cashless exercises should not be prohibited, but many of these arguments depend on the particular manner in which the cashless exercise is implemented.

#### 4. “Arranging” of Personal Loans

- (a) **General.** The prohibition under Section 402 applies not only to the issuer's making or maintaining a personal loan to or for its directors or executive officers, but also to “arranging” for such a loan by third parties.
- (b) **Interpretative Guidance.** The term “arrange” is not defined in the Sarbanes-Oxley Act. There is a fairly well-developed body of regulatory and judicial interpretations of the term under the margin lending rules to which the SEC may look for guidance (even though the policy considerations underlying the margin lending rules and Section 402 are different). The standard that has developed under the margin lending rules is essentially a “but for” test. In other words, would the participation by the bank or broker (for Section 402 purposes, the issuer) have the effect of causing the loan to be made where it may not otherwise have been made? Under this standard, there are four primary types of activities that can constitute the “arranging” of credit:

- introducing the borrower to a lender,
- furnishing information about the borrower to the lender,
- procuring or negotiating a loan for the borrower, and
- acting as an intermediary between the borrower and the lender.

**(c) Examples of Circumstances Found to Constitute an Arranging of Credit Under the Margin Lending Rules.**

- guarantee of a third-party loan,
- recommendation of a specific lender to the borrower,
- conveying instructions from the borrower to the lender or responding to requests or instructions of the lender concerning the customer's transactions.

**(d) Cashless Exercise of Stock Options.** If a broker advances payment to the issuer of the exercise price and related tax withholding prior to delivery of the shares, the broker may be deemed to have made a “personal loan” to the insider exercising the option for purposes of Section 402. If so, any involvement by the issuer in that process could be deemed to constitute an arranging of the loan.

- Note that under the margin lending rules, a broker implementing a cashless exercise of options must obtain a confirmation from the issuer to promptly deliver the shares upon the issuer's receipt of the exercise price and related tax withholding.

**5. Potential Consequences of Violating the Rule**

**(a) Civil Sanctions for Issuers.** Issuers can be subject to the following civil sanctions:

- SEC could seek injunctive remedies (conditional and unconditional, limited or unlimited in duration), or monetary penalties of up to \$500,000 (§21 of the 1934 Act).
- SEC could seek “cease and desist orders” or impose a temporary freeze on “extraordinary payments (whether compensation or otherwise)” during pendency of investigation (§21C of the 1934 Act).
- Unclear whether any private right of action or injunction or monetary damages will be implied under the 1934 Act.
- Directors and executive officers may be subject to state law derivative actions to recover proceeds of the loans.

- Directors and executive officers may, under certain circumstances, also be subject to liability as controlling persons and for aiding and abetting violations of Section 402 (§20 of the 1934 Act).
- (b) **Criminal Sanctions for Issuers.** In addition, issuers can be subject to criminal penalties:
- DOJ could bring criminal proceedings under §32 of the 1934 Act for knowing and willful violations.
  - Criminal fines of up to \$2.5 million for corporations.
- (c) **Potential Liability for Third-Party Lenders.** Third-party lenders who participate in the unlawful loan may be subject to claims that they colluded in or aided and abetted the loan. The SEC may bring an action for administrative and civil remedies for aiding and abetting an improper loan in violation of Rule 402 (§ 21 of the 1934 Act). For purposes of an aiding and abetting action, any person who “knowingly provides substantial assistance to another person” will be deemed to have violated the Act to the same extent as the person to whom such assistance is provided (§20(e) of the 1934 Act). “Actual knowledge” of the primary violation is usually required, although “recklessness” has been held to satisfy the scienter requirement under certain circumstances. See SEC v. Lybrand, 200 F. Supp. 2d 384 (S.D.N.Y. 2002). It is likely that acting as the lender in connection with a loan prohibited by Rule 402 constitutes “substantial assistance.” Penalties for aiding and abetting are the same as for the primary violator (injunctive remedies, civil penalties of up to \$500,000, prosecution by the DOJ for willful violations and criminal fines of up to \$2.5 million for corporations).

## 6. So, All of This Means What For a Lender?

- (a) **Loans to Insiders Guaranteed by Issuer.**
- Your loan to a director or officer (or their immediate family members) for personal purposes that is guaranteed by an issuer is in all likelihood an “indirect” loan by the issuer, and thus prohibited by the Sarbanes-Oxley Act.
  - The exposure of the Bank in this context is as an “aider and abettor” of the issuer.
- (b) **Loans to Insiders Arranged by Issuer.**
- Your loan to a director or officer (or their immediate family members) for personal purposes that is arranged by an issuer is in all likelihood prohibited by the Sarbanes-Oxley Act.

- Uncertainty as to the meaning of the word “arrange” in Section 402 frequently complicates the analysis of officer and director loans.

**(c) Loans to an Issuer for the Benefit of an Insider.**

- Your loan to an issuer that is to fund a program of loans to insiders is in all likelihood prohibited as aiding and abetting the making of a prohibited loan by an issuer.

**7. Contexts of Prohibited Loans: Time of Extension.**

**(a) Originations on or after July 30, 2002**

- Lenders who extend credit in one of the situations described in part 6 above violate the Sarbanes-Oxley Act.

**(b) Originations before July 30, 2002.**

- Lenders who extended credit before July 30, 2002 which is otherwise violative of Sarbanes-Oxley Act enjoy the grandfathering provisions of the Act.
- But, grandfathered credits may not be (i) materially modified or (ii) renewed.

**8. Grandfathered Loans and Forbearance, Work-Out.**

- A “material modification” may have a different meaning in the securities law context than in the commercial lending context.
- For example: Consider these alternative scenarios in a grandfathered credit that matures May 1, 2003 and the borrower requests “a little more time” to pay or refinance:
  - Do nothing until it becomes clear what the borrower can do
  - Enter into a standstill/forbearance agreement – 90 day period
  - Waive or modify the busted covenant and give the borrower 90 days to refinance.

**9. Sample Fact Patterns.**

- (1)** Bank loans money to an executive officer of Issuer on August 1, 2002; the loan is fully guaranteed by Issuer.
- The proceeds of the loan are to cover relocation expenses of officer.

- The proceeds of the loan are to acquire additional stock of Issuer.
  - The proceeds of the loan are to retire existing indebtedness of the officer to the Issuer, and that indebtedness was created by an advance of the officer to Issuer to fund an acquisition by Issuer.
- (2) Bank loans money to Issuer on August 1, 2002; the proceeds of the loan are used to fund Issuer's advances to executive officers for stock purchase plan implemented by Issuer for its executive officers.
- (3) Bank loans money to executive officer to fund personal financial needs, and the loan is made in 2001 and is guaranteed by the Issuer.
- Loan matures in May, 2003, and is paid in full.
  - Loan matures in May, 2003, and borrower seeks a three-month extension, with no other changes in terms.
  - Loan is a revolving credit loan, and draws are sought by borrower after July 30, 2002.
- (4) Issuer sets up a program in April, 2003, to fund, on a no-cost loan basis, relocation expenses of its executive officers and its non-officer managers. Issuer asks its main senior lender to set up a facility within its term and revolving credit facility to fund these advances (with a sublimit).
- (5) Bank loans money to non-officer supervisor for personal purposes in August of 2002. Due to a promotion, borrower becomes a senior vice president in 2003 and her employer, an Issuer, guarantees the loan.
- (6) A "grandfathered" bank loan to an executive officer is guaranteed by the employer, an Issuer. The loan goes into default in April, 2003. The Bank decides to:
- Declare a default and realize on the collateral and the guaranty.
  - Re-structure the loan by capitalizing accrued interest, extending the maturity by one year, taking additional collateral for the guaranty but also limiting the maximum exposure under the guaranty by 50%.
  - Increase the interest rate, extend the maturity and accept a 30% reduction of the outstanding principal.
  - Assign the loan to the Issuer-guarantor for 90% of par.

## APPENDIX A – COMPLETE TEXT OF SECTION 402

**Sec. 402. Enhanced Conflict of Interest Provisions.** (a) Prohibition on Personal Loans to Executives. – Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m), as amended by this Act, is amended by adding at the end the following: “(k) Prohibition on Personal Loans to Executives. —

“(1) In general. – It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), 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. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that 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 of enactment.

“(2) Limitation. – Paragraph (1) does not preclude any home improvement and manufactured home loans (as that term is defined in section 5 of the Home Owners’ Loan Act (12 U.S.C. 1464)), consumer credit (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602)), or any extension of credit under an open end credit plan (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602)), or a charge card (as defined in section 127(c)(4)(e) of the Truth in Lending Act (15 U.S.C. 1637(c)(4)(e)), or any extension of credit by a broker or dealer registered under section 15 of this title to an employee by a broker or dealer to buy, trade, or carry securities, that is permitted under rules or regulations of the Board of Governors of the Federal Reserve System pursuant to section 7 of this title (other than an extension of credit that would be used to purchase the stock of that issuer), that is – “(A) made or provided in the ordinary course of the consumer credit business of such issuer; “(B) of a type that is generally made available by such issuer to the public; and “(C) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.

“(3) Rule of construction for certain loans. – Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b).”

## APPENDIX B - SAMPLE CREDIT AGREEMENT PROVISIONS

### A. Loans to Corporate Borrower

#### Representations and Warranties

1. If borrower is not a reporting company: add to the rep and warranty concerning Investment Company Act of 1940, Public Utility Holding Company Act of 1935, or as a stand-alone rep and warranty:
  - No Borrower or Guarantor (i) is required to file reports under Section 15(d) of the Securities Exchange Act of 1934, (ii) has securities registered under Section 12 of the Securities Exchange Act of 1934 or (iii) has filed a registration statement that has not yet become effective under the Securities Act of 1933.
2. If Borrower or a Guarantor is a reporting company, add as a rep and warranty:
  - None of the proceeds of the Loan will be used directly or indirectly to fund a personal loan to or for the benefit of a director or executive officer of a Borrower or Guarantor.

#### Covenant

3. If Borrower is not a reporting company at the inception of the Loan, add an affirmative covenant:

Borrower will notify Lender promptly upon a Borrower (i) being required to file reports under Section 15(d) of the Securities Exchange Act of 1934, (ii) registering securities under Section 12 of the Securities Exchange Act of 1934 or (iii) filing a registration statement under the Securities Act of 1933.
4. If Borrower is a reporting company, add affirmative covenants requiring Borrower (A) to submit, along with the annual audited financial statements, the certification of the financial statements required of the chief executive officer or the chief financial officer, and (B) to comply in all material respects with the provisions of the Sarbanes-Oxley Act.

### B. Loans to Director or Executive Officer Guaranteed by Corporation

#### Representation and Warranty by Non-Reporting Guarantor

- Guarantor (i) is not required to file reports under Section 15(d) of the Securities Exchange Act of 1934, (ii) has no securities registered under Section 12 of the

Securities Exchange Act of 1934, and (iii) has not filed a registration statement that has not yet become effective under the Securities Act of 1933.

Affirmative covenant by Non-Reporting Guarantor

- Guarantor will notify Lender promptly upon the Guarantor (i) being required to file reports under Section 15(d) of the Securities Exchange Act of 1934, (ii) registering securities under Section 12 of the Securities Exchange Act of 1934 or (iii) filing a registration statement under the Securities Act of 1933.