NEW PROHIBITION ON LOANS TO EXECUTIVES MAY CONFLICT WITH COMMON COMPENSATION PRACTICES

As noted in our memorandum dated July 29, 2002, the Sarbanes-Oxley Act of 2002 (the “Act”) provides that public companies may not, directly or indirectly, extend or maintain credit, or arrange for the extension of credit, to their executive officers or directors. While the scope of this provision is not clear at this time, the Act’s broadly-worded language could prohibit a number of common compensation practices. Although we expect the SEC to clarify the Act’s application to such practices, a conservative interpretation of its provisions may be prudent until guidance is issued.

Cashless Exercise Programs

Many public companies maintain so-called “cashless exercise” programs for their employees. These programs are offered by most major brokerage houses, and are perhaps the most common method used by employees to exercise public company options.

Under a typical cashless exercise program, the company will designate a single broker to facilitate the exercise of employee options. While not all arrangements are identical, most allow employees to exercise options simply by delivering an exercise notice. The exercise price is paid either from the proceeds of the sale of the stock delivered, or through a loan from the broker. As a result, the company could be viewed as either extending credit, or (in the case of a loan from the broker) arranging for the extension of credit, which would be prohibited by the Act if the optionee is an executive officer or director.

It seems unlikely that Congress intended to prohibit this customary method of exercising options. In the absence of further guidance, however, we believe companies generally should exclude executive officers and directors from their cashless exercise programs. While there may be circumstances where an executive officer can arrange for the extension of credit by a broker without involvement by the company, such that the company would not be viewed as “arranging” for such credit, such arrangements should be evaluated carefully on a case-by-case basis.

Split-Dollar Life Insurance

A related concern arises with split-dollar life insurance arrangements, both ongoing and pre-enactment. Typical employee-owned, collateral assignment life insurance policies often can be viewed as analogous to a loan arrangement, and recent IRS proposed regulations would treat the

arrangement as a loan for tax purposes. The grandfathering provisions of the Act only protect extensions of credit outstanding on the date of enactment. Conceivably, the payment of premiums on a pre-enactment split-dollar policy for an executive officer or director could be viewed as a new extension of credit, since the amount of the loan is arguably increased. It seems very unlikely that this was intended, given the magnitude of pre-enactment split-dollar insurance that is in force. Nevertheless, deferring payment of further premiums on pre-enactment policies until additional guidance has been issued may be prudent.

Loans under 401(k) Plans

Many 401(k) plans maintained by public companies allow participants to take loans against their plan accounts. If the plan permits loans, ERISA requires that these loans be made available to all participants on a reasonably consistent basis. Failure to do so would cause the loans to be "prohibited transactions" under ERISA.

The prohibited loan provisions of the Act do not contain an exception for 401(k) plan loans. This issue has some particularly troubling implications since, under ERISA, companies that prohibit loans to executive officers would likely have to prohibit loans to all plan participants. While we are not suggesting that companies take that drastic measure, executive officers should be advised not to take out new 401(k) plan loans until further guidance is issued. Loans made prior to the adoption of the Act are grandfathered.

Loans to Executive Officers of Private Companies Which Go Public

It is common for private companies to extend loans to executive officers to purchase company stock. While these loans are permissible for so long as the company is private, continuing such loans after the company's initial filing of a Securities Act registration statement could be viewed as a prohibited "maintenance" of credit under the Act. It is unclear whether loans of this type were intended to be prohibited and, in the absence of further guidance, any new loans entered into between private companies and their executive officers should contain provisions requiring termination prior to a public offering, unless permitted under applicable guidance at that time.

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If you wish to obtain additional information regarding the foregoing, please contact Frank A. Daniele (212-728-8216, fdaniele@willkie.com), Stephen T. Lindo (212-728-8242, slindo@willkie.com) or the partner who regularly works with you.

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