

Sarbanes-Oxley Act Hastily Extinguishes Executive Loans: Recommending Less Drastic Regulatory Alternatives

“My amendment is very simple: it makes it unlawful for any publicly traded company to make loans to its executive officers. Let me give a few examples as to why we should do this.

Executives of major corporations, including Enron, WorldCom, and Adelphia, collectively received more than \$5 billion in company funds in the form of personal loans. For example, Bernard Ebbers, CEO of WorldCom, borrowed a mind-boggling \$408 million from the corporation over several years, while receiving a compensation package valued at over \$10 million annually, all the while the company was facing massive losses. In the case of Adelphia, the Rigas Family received loans and other financial benefits totaling a staggering \$3.1 billion, while that company has also reported huge financial losses.

The question is: Why can't these super rich corporate executives go to the corner bank, the Suntrust's or Bank of America's, like everyone else to take loans?”¹

I. INTRODUCTION

Corporate law is generally a function of state law.² While the Federal Government has the power to trump state corporate law, it has historically refrained from intruding upon internal corporate affairs unless the issue rose to a level of national importance.³ In the rare instances where national corporate governance legislation has been enacted, Congress did so only after extensive

1. 148 CONG. REC. S6690 (daily ed. July 12, 2002) (statement of Sen. Schumer) (explaining need for amendment to Sarbanes-Oxley Act banning personal loans to executives).

2. See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 598 (2003) (discussing federal intrusion on state-dominated corporate law).

3. See *id.* (characterizing internal affairs doctrine as informal arrangement, not definite constitutional rule). The Supreme Court has repeatedly acknowledged the states' regulation of internal corporate affairs. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 91 (1987) (noting state regulation of corporate governance “accepted part” of country's “business landscape”); *Edgar v. Mite Corp.*, 457 U.S. 624, 645 (1982) (acknowledging state of incorporation governs corporation's internal affairs). Federal authorities no longer grant states total control over internal corporate governance, choosing to intervene when issues of national importance arise. See Roe, *supra* note 2, at 598-600. Most notably, under the 1934 Exchange Act, Congress infringed on state proxy law. *Id.* at 598. The states' primary governing authority rests in establishing fiduciary duties of corporate directors. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318-19 (2004) (criticizing state corporate laws and signaling demand for additional federal regulation of corporate governance).

hearings and debate.⁴ For over two hundred years, states had sole authority to determine whether corporations could make loans to their executives.⁵

State views on the propriety of executive loans have evolved over time.⁶ Early state law strictly prohibited companies from lending money to officers and directors unless the company was in the business of making loans.⁷ Beginning in the 1930s, however, a majority of states enacted laws permitting loans to executives.⁸ Though some states imposed significant restrictions, the majority granted boards wide discretion to make loans, provided the loans benefited the company.⁹

Executive loans are not necessarily detrimental to companies, and may serve a number of valuable purposes.¹⁰ Boards might offer loans to supplement compensation packages to help lure top executive talent.¹¹ Executive loans that facilitate the exercise of stock options or the purchase of company stock may be used to align management's interests with those of shareholders.¹² Loans that make transactions hassle-free, such as relocation loans and travel advances, allow executives to devote more time to running the company.¹³

4. See Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 47 (2002) (contrasting extensive hearings preceding 1934 Securities and Exchange Act with hasty adoption of Sarbanes-Oxley Act).

5. See generally Roe, *supra* note 2 (discussing federal intrusion into state-dominated corporate law).

6. See generally Jayne W. Barnard, *Corporate Loans to Directors and Officers: Every Business Now a Bank?*, 1988 WIS. L. REV. 237 (1988) (providing history of state laws regulating executive loans).

7. See Barnard, *supra* note 6, at 240-46 (detailing history of executive loans); Paul W. Eaton, Jr., Comment, *Corporations—General Effect of Statutes Prohibiting Corporate Loans to Directors, Officers and Stockholders*, 48 MICH. L. REV. 213, 220 (1949) (characterizing statutes prohibiting executive loans as unnecessary in light of existing law). By 1949, twenty-two states enacted laws banning or limiting the scope of executive loans. Eaton, *supra*, at 213. The laws were generally intended to prevent corporate directors from dissipating company assets through unwarranted loans to themselves or other officers. *Id.* at 214.

8. See Barnard, *supra* note 6, at 244 (identifying Michigan as first state to permit executive loans). Michigan's loan-enabling statute was conservative in that it provided for full disclosure of the loan to shareholders and required approval of two-thirds of a disinterested board of directors. *Id.* In 1967, Delaware enacted the most liberal loan statute to date. *Id.* Delaware law grants board members power to make loans to officers and directors, provided that, "in the judgment of the directors, such loan . . . may reasonably be expected to benefit the corporation." DEL. CODE ANN. tit. 8, § 143 (2001). The statute provides directors with broad discretion in defining the terms of the loan and determining whether the loan is beneficial to the corporation. *Id.*

9. Compare TENN. CODE ANN. § 48-1-814 (1986) (repealed Jan. 1, 1988) (authorizing executive loans only if shareholders consent), with DEL. CODE ANN. tit. 8, § 143 (granting boards power to make executive loans).

10. See Eaton, *supra* note 7, at 215 (finding "no corollary" between corporate loans and dissipation of assets).

11. See Barnard, *supra* note 6, at 261-63 (maintaining compensation schemes serve valid business purposes and deserve wider discretion).

12. See Barnard, *supra* note 6, at 266 (acknowledging studies linking increased stock ownership by management to enhanced shareholder value); Miron Stano, *Executive Ownership Interests and Corporate Performance*, 42 S. ECON. J. 272, 277 (1975) (concluding rise in management stock ownership leads to rise in company stock price).

13. Barnard, *supra* note 6, at 261-63 (noting home relocation loans offered to facilitate company-directed transfers advance specific corporate purpose). An employee is also more likely to relocate knowing that a

Unfortunately, some corporate executives have abused liberal state law by borrowing millions of dollars for personal expenses with little, if any, resistance from company directors responsible for approving the loans.¹⁴ Inadequate public disclosure requirements enabled such loans to go largely unscrutinized.¹⁵ Consequently, lavish executive loans became commonplace among America's largest companies.¹⁶ Moreover, many companies issued loans on extremely favorable terms, or forgave the debt altogether.¹⁷

Responding to a rash of corporate scandals that resulted in some of the largest bankruptcies in United States history, Congress enacted the Sarbanes-Oxley Act of 2002 (SOX).¹⁸ Pressured by public outrage at corporate scandals, Congress acted in haste and the ramifications of the statute will likely extend far beyond its stated objectives.¹⁹ SOX is the most sweeping overhaul of securities law in seventy years.²⁰ While it primarily targets securities law, several provisions apply to internal corporate affairs.²¹ Notably, SOX prohibits public companies from making personal loans to their corporate officers and directors.²²

SOX's absolute loan prohibition signals the end of many legitimate corporate loan practices.²³ Moreover, because the ban sweeps broadly, it

company loan will ease the purchasing a new home. *Id.* at 263.

14. See generally Paul Hodgson, *My Big Fat Corporate Loan* (Dec. 2002), at http://www.thecorporatelibrary.com/company_research/reports/loanreport_120402.pdf (describing extent of executive loans granted at major United States companies).

15. See *infra* Part III.C (discussing state and federal law and loan disclosure practices of major corporations).

16. See Hodgson, *supra* note 14, at 1 (discussing prevalence of executive loans).

17. See Hodgson, *supra* note 14, at 2 (characterizing large percentage of loans as either low interest, interest free, or forgiven). Hodgson's 2002 study reveals that 102 out of 362 major companies forgave or intended to forgive loans to executives. *Id.* In addition, the study indicates that only about half of the 362 companies charged executives any interest. *Id.*

18. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18, 28 and 29 U.S.C.); see Shawn Young et al., *WorldCom Files for Bankruptcy: Debt, Scandal Overwhelm; Operations Set to Continue During a Reorganization*, WALL ST. J., July 22, 2002, at A3 (discussing WorldCom bankruptcy and fraud responsible for company failure). The magnitude of the Enron and WorldCom bankruptcies is evident by their market values prior to collapse—Enron at \$63.4 billion and WorldCom at \$107 billion. Young, *supra*, at A3.

19. Kathryn Stewart Lehman, *Executive Compensation Following the Sarbanes-Oxley Act of 2002*, 81 N.C. L. REV. 2115, 2117 (2003) (describing negative implications of SOX executive loan ban on compensation practices).

20. See Mike Allen, *Bush Signs Corporate Reforms into Law; President Says Era of 'False Profits' is Over*, WASH. POST, July 31, 2002, at A4 (stressing monumental scope of SOX).

21. See Roe, *supra* note 2, at 633-34 (characterizing SOX as federal intrusion on state corporate law). SOX trumps state corporate law in several areas, including executive compensation, audit committee independence, and corporate board composition. *Id.*

22. Sarbanes-Oxley Act of 2002 § 402 (codified in 15 U.S.C. § 78m(k) (2004)) (amending section 78m of 1934 Exchange Act to prohibit executive loans). Through the enactment of section 402, the Federal Government overruled existing state laws permitting personal loans to executives. Roe, *supra* note 2, at 633.

23. See Lehman, *supra* note 19, at 2117 (criticizing SOX ban on executive loans).

leaves many issues open to interpretation.²⁴ Corporate directors will likely need significant legal advice to determine whether SOX prohibits certain transactions, thereby increasing business costs.²⁵

This Note explores ways Congress can allow legitimate corporate loans and still regulate loans in a manner that thwarts abusive practices. Part II discusses early state laws that prohibited corporate lending to executives.²⁶ Part III examines state enabling statutes that granted company boards broad discretion in making executive loans.²⁷ It further discusses state fiduciary duty laws that unsuccessfully attempted to restrict executive loans, and federal disclosure laws that provided inadequate information to regulators and investors.²⁸ Part IV highlights the major loan scandals that sparked demand for federal intervention.²⁹ Part V describes SOX section 402, which bans corporate loans to executives.³⁰ Part VI analyzes alternative methods to achieve section 402's stated objectives without banning reasonable corporate loan practices.³¹ Finally, Part VII recommends that Congress adopt one or more of these alternative methods.

II. EARLY CORPORATE LAW STRICTLY PROHIBITED EXECUTIVE LOANS

Throughout the early twentieth century, courts narrowly construed corporate powers, limiting their authority to the express provision of the corporation's charter.³² Many courts declared that loans by non-bank businesses were *ultra vires*, and therefore void.³³ Some courts took a more lenient approach, holding that corporate charters impliedly authorized loans that were incidental to the

24. See Amalia Deligiannis, *Uncle Sam Cracks Down on Executive Loans: In-house Counsel Strive to Untangle New Restrictions*, CORP. LEGAL TIMES, July, 2003, at 24 (describing legal uncertainties after passage of SOX loan prohibition). The ambiguous nature of section 402 will undoubtedly lead to increased corporate reliance on legal counsel. See *id.*

25. Nanette Byrnes, *Reform: Who's Making the Grade; A Performance Review for CEOs, Boards, Analysts and Others*, BUS. WK., Sept. 22, 2003, at 80 (noting companies have spent at least \$1 billion complying with SOX requirements). The adoption of SOX has increased the average cost associated with operating as a public corporation from \$1.3 million to almost \$2.5 million for mid-sized companies. See W. Randy Eaddy & Neil D. Falis, *Sarbanes-Oxley: A Year of Nervous Governing*, 25 NAT'L L.J. 22 (2003). Rising liability insurance premiums for directors and officers and increased legal and accounting fees have primarily caused the increase. *Id.*

26. See *infra* notes 37-42 and accompanying text.

27. See *infra* Part III.A.

28. See *infra* Part III.B-C.

29. See *infra* Part IV.

30. See *infra* Part V.

31. See *infra* Part VI.

32. Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1302-09 (2001) (discussing history of ultra vires doctrine).

33. See *Riley v. Callahan Mining Co.*, 155 P. 665, 670 (Idaho 1916) (holding loans ultra vires because outside charter of mining business); *Leigh v. Am. Brake Beam Co.*, 68 N.E. 713, 715 (Ill. 1903) (holding brake business loan ultra vires because power not granted in charter). Even loans of surplus funds intended to earn the company interest were held improper. *Riley*, 155 P. at 669, 670.

business.³⁴ Thus, a brewing company could lend money to assist customers in purchasing saloons and liquor licenses because such loans were incidental and reasonably necessary to the objective of making and selling beer.³⁵ Eventually, few courts went even further, allowing executive loans as long as the funds could not have yielded higher interest elsewhere and absent a showing of fraud.³⁶

A number of states statutorily prohibited corporations from making any type of loan unless the company was in the business of lending money.³⁷ The purpose of these loan prohibition statutes was to protect corporations and shareholders from “unscrupulous directors” who might dissipate corporate assets.³⁸ While most statutes stopped at banning executive loans, a minority went further to discourage directors from approving loans.³⁹ For example, some prohibition statutes held directors personally liable for unpaid loans, even those made in good faith.⁴⁰ Critics noted that common law fiduciary duties

34. See *Kraft v. W. Side Brewery Co.*, 76 N.E. 372, 373 (Ill. 1905) (declaring brewery loan to saloon valid because implied power to advance and promote brewery’s business); *Edwards v. Int’l Pavement Co.*, 116 N.E. 266, 269 (Mass. 1917) (holding patent licensing company’s loan to licensee not ultra vires because loan incidental to business).

35. *Brophy v. Am. Brewing Co.*, 11 Pa. 333, *3 (Pa. Com. Pl. 1902) (holding corporate loans to customers not unlawful); see also *Kraft*, 76 N.E. at 373 (holding brewery loans to saloon-keepers not ultra vires).

36. See, e.g., *Garrison Canning Co. v. Stanley*, 110 N.W. 171, 173 (Iowa 1907) (noting manufacturing company not expressly prohibited from making temporary loans of unused funds for profit); *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App. 1953) (allowing loans to officers unless expressly prohibited by statute); *Felsenheld v. Bloch Bros. Tobacco Co.*, 192 S.E. 545, 549 (W. Va. 1937) (holding loans of surplus funds to directors not automatically improper without fraud or self-dealing); see also *Barnard*, *supra* note 6, at 241 (noting liberal stance of some courts). Such courts provided that while insider loans were not inherently fraudulent or illegal, they were still subject to close scrutiny. See *Milam*, 258 S.W.2d at 956.

37. See *Barnard*, *supra* note 6, at 241-42 (discussing history of state prohibitions on executive loans).

38. See *Barnard*, *supra* note 6, at 242 (quoting *Wulfjen v. Dolton*, 151 P.2d 846, 849 (Cal. 1944)) (describing intent of state laws prohibiting executive loans); John F. Rich, *Corporate Loans to Officers, Directors and Shareholders*, 14 BUS. LAW. 658, 659 (1959) (noting common intent of prohibition statutes); *Eaton*, *supra* note 7, at 214 (indicating state justifications for enactment of loan prohibition statutes).

39. See *Barnard*, *supra* note 6, at 241-42 (discussing early state corporate law regarding executive loans). Directors who violated state loan prohibition statutes were often held jointly and severally liable for unpaid loans, even those made in good faith. See *Eaton*, *supra* note 7, at 218; see also *Maclary v. Pleasant Hills Inc.*, 109 A.2d 830, 836 (Del. Ch. 1954) (holding directors liable for loan despite good faith and lack of knowledge of loan prohibition). Directors could not claim good faith nor ignorance of the statute as a defense for improper loans under state prohibition statutes. See *Maclary*, 109 A.2d at 826. In effect, directors guaranteed the repayment of improper loans. See *id.*

40. See *Eaton*, *supra* note 7, at 218 (describing state statutes discouraging executive loans by holding directors personally liable). For example, an Illinois statute provided that directors who voted for or assented to an insider loan would be held jointly and severally liable until the loan was repaid. *Id.* (quoting 32 ILL. COMP. STAT. ANN. 157/42-d (1948)). If a director was present at the loan approval meeting, he had to prove that he actually dissented to overcome the presumption. *Id.* Indiana, Massachusetts, and New York also enacted laws that held directors liable for unpaid executive loans, though the laws varied slightly as to proving assent by directors. *Id.* Indiana held directors liable if they “knowingly and willfully” assented to the loan. *Id.* (citing 25 IND. CODE § 251 (1948)). Directors in Massachusetts could avoid liability only if they voted against the loan. *Id.* (citing MASS. GEN. LAWS ch. 156, § 37 (1948)). In New York, directors had to prove they lacked knowledge of the loan to evade liability. See *Murray v. Smith*, 120 N.E. 60, 62 (N.Y. 1918).

already protected against director abuse of corporate assets.⁴¹ Nonetheless, many states insisted on prohibiting executive loans altogether or imposing significant limitations to prevent abuse.⁴²

III. STATE ENABLING STATUTES AND THE RISE OF EXECUTIVE LOANS

A. *Views on Executive Loans Change Slowly But Gain Momentum*

In 1931, Michigan became the first state to enact a law permitting corporate loans to directors, officers, and shareholders.⁴³ Michigan carefully worded its statute to prevent abuse by requiring two-thirds approval by a disinterested board and full, detailed disclosure to shareholders.⁴⁴ A small number of states followed Michigan's lead in permitting executive loans but imposed even greater restrictions, such as shareholders' consent.⁴⁵ For years, the amount and scope of executive loans remained constrained, until Delaware enacted its

41. See Eaton, *supra* note 7, at 214-16 (questioning need for loan prohibition statutes). The prohibition statutes were based on the assenting directors' fiduciary obligations to the corporation. *Id.* If a loan was not in the best interest of the company and led to bankruptcy, the corporation and its creditors could sue directors for breach of their fiduciary duties and breach of trust, respectively. *Id.* at 214. If the loans did not cause bankruptcy, directors were still liable to the corporation for approving improper loans in breach of their fiduciary obligations. *Id.* Although the common law required proof that a director breached a fiduciary duty and violated the business judgment rule in certain cases, violations of the state prohibition statute presumptively established breach. *Id.* at 215.

42. Eaton, *supra* note 7, at 213 (noting rise in state loan prohibition statutes). By 1949, twenty-two states enacted laws prohibiting executive loans or limiting their scope. *Id.* These included: California, Connecticut, Delaware, Georgia, Illinois, Indiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Rhode Island, and South Dakota. *Id.* at 213 n.1.

43. See Barnard, *supra* note 6, at 244 (identifying Michigan as first state to permit executive loans). Michigan's enabling statute provided that:

No officer or director of a corporation, other than a corporation an integral part of whose business permits it to make loans, shall either directly or indirectly authorize, consent to, make or allow any loan or advance to or overdraft or withdrawal by an officer, director or shareholder of such corporation out of its funds otherwise than in the ordinary and usual course of the business of the corporation and on the ordinary and usual terms of payment and security unless each such loan, advance, overdraft or withdrawal is approved by the vote of at least two-thirds of all the members of the board of directors of the corporation excluding any director obtaining such loan or advance or making such withdrawal or overdraft. A full and detailed statement of all such loans, advances, overdrafts and withdrawals and repayments thereof shall be submitted at the next annual meeting of shareholders and the aggregate amount of such loans, advances, overdrafts and withdrawals and repayments thereof shall be stated on the next annual report to shareholders.

1931 Mich. Pub. Acts 327, § 46, quoted in *In re Wood's Estate*, 1 N.W.2d 19, 23 (Mich. 1941).

44. See *Wood's Estate*, 1 N.W.2d at 23 (setting forth Michigan's enabling statute). Generally, a disinterested director is one that will not receive any personal benefit from the transaction apart from the broad benefit conferred on the corporation and its shareholders. *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995) (citing *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

45. See *Wulfjen v. Dolton*, 151 P.2d 840, 843 (Cal. 1944) (quoting CAL. CIV. CODE § 366 (repealed 1947)) (requiring consent of two-thirds of all classes of shares except those held by interested party); TENN. CODE ANN. § 48-1-814 (1984) (declaring loans to insiders require consent of shareholders); Barnard, *supra* note 6, at 244 (discussing early history of states' enabling statutes).

enabling statute in 1967.⁴⁶

Delaware law has stood on the forefront of corporate governance.⁴⁷ Though not the first state to allow executive loans, Delaware's position is the most tolerant and influential.⁴⁸ Delaware's enabling statute permits corporate loans to any officer provided that the board finds the loan "may reasonably be expected to benefit the corporation."⁴⁹ Neither the Delaware legislature nor the judiciary has provided a meaningful definition of the "benefit" standard or articulated any concrete limitations to loan grants.⁵⁰ Consequently, the statute affords directors wide discretion, permitting executive loans for a variety of purposes and according to a countless array of terms and conditions.⁵¹

Within a few years, several states followed Delaware's example and enacted loan enabling statutes.⁵² The Model Business Corporation Act was also revised

46. See *infra* notes 47-51 and accompanying text (discussing Delaware's liberal loan enabling statute).

47. See Roe, *supra* note 2, at 590 (acknowledging Delaware earns more corporate tax revenue than any other state). Most large United States companies are incorporated in Delaware. *Id.* In part, Delaware's dominance in corporate law stems from its small size, which gives corporate interest groups greater influence, as well as its specialized and esteemed judiciary. *Id.* at 594.

48. Barnard, *supra* note 6, at 244 (describing Delaware's liberal stance on executive loans).

49. DEL. CODE ANN. tit. 8, § 143 (2001) (allowing personal loans to executives). Delaware's loan enabling statute superceded previous law which prohibited insider loans and held directors jointly and severally liable until such loans were repaid in full with interest. See DEL. CODE ANN. tit. 8, § 143 (1951) (repealed 1967).

50. See Barnard, *supra* note 6, at 256-58 (noting failure of legislature to define benefit and analyzing case law to extrapolate benefit standard). Applying their respective state enabling statutes, only two state court decisions have addressed the benefit issue, and both failed to provide guidance. See *Oberhelman v. Barnes Inv. Corp.*, 690 P.2d 1343, 1349 (Kan. 1984) (framing loan to executive as personal); *Roxbury State Bank v. The Clarendon*, 324 A.2d 24, 34 (N.J. Super. Ct. App. Div. 1984) (characterizing transactions between corporation and directors as neither loan nor guarantee).

51. See Barnard, *supra* note 6, at 244 (noting variety of loans permitted under Delaware's liberal enabling statute). Delaware's statute does not place any restrictions on the interest, if any, to be charged, collateral or other security provided by the borrower, or whether it may be eventually forgiven. DEL. CODE ANN. tit. 8, § 143 (2001).

52. See ALA. CODE § 10-2B-3.02 (1975) (empowering corporations to lend money); ALASKA STAT. § 10.06.485 (Michie 2004) (requiring two-thirds of board approve executive loans and holding directors to duty of good faith); CAL. CORP. CODE § 315 (West 1990) (mirroring Delaware's benefit standard but expressly prohibiting interested directors from voting on loan grants); COLO. REV. STAT. ANN. § 7-108-501(4)(a) (West 2004) (permitting loans if disclosed to and authorized, approved or ratified by directors or shareholders); FLA STAT. ANN. ch. 607.0833 (West 2001) (allowing loans beneficial to corporation); 805 ILL. COMP. STAT. 5/3.10 (2004) (granting general power to directors to loan money to directors, officers, employees, and agents); IND. CODE § 23-1-35-3 (2004) (requiring vote by shareholders or approval by board after determination loan benefits corporation); KAN. STAT. ANN. § 17-6303 (1995) (permitting executive loans reasonably expected to benefit corporation); KY. REV. STAT. ANN. § 271B.8-320 (Michie 2003) (requiring vote by shareholders or board determination of benefit to corporation); ME. REV. STAT. ANN. tit. 13-A, § 2-416 (West 2002) (repealed 2003) (allowing executive loans); MD. CODE ANN., CORPS. & ASS'NS § 2-416 (1999) (allowing interest-free or unsecured loan if directors believe it benefits corporation); MASS. GEN. LAWS ch. 156B, § 62 (2004) (permitting beneficial executive loans approved or ratified by board); MICH. COMP. LAWS ANN. § 450.1548 (West 2004) (authorizing loans to officers and expressly permitting purchase of company stock); MINN. STAT. ANN. § 302A.501 (West 2004) (allowing executive loans approved by board and intended to benefit corporation); N.H. REV. STAT. ANN. § 293-A:8.32 (1999) (permitting executive loans approved by board and intended to benefit corporation); N.J. STAT. ANN. § 14A:6-11 (West 2003) (mirroring Delaware's benefit

to permit executive loans.⁵³ The limited legislative histories of state enabling statutes suggest they were enacted to meet the temporary needs of executives being moved around the country on short notice and to facilitate stock purchase plans.⁵⁴ Indicating corporate convenience as a factor, a few states expressly authorized corporations to make routine loans for reimbursable business expenses without board approval.⁵⁵

Federal tax law and an increase in the use of stock options in executive compensation packages provided further impetus for loan enabling statutes and executive loan grants.⁵⁶ Until the Tax Reform Act of 1984, executives could choose low-interest or no-interest loans instead of taxable compensation.⁵⁷ Despite the Internal Revenue Service's elimination of the tax incentive, executive loans grew in the 1990s as a means to attract and retain highly qualified executives.⁵⁸ As stock options proliferated in the 1990s as a compensation tool, so did the practice of granting executive loans to facilitate their exercise.⁵⁹ Finally, dramatic increases in overall executive compensation

standard for approval of executive loans); N.Y. BUS. CORP. LAW § 714 (McKinney Cum. Supp. 2005) (allowing loans to company directors); N.C. GEN. STAT. § 55-8-32 (2003) (permitting loans approved by shareholders or directors after determining benefit to corporation); N.D. CENT. CODE § 10-19.1-89 (2001) (providing corporations authority to make loans); OKLA. STAT. ANN. tit. 18, § 1029 (1999) (mirroring Delaware's benefit standard for approval of executive loans); OR. REV. STAT. § 60.364 (1999) (permitting executive loans approved by shareholders or approved by board and deemed beneficial); R.I. GEN. LAWS § 7-1.1-42 (1999) (repeal effective July 1, 2005) (permitting executive loans); S.C. CODE ANN. § 33-8-320 (Law. Co-op. 1990) (allowing executive loans); S.D. CODIFIED LAWS ANN. § 47-2-58 (Michie 2000) (granting corporations power to lend money to employees); TENN. CODE ANN. § 48-18-303 (2002) (employing benefit standard for executive loans); TEX. BUS. CORP. ACT ANN. art. 2.02 (Vernon 2002) (permitting loans to officers, directors, and employees); WIS. STAT. ANN. § 180.0832 (West 2002) (permitting loans to directors); WYO. STAT. ANN. § 17-16-832 (Michie 2003) (granting corporations power to lend money).

53. MODEL BUS. CORP. ACT § 47 (1969) (permitting loans benefiting corporation); Willard P. Scott, *Changes in the Model Business Corporation Act*, 24 BUS. LAW. 291, 292 (1968) (disclosing changes to Model Business Corporation Act). The Act also influenced states to enact loan enabling statutes. See Barnard, *supra* note 6, at 244-45.

54. See Oberhelman, 690 P.2d at 1349 (noting executive loans initially authorized as response to specific and limited problem); Barnard, *supra* note 6, at 245 (commenting on scarcity of legislative history surrounding state enabling statutes); Scott, *supra* note 53, at 292 (advocating reversal of Model Act's loan prohibition to help move officers and facilitate stock purchase plans).

55. See MINN. STAT. ANN. § 302A.505 (permitting certain advances to executives without board approval); N.D. CENT. CODE § 10-19.1-90 (authorizing corporations to advance money without board approval to cover executive's business expenses).

56. See Barnard, *supra* note 6, at 246 (discussing rise in executive loans).

57. See Tax Reform Act of 1984, I.R.C. § 7872 (treating loans with below market rates of interest as income to employees); Barnard, *supra* note 6, at 246 (noting tax incentives of executive loans); S. J. Willbanks, *Interest Free Loans Are No Longer Free: Tax Consequences of Business Loans*, 47 MONT. L. REV. 335, 340-345 (1986) (discussing tax treatment of executive loans under new law).

58. See JAMES E. CHEEKS, HOW TO COMPENSATE EXECUTIVES 212 (1974) (noting executive positions sweetened by low-interest loans); Joann S. Lublin, *Loan Dangers: Companies Are Having Second Thoughts About Lending Money to Their Top Executives*, WALL ST. J., Apr. 12, 2001, at R6 (commenting on widespread use of executive loans).

59. See STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 341-42 (Academic Press ed., 2002) (describing huge increase in value and number of stock options granted during 1990s); Hodgson, *supra* note 14, at 3 (noting majority of loans made for stock-related purposes including stock option exercise). One

contributed to more expensive loan grants.⁶⁰

B. Fiduciary Duties Provide Minimal Restrictions on Directors

State law allows for the creation of corporate entities and sets forth the basic framework for corporate governance.⁶¹ Corporate powers are vested solely in the board of directors, who are restrained by fiduciary obligations to the corporation.⁶² After the adoption of loan enabling statutes, directors were no longer held strictly liable for insider loans.⁶³ Instead, fiduciary duties require that directors only grant loans that “benefit” the company.⁶⁴ These fiduciary duties are drastically weakened by the business judgment rule and have generally proven ineffective in limiting the scope of executive loans.⁶⁵

In Delaware, as in many other states, the business judgment rule insulates directors from liability by presuming they made decisions on an informed basis, in good faith, and in the best interest of the company.⁶⁶ The business judgment rule grants directors the legal breathing-room needed to take risks in their efforts to achieve profitability and success for their companies.⁶⁷ Unless

study shows that the value of stock option grants increased from \$592,000 in 1992 to \$5,589,000 in 2000. BALSAM, *supra*, at 341. Stock options accounted for the majority of the rise in executive compensation over this period. *Id.* As SOX was being drafted, members of the Senate proposed studies of stock options while others proposed changes to the accounting rules for stock options. David S. Hilzenrath & Helen Dewar, *Senate Vote to Curb Insider Lending; Provision Targets Terms That Companies Set for Directors, Executives*, WASH. POST, July 13, 2002, at A13. A majority of Senators, however, blocked such proposals. *Id.*

60. See generally Charles Elson, *What's Wrong With Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68 (discussing executive compensation).

61. See Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 963-64 (2003) (outlining state corporations law). State law has traditionally dominated corporate governance, but the federal government has, at times, regulated certain areas of corporate affairs. See Roe, *supra* note 2, at 596-97. The government has also been influential in guiding state decisions. *Id.*

62. See Thompson, *supra* note 61, at 963-64 (describing basic structure of state corporate law); see, e.g., CONN. GEN. STAT. § 33-735 (1997) (granting boards authority to manage corporations); DEL. CODE ANN. tit. 8, § 141(a) (2001) (vesting exercise of corporate powers in board of directors); HAW. REV. STAT. § 414-191 (2004) (establishing authority of board to exercise corporate powers). A large percentage of shareholder actions against corporate directors pertain to conflict of interest and breach of duty of loyalty. Thompson, *supra* note 61, at 964.

63. See *supra* note 40 and accompanying text (describing personal liability of directors under state loan prohibition statutes).

64. See DEL. CODE ANN. tit. 8, § 143 (permitting only loans beneficial to company).

65. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318-19 (noting limited actions for duty of care violations and procedure validating duty of loyalty violations).

66. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000) (discussing application of business judgment rule in derivative suit). The purpose of the business judgment rule is to prevent courts from using hindsight to second-guess decisions made by corporate officers and directors. See *Pereira v. Cogan*, 294 B.R. 449, 526 (S.D.N.Y. 2003) (discussing reasons behind business judgment rule). The business judgment rule only protects disinterested directors who are neither on both sides of the transaction nor receive personal benefits from it, unless a majority of disinterested directors approve the transaction. See *Aronson*, 473 A.2d at 812.

67. See Brian Kim, *Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235, 245 (2003) (discussing SOX's

directors abuse their discretion, courts will respect their decisions.⁶⁸ The business judgment rule only protects disinterested directors who are neither on both sides of the transaction nor receive personal benefits from it, though interested parties may still be protected if the transaction is approved by a majority of disinterested directors.⁶⁹

Assuming proper board approval, loans intended as compensation were generally upheld unless they constituted waste, meaning they were analyzed for rational business purpose.⁷⁰ Compensation constitutes waste if the benefit the corporation receives is so inadequate that no person of ordinary, sound business judgment would pay it.⁷¹ Directors simply had to show that in return for the loan, the corporation would receive some articulated benefit such as increased productivity or loyalty.⁷² Loans that facilitated the purchase of company stock or the exercise of stock options were also viewed as deserving liberal review because the loans were intended to align management's interest with the interest of the shareholders through stock ownership.⁷³ Provided the board followed minimum procedures for making an informed decision, most executive loans withstood judicial scrutiny under state law.⁷⁴

As the business judgment rule only protects non-self-interested conduct of directors, loans that involved self-dealing subjected the actions of interested directors to stricter scrutiny.⁷⁵ Loans related to business transactions with insiders fell into this suspect class.⁷⁶ Directors responsible for such loans had the high burden of showing the entire fairness of the transaction.⁷⁷ Procedural

certification provision's potential effect on business judgment rule).

68. See *Aronson*, 473 A.2d at 812 (indicating court's deference to board's business decisions).

69. See *id.* (defining scope of business judgment rule).

70. See *Barnard*, *supra* note 6, at 262 (discussing reasons why minimal judicial scrutiny afforded to compensation loans).

71. See *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962) (defining waste standard).

72. See *Barnard*, *supra* note 6, at 262-63 (noting liberal standard of review afforded to compensation-type loans).

73. See *Barnard*, *supra* note 6, at 266 (discussing perceived benefits of managerial stock ownership); *Stano*, *supra* note 12, at 272-78 (illustrating rise in management stock ownership leads to rise in company stock price).

74. See *Pereira v. Cogan*, 294 B.R. 449, 537 (S.D.N.Y. 2003) (noting Delaware law requires board to follow basic procedures prior to granting loan); *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (analyzing whether board's failure to monitor corporation's information and reporting systems established fiduciary duty liability). Proper loan approval demands that directors establish procedures that allow the board to discuss the appropriateness of a particular loan, to insure fair loan terms and proper collateral, and to insure repayment. See *Pereira*, 294 B.R. at 537 (discussing failure of board to establish minimum procedures prior to making loans to CEO).

75. See *Puma v. Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971) (upholding business judgment of disinterested directors who transacted with company's controlling family); *Barnard*, *supra* note 6, at 264 (noting loans containing conflicts of interest subject to stricter scrutiny than compensation loans).

76. See *Barnard*, *supra* note 6, at 264 (analyzing loans involving conflict of interest transactions).

77. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (setting forth "entire fairness" standard). Fairness has two elements: fair dealing and fair price. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). In the loan context, fair dealing generally requires directors to establish procedures for approving

mechanisms, such as barring interested directors from voting on the loan could validate the self-dealing transactions.⁷⁸ Thus, even self-dealing loans could withstand scrutiny under state fiduciary duty standards.⁷⁹

C. Inadequate Disclosure Requirements Limit Public Scrutiny

Not only are most executive loans difficult to challenge under state fiduciary duty law, lack of strict disclosure requirements have made executive loans difficult to monitor.⁸⁰ Prior to SOX, federal securities law directed public companies to disclose executive loans in excess of \$60,000 in annual reports and proxy statements.⁸¹ The law required companies to report the borrower's name, his or her relationship to the corporation, the largest aggregate amount of indebtedness outstanding, the nature of the transaction, and the amount of the loan and interest charged.⁸² Such loans, however, were exempt from the highly visible and comprehensive disclosure rules for executive compensation, which employ detailed graphs and tables.⁸³ Instead, loans were reported separately and inconspicuously.⁸⁴

Nonwithstanding the unambiguous federal requirements, many corporations neglected to include a description of executive loans in their annual reports and

loans, seek assurances that loans will be repaid, and investigate the loan's fairness to the company. *Pereira*, 294 B.R. at 537 (discussing elements of fair dealing in loan context). Fair price looks at the terms of the agreement. *Weinberger*, 457 A.2d at 710 (calling for economic showing of financial fairness). A fair executive loan would likely demand a reasonable interest rate, adequate collateral, and establish a firm timetable for repayment. *Pereira*, 294 B.R. at 537 (noting low-interest terms set by borrowing CEO did not constitute fair price).

78. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (indicating business judgment rule protects self-dealing transaction approved by majority of disinterested directors); *Brown*, *supra* note 3, at 319 (noting procedural mechanisms available to validate self-dealing loans).

79. See *Aronson*, 473 A.2d at 812. (suggesting self-dealing loans can be authorized or ratified by company boards).

80. See *Barnard*, *supra* note 6, at 253-54 (criticizing federal loan disclosure requirements and failure of companies to comply with those standards).

81. 17 C.F.R. § 249.310 (2005) (requiring filing of annual 10-K Report including loan disclosure pursuant to 17 C.F.R. § 229.404); 17 C.F.R. § 240.14a-101 (mandating filing of annual Proxy Statement incorporating loan disclosure pursuant to 17 C.F.R. § 229.404); 17 C.F.R. § 229.404 (setting forth loan description requirements and \$60,000 materiality threshold). States also regulated loan disclosure, though most state laws were not as stringent as the former federal requirements. See Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance*, 48 VILL. L. REV. 1189, 1203 (2003) (criticizing state law disclosure requirements for compensation loans). *But see* 1931 Mich. Pub. Acts 327, § 46 quoted in *In re Wood's Estate*, 1 N.W.2d 19, 23 (1941) (requiring full and detailed disclosure to shareholders of executive loan grants).

82. 17 C.F.R. § 229.404 (detailing loan reporting requirements); see HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 6:28 (2d ed. 2004) (noting federal law requires disclosure of all loans between corporation and officers and directors).

83. 17 C.F.R. § 229.402 (mandating detailed disclosure of executive compensation but excepting loans disclosed under 17 C.F.R. § 229.404); see Halle Fine Terrion, Comment, *Regulation S-K, Item 402: The New Executive Compensation Disclosure Rules*, 43 CASE W. RES. L. REV. 1175, 1175-77, 1179 (1993) (analyzing federal executive compensation disclosure requirements).

84. See *infra* notes 85-86 and accompanying text (showing inadequate disclosure of executive loans).

proxy statements.⁸⁵ Those corporations that actually disclosed the nature or purpose of outstanding loans usually utilized boilerplate descriptions and hid the information in footnotes.⁸⁶ Inadequate disclosure has been widespread despite the low cost of proper disclosure.⁸⁷ Absent full disclosure, uninformed shareholders have no basis for initiating derivative lawsuits challenging improper loans.⁸⁸

IV. EXTENSIVE LENDING AND ABUSE

State corporate laws that permitted liberal lending to executives and inadequate oversight of directors created an environment ripe for managerial abuse.⁸⁹ A 2002 study of 416 companies revealed their amount of outstanding executive loans to average \$10.7 million.⁹⁰ In 2001, over a third of the largest 1,500 companies in the United States had outstanding loans totaling almost \$5 billion.⁹¹ Corporate loans were also difficult to scrutinize as they were frequently disclosed in vague and often overlooked footnotes of annual reports.⁹² At most corporations, executives repaid loans without incident.⁹³ But given the ubiquitous nature of corporate loans and the lenient standards for their approval, abuse was inevitable.⁹⁴

A. WorldCom

In 2002, the fall of telecommunications giant WorldCom marked the largest bankruptcy in United States history.⁹⁵ As the company disclosed massive

85. See Barnard, *supra* note 6, at 253-54 (noting almost one-third of companies in study failed to include description of executive loans); Hodgson, *supra* note 14, at 3 (finding more than one-fourth of sample companies did not disclose loan's purpose).

86. See Kathy M. Kristof, *The Icing on the Cake Can Be Quite Rich for Some Executives*, L.A. TIMES, June 15, 2003, at C5 (noting details of executive perks often buried in footnotes).

87. See Jayne M. Barnard, *Curbing Management Conflicts of Interest—The Search for an Effective Deterrent*, 40 RUTGERS L. REV. 369, 402-09 (1988) (noting minimal cost of disclosure on corporations).

88. See Barnard, *supra* note 6, at 254 (noting nondisclosure restricts shareholders' ability to determine whether executive loans benefit corporation).

89. See *supra* Part III.B (outlining limited director duties and liabilities for approving executive loans).

90. Hodgson, *supra* note 14, at 3 (detailing loan statistics of major United States corporations).

91. Hodgson, *supra* note 14, at 1 (detailing prevalence of executive loans among major corporations).

92. Hodgson, *supra* note 14, at 3 (finding large percentage of companies reporting executive loans failed to disclose loan's purpose); Kristof, *supra* note 86, at C5 (noting details of executive perks often buried in footnotes of company proxy statements); see also Mitchell, *supra* note 81, at 1203 (criticizing state law disclosure requirements for compensation loans).

93. See James F. Peltz & Lisa Girion, *Crisis in Corporate America: Bush Spurs Debate Over Loans to Execs*, L.A. TIMES, July 11, 2002, at C1 (noting many analysts believe abuse of corporate loans limited to major scandals). Prior to SOX's adoption, many companies instituted policies that restricted executive loans to prevent abuse. See Hodgson, *supra* note 14, at 7-8. For example, since 2001, Nortel Networks has expressly limited executive loan grants to relocations. *Id.*

94. See 148 CONG. REC. S.6690 (July 12, 2002) (statement of Sen. Schumer) (identifying WorldCom and Adelphia as key examples of need for SOX section 402).

95. Young, *supra* note 18, at A3 (listing WorldCom's peak market value in 1999 at about \$120 billion).

accounting fraud, several quarters of reported profits transformed into enormous losses.⁹⁶ Further investigation revealed that WorldCom misstated its profitability by more than \$11 billion and its balance sheet by more than \$80 billion.⁹⁷ A Securities and Exchange Commission (SEC) investigation into WorldCom's extravagant loans to CEO Bernard Ebbers discovered the scandal.⁹⁸

Totaling over \$408 million, WorldCom's executive loans illustrate abusive compensation and deficient corporate governance.⁹⁹ Members of the board's compensation committee initiated the series of loans to Mr. Ebbers, originally granting him \$50 million to pay off mounting personal debts.¹⁰⁰ The committee, however, failed to address key terms of the loan such as interest rate, maturity date, and collateral requirements, and granted the loan without full board approval.¹⁰¹ Despite the tenuous purpose of the loan, poor documentation, and lack of security, WorldCom's board later ratified the loan.¹⁰² The board reasoned that the loan would benefit the company because a forced sale of Mr. Ebbers' shares to pay off his personal debts would have caused WorldCom's stock price to decline.¹⁰³ The compensation committee

WorldCom's listed assets at the time of its bankruptcy filing were valued at \$107 billion. Voluntary Bankruptcy Petition at *7, *In re WorldCom*, No. 02-13533, available at <http://news.findlaw.com/hdocs/docs/worldcom/72102ch11pet.pdf> (last visited Mar. 15, 2005). The company had outstanding debts of \$41 billion. *Id.*

96. See Young, *supra* note 18, at A3 (recognizing extent of WorldCom accounting fraud). The company admitted to misstating \$3.8 billion in expenses. *Id.* WorldCom defrauded the investing public by inappropriately treating routine expenses as capital expenditures. Daniel Kadlec et al., *WorldCom: Nailed for the Biggest Bookkeeping Deception in History, a Fallen Telecom Giant Gives Investors One More Reason to Doubt Corporate Integrity*, TIME, July 8, 2002, at 25. The misstatement allowed the company to boost current profits because capital expenditures are deducted ratably over a period of time while ordinary expenses reduce profits immediately. *Id.*

97. RICHARD C. BREEDEN, RESTORING TRUST: REPORT ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. 24 (Aug. 2003), available at http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf (last visited Mar. 28, 2005) (concluding WorldCom's misstatements caused by "deliberate manipulation and falsification of accounting records").

98. See *In re WorldCom*, No. 02-15533, at 71-73 (Nov. 4, 2002) (first interim report of Dick Thornburgh), available at <http://news.corporate.findlaw.com/hdocs/docs/worldcom/thornburgh1strpt.pdf> (discussing extent of WorldCom's loans to CEO Bernard Ebbers); Shawn Young, *Big WorldCom Loan May Have Spurred Inquiry*, WALL ST. J., Mar. 14, 2002, at A3 (suggesting SEC investigation into loans led to broader inquiry into WorldCom's finances).

99. See BREEDEN, *supra* note 97, at 26-34 (describing WorldCom's improper compensation practices and board's lax governance).

100. See DENNIS R. BERESFORD ET AL., SPECIAL INVESTIGATIVE COMMITTEE OF THE Bd. OF DIRECTORS OF WORLDCom, INC., REPORT OF INVESTIGATION 296-298 (Mar. 31, 2003), available at <http://news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf> (describing initial loan made to Ebbers). Mr. Ebbers needed the funds to pay margin loans secured by shares of his WorldCom stock. *Id.* at 295. He had taken out the loans in connection with his many side-businesses including a rice farm, luxury yacht company, country club, trucking company, hockey team, and various real estate holdings. *Id.* The loans were comprised of direct loans and guarantees. *Id.* at 304-05.

101. *Id.* at 297 (noting board's lack of formality in granting multi-million dollar executive loans).

102. *Id.* at 298 (finding board approved loans after they were granted by compensation committee).

103. *Id.* at 300-01 (discussing boards justification for loans).

thus continued to grant additional loans and guarantees to Mr. Ebbers while obtaining board ratification after the fact.¹⁰⁴ Furthermore, not until several months after the loans were made did WorldCom seek to perfect its security interests in Mr. Ebbers' stock or request security interests in his non-stock assets.¹⁰⁵

WorldCom's public disclosure of the loans was also delayed.¹⁰⁶ Although the compensation committee approved Mr. Ebbers' initial \$50 million loan on September 6, 2000, it was not disclosed until November 14, 2000 in the company's quarterly report.¹⁰⁷ The disclosure provided that "Mr. Ebbers has used, or plans to use, the proceeds of the loans . . . to repay certain indebtedness under margin loans from institutional investors . . ." ¹⁰⁸ When WorldCom discovered that Mr. Ebbers was actually using some of the money to fund his side businesses, it altered its future disclosures to broadly indicate that Ebbers planned to use the loans for "private business purposes."¹⁰⁹ Subsequent media attention led to a derivative lawsuit challenging the loans.¹¹⁰ The complaint alleged that the loans amounted to corporate waste and therefore the board breached its fiduciary duties.¹¹¹ The case appears to have been settled out of court.¹¹²

104. BERESFORD, *supra* note 100, at 301 (noting board repeatedly ratified loans after they were issued). The corporate examiner assigned as part of WorldCom's bankruptcy proceeding strongly criticized the compensation committee and the full board's handling of the loans. See *In re WorldCom*, No. 02-15533, at 108-36 (June 9, 2003) (second interim report of Dick Thornburgh), available at <http://news.corporate.findlaw.com/hdocs/docs/worldcom/bkexmnr60903rpt2d.pdf> (last visited Mar. 29, 2005). In particular, the examiner cited a lack of due diligence prior to issuing the loans and failure to properly document the loans before they were disbursed as well as to monitor Ebbers' financial ability to repay the loans. *Id.* at 114-15. He concluded that in light of Ebbers' failing financial condition, approval of the loans was "unjustified and without rational basis." *Id.* at 127.

105. See BERESFORD, *supra* note 100, at 306-07 (criticizing board for delay and noting commercial lenders would not find delay acceptable). The many loans and guarantees WorldCom granted to Mr. Ebbers were eventually consolidated into a single promissory note requiring repayment in five annual installments. *Id.* at 306. Mr. Ebbers, whose wealth was largely tied to WorldCom stock that plummeted after news of the accounting fraud went public, defaulted on the loan by missing his first payment. See Geoffrey Colvin, *Money Woes Strike Ex-CEOs: Bernie Ebbers owes WorldCom \$408 million and Can't Pay. Perhaps He Should Emulate Another Debtor: The Donald*, FORTUNE, June 24, 2002, at 48; Assoc. Press, *Ebbers Defaults on Loan Payments, WorldCom Says*, NAT'L POST, May 17, 2003.

106. See BERESFORD, *supra* note 100, at 299-300 (noting delay in public disclosure).

107. BERESFORD, *supra* note 100, at 299-300 (describing public disclosure of loans).

108. BERESFORD, *supra* note 100, at 307-08 (quoting WorldCom Nov. 14, 2000 quarterly report) (suggesting deficiency in public disclosure as some loan proceeds actually used for other purposes).

109. BERESFORD, *supra* note 100, at 308 (quoting SEC filing) (indicating change in disclosure).

110. BERESFORD, *supra* note 100, at 301-02 (highlighting shareholder derivative lawsuit challenging WorldCom's loans to Ebbers); Jimmie E. Gates, *Two Stockholders File Lawsuit Over Loans to Ebbers*, CLARION-LEDGER (Jackson, Miss.), Mar. 31, 2002, at C1 (reporting shareholder lawsuit instituted "after national publications wrote about Ebbers' loans").

111. See BERESFORD, *supra* note 100, at 302 (noting basis for cause of action); Gates, *supra* note 110, at C1 (noting lawsuit focused on WorldCom's lack of security, low-interest charged, and Ebbers' inability to repay).

112. BERESFORD, *supra* note 100, at 302 (suggesting company was close to settling case).

B. Adelfia

Once an admired cable company, Adelfia's success came to a crashing halt when it disclosed \$2.3 billion in off-balance sheet loans made to the Rigas family, who founded the company in 1952.¹¹³ John Rigas and his three sons, all top executives and board members, had used the company as their personal bank account.¹¹⁴ The family financed their personal lives with corporate funds, borrowing millions to purchase a hockey team, build a golf course, and even produce a movie.¹¹⁵ The loans led to criminal convictions of John Rigas and his son, Timothy Rigas, for conspiracy, securities fraud, and bank fraud.¹¹⁶

The Rigases' criminal trial exposed how family dominance and a lack of internal controls precipitated loan abuse.¹¹⁷ A former Adelfia executive testified that he warned CEO John Rigas and CFO Timothy Rigas that their use of company funds for personal uses was improper.¹¹⁸ The executive also recommended a system of internal controls but the Rigases ignored him and continued to book personal expenses to the company.¹¹⁹ Another witness testified that John Rigas pocketed \$1 million in cash per month without signing anything and without agreeing to pay interest.¹²⁰ The Rigas family countered that the company's board authorized the loans without protest.¹²¹ The independent directors claimed that while they signed off on the loans, John

113. See David Leonard, *The Adelfia Story*, FORTUNE, Aug. 12, 2002, at 136 (discussing respectable reputation of company and Rigas family). After detailed review of its records, Adelfia determined that the Rigas family actually owed the company \$3.2 billion. See Peter Grant, *Adelfia Tallies Debt of Rigases*, WALL ST. J., Aug. 24, 2004, at C4. The scandal forced the company into bankruptcy. See *id.*

114. See Roger Lowenstein, *The Company They Kept*, N.Y. TIMES MAG., Feb. 1, 2004 (outlining extent of loans Rigas family obtained).

115. See *id.* (detailing Rigases various uses of loan money). The Rigas family also used a substantial portion of the loan money to buy Adelfia stock. *Id.*

116. Peter Grant & Christine Nuzum, *Adelfia Founder and One Son Are Found Guilty—Jury Remains Deadlocked on Second Son, Acquits Former Assistant Treasurer*, WALL ST. J., July 9, 2004, at A1 (discussing trial and convictions of Rigases). Michael Rigas was also indicted on similar charges but his case resulted in a mistrial. Peter Grant, *Adelfia Sentences Look Thorny—Defense Hopes to Exploit Recent High Court Ruling; Mistrial for Michael Rigas*, WALL ST. J., July 12, 2004, at A3. Though not criminally indicted, James Rigas faces SEC civil charges along with his father and two brothers. Grant & Nuzum, *supra*, at A1.

117. See Kara Scannell, *Executives on Trial: Ex-Adelfia Official Testifies He Warned Rigases on Expenses*, WALL ST. J., Mar. 23, 2004, at C1 (detailing aspects of prosecution of Rigases). When Adelfia went public the Rigases retained a class of shares that ensured they had enough votes to choose the board of directors. Leonard, *supra* note 113, at 136. As a result, John Rigas, his three sons, and his daughter's husband held five of the nine board seats. *Id.* For example, Timothy Rigas was Chief Financial Officer as well as chairman of the board's audit committee, a textbook example of an improper conflict of interest. *Id.* Government investigations of Adelfia's records revealed commingling of public and private accounts as well as extensive "co-borrowing" from banks with Adelfia as guarantor. Lowenstein, *supra* note 114.

118. Scannell, *supra* note 117, at C1 (discussing important testimony of Mr. LeMoyne Zacherl).

119. Scannell, *supra* note 117, at C1 (summarizing Mr. Zacherl's testimony of his experiences at Adelfia).

120. Grant & Nuzum, *supra* note 116, at A1 (noting key points of prosecution's case against Rigases).

121. See Lowenstein, *supra* note 114 (indicating parties responsible for preventing loan abuse present but failed to dissent).

Rigas led them to believe the loans would be used to buy cable systems, not company stock or personal items.¹²²

Adelphia first disclosed the existence of executive loan agreements in its 1999 and 2000 annual reports.¹²³ The disclosures were hardly comprehensive as they failed to disclose the amount, applicable terms, or intended purpose of the loans.¹²⁴ Adelphia did not make specifics available to the public until March 27, 2002.¹²⁵ Even then, the company disclosed the \$2.3 billion in off-balance sheet loans in a footnote on the last page of its quarterly earnings press release.¹²⁶ Unfortunately, it was too little, too late.

C. Tyco

One of the most flagrant examples of corporate loan abuse is Tyco Corporation and its now infamous CEO, Dennis Kozlowski.¹²⁷ Kozlowski used millions in allegedly unapproved and illegally forgiven loans to pay for personal expenses, such as a \$6,000 shower curtain, a \$15,000 umbrella stand, and a \$2 million birthday party for his ex-wife.¹²⁸ The SEC indicted Kozlowski and former CFO, Mark Swartz, for looting Tyco of more than \$600 million.¹²⁹

At the heart of the criminal case against Kozlowski and Swartz is a \$38.5 million credit against the employee-loan accounts of Kozlowski, Swartz, and a Tyco events planner.¹³⁰ Tyco claims that Kozlowski and Swartz concealed the

122. See Leonard, *supra* note 113, at 136 (observing actions of board members to investigate executive loans after discovering true purposes).

123. See Jonathan Weil & Dennis Berman, *Auditing the Audit Committee—Lawmakers Toughen Rules, But Toughness Can't Be Legislated*, WALL ST. J., Dec. 9, 2002, at C1 (discussing importance of skeptical and aggressive audit committees in preventing fraud).

124. See *id.* (suggesting warning signs of abuse existed prior Adelphia's collapse in 2002). The disclosures merely provided the maximum the Rigases could borrow under the loan agreements. See *id.*

125. See Leonard, *supra* note 113, at 136 (noting analyst's skepticism of Rigases' purchase of billions in stock and his satisfaction when loans revealed). The disclosure caused Adelphia's stock price to drop thirty-five percent in three days. See *id.*

126. See Leonard, *supra* note 113, at 136 (recounting Adelphia's method of disclosing loan to public).

127. See Nicholas Varchaver, *The Big Kozlowski*, FORTUNE, Nov. 18, 2002, at 122 (claiming Kozlowski's extravagance likely unforgettable by public).

128. See *id.* (citing examples of Kozlowski's lavish spending); see also Chad Bray, *Executives on Trial: Tyco Ex-Director Testifies Board Didn't Approve Loan Forgiveness*, WALL ST. J., Dec. 9, 2003, at C14 (describing role of board and compensation committee in loan scandal). The former director argued that neither the board nor its compensation committee approved the disputed special bonuses to Mr. Kozlowski and Mr. Swartz. Bray, *supra*, at C14.

129. See Complaint, SEC v. Kozlowski, No. 02CV7312 (S.D.N.Y. filed Sept. 12, 2002) (setting forth charges against Kozlowski). The first case against Mr. Kozlowski and Mr. Swartz ended in a mistrial in April of 2004. Chad Bray, *Executives on Trial: Retrial of Tyco Ex-Officers Begins—No Sardinia: April Mistrial Appears to Have Influenced Prosecution's Legal Tactics*, WALL ST. J., Jan. 27, 2005, at C4. The retrial began in January of 2005. *Id.*

130. See Mark Maremont, *Tyco's 'Special Bonus' on Trial: Credits Added to Loan Accounts Are Seen as Strong Ammunition in Prosecution of Top Executives*, WALL ST. J., Oct. 3, 2003, at C1 (reporting strengths and weakness of case against Kozlowski). Prosecutors argued that the credits were never approved by the

loans from the company's directors and the public, that the loans were unapproved by the board, and that an authorized loan program was used for illegitimate personal purposes.¹³¹ While the company denies knowledge of the loans, one of Tyco's former directors acknowledged disclosure of some of the loans in the company's annual proxy statement.¹³² Kozlowski's defense team argues that company directors failed to notice major corporate transactions, including the loans to Kozlowski and Swartz.¹³³ Disclosure of the loans in a proxy statement suggests the board either directly or indirectly approved the transactions.¹³⁴ Failure to approve the loans, however, would possibly explain Tyco's delayed disclosure.¹³⁵

V. CONGRESS RESPONDS WITH THE SARBANES-OXLEY ACT AND BANS EXECUTIVE LOANS

Following the demise of Enron, the troubles at WorldCom, Adelphia, and Tyco could not have come at a worse time.¹³⁶ Public confidence in the stock market was shaken as scandal after scandal hit newsstands.¹³⁷ Restoring confidence in the market became Congress' top priority.¹³⁸ In a matter of months, President Bush signed SOX into law.¹³⁹ The urgency resulted in a hodgepodge of seemingly unrelated laws covering everything from independence of corporate directors, to accounting standards, to ethical rules for corporate lawyers, to rules for securities analysts.¹⁴⁰ While the main purpose of SOX is to fortify existing securities law, a number of provisions

company's board of directors. *See id.* The corporate officers are expected to argue that the board did in fact authorize the credits, which would negate accusations that the money was unlawfully taken. *See id.*

131. *See Bray, supra* note 128, at C14 (reporting ex-director testified that neither board nor compensation committee approved loan forgiveness).

132. *See Bray, supra* note 128, at C14 (noting ex-director admitted to signing off on proxy statement listing loans to CFO).

133. *See Ex-Tyco Director Says He Didn't Scrutinize Filings*, L.A. TIMES, Dec. 10, 2003, at C5 (citing testimony of ex-director outlining failure to review details in company proxy statements).

134. *See id.* (noting possibility board actually approved suspect loans).

135. *See Hodgson, supra* note 14, at 8 (noting loans to Kozlowski and Swartz undisclosed for considerable period of time).

136. *See Phyllis Plitch, When Market Scandals Erupt, Regulation Can Come in a Flood*, WALL ST. J., Jan. 15, 2003 (noting drive for legislation fueled by WorldCom); *see also* HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE 18-20 (2002) (referring to role of Enron and WorldCom in SOX creation). The shift in political climate following the scandals put significant pressure on lawmakers to support corporate reforms, even if they did not believe reform was necessary. Kim, *supra* note 67, at 240-41.

137. *See The New Dimension of Corporate Governance Responsibilities After Sarbanes-Oxley*, METRO. CORP. COUNS., Sept. 2003, at 28 (indicating dot.com crash and corporate scandals resulted in lack of confidence in capital markets).

138. *See id.* (asserting public outrage and lack of confidence in market forced Congress into action).

139. *See Allen, supra* note 20, at A4 (describing President's staunch position against corporate fraud and dedication to restoring investor confidence).

140. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15, 18, 28 and 29 U.S.C.) (creating laws affecting securities and corporations).

regulate internal corporate affairs.¹⁴¹ Of particular importance is its ban on personal loans to executives.¹⁴²

Section 402 of SOX makes it unlawful for public companies to “directly or indirectly . . . 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.”¹⁴³ The provision does not have a materiality threshold, therefore even low-value loans are prohibited.¹⁴⁴ It also lacks any definition of key terms such as “personal loan,” “arranging,” and “extension of credit,” leaving company directors and their lawyers to struggle to find a common understanding of the statute’s meaning.¹⁴⁵

Executive loans made prior to SOX’s adoption are exempt from section 402.¹⁴⁶ The amendment prohibits any renewal or modification, forcing companies to carefully monitor outstanding loans.¹⁴⁷ Section 402 provides three statutory exceptions for companies in the lending business, including consumer credit companies, registered brokers, and banking institutions.¹⁴⁸ These businesses may make loans provided they are made in the ordinary course of business, are of a type generally made available to the public, and are subject to market terms.¹⁴⁹

Violations of section 402 may result in fines of up to \$25 million and twenty-five years in prison, subject only to the defense that the violation was not “willful.”¹⁵⁰ As a result of the provision’s uncertainty and the potential for

141. *See id.* § 301 (codified at 15 U.S.C. § 78j-1(m)) (imposing restrictions on company audit committees); *id.* § 304 (codified at 15 U.S.C. § 7243) (requiring executive forfeiture of bonuses and profits for certain violations); *id.* § 404 (codified at 15 U.S.C. § 7262) (demanding management assessment of company’s internal controls).

142. *See id.* § 402 (setting forth enhanced conflict of interest provision).

143. *See* Sarbanes-Oxley Act § 402 (banning personal loans to executives).

144. *Id.* (failing to include materiality provision).

145. *See generally* Sarbanes-Oxley Act: Interpretive Issues Under § 402—Prohibition of Certain Insider Loans (Oct. 15, 2002), available at http://www.ffhsj.com/cmemos/sarbanes_insider_loans.pdf [hereinafter Interpretive Issues White Paper] (outlining opinions of twenty-five large law firms on application of section 402 to various transactions).

146. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 78m(k) (2004)) (exempting loans made prior to SOX adoption).

147. *Id.* (prohibiting “material modification of any term” or renewal of grandfathered loans); *see also* Deligiannis, *supra* note 24, at 24 (advising in-house counsel to identify grandfathered loans and establish procedures to prevent modification).

148. Sarbanes-Oxley Act § 402 (codified at 15 U.S.C. § 78m(k) (2004)) (setting forth exemptions).

149. *Id.* (limiting scope of exempted loans).

150. *See* John C. Coffee Jr., *Leading Issues Under Sarbanes-Oxley, Part I*, N.Y. L.J., Sept. 19, 2002, at 5 (arguing advances for litigation may constitute unlawful loans under section 402 thus violating 1934 Act); *see also* 15 U.S.C.A. § 78ff(a) (2005) (setting forth penalties for “willful” violations of 1934 Act). The section provides in relevant part: “Any person who willfully violates any provision of this title . . . or any rule or regulation thereunder the violation of which is made unlawful . . . shall upon conviction be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both . . .” 15 U.S.C.A. § 78ff(a). The company also may be subject to a criminal penalty of up to \$25 million dollars. *Id.* Corporations may also be subject to SEC administrative penalties. *See* 15 U.S.C.A. § 78u-2 (2002) (noting SEC’s ability to levy fines).

stiff penalties, corporations are likely to be overly cautious, when it comes to transactions that may be classified as loans.¹⁵¹ Section 402 forces corporations to seek counsel before any loan decisions.¹⁵²

Although section 402 supplants two-hundred years of evolving state law on executive loans, Congress enacted it without significant debate or studies on the best way to regulate executive loans.¹⁵³ Early congressional reports indicate that Congress originally intended the loan provision merely to demand increased disclosure to shareholders.¹⁵⁴ In a last-minute adjustment, Senator Charles Schumer, the provision's main supporter, changed the requirements from disclosure to a complete prohibition on executive loans.¹⁵⁵ Aiming to

151. See Coffee, *supra* note 150, at 5 (noting enhanced penalties for violations of section 402 deter corporations from making potentially unlawful loans); Deborah Solomon, *Sarbanes and Oxley Agree to Disagree*, WALL ST. J., July 24, 2003, at C1 (showing concern that Sarbanes-Oxley has made companies risk averse and "extra cautious"); Jerry Useem, *In Corporate America It's Cleanup Time: Under Pressure, A Slew of Companies Are Now Changing the Way They Do Business. Will It Last?*, FORTUNE, Sept. 16, 2002, at 62 (quoting executive who believes uncertainty surrounding section 402 has made companies "paranoid").

152. See Deligiannis, *supra* note 24, at 24 (asserting responsibility on in-house counsel to define proper loans and develop procedures to ensure compliance); *Partnering with Corporate Counsel to Comply with Sarbanes-Oxley*, METRO. CORP. COUNS. 9, Sept. 2002, at 26 (recognizing increased demand on corporate and securities lawyers resulting from SOX compliance efforts).

153. See Lehman, *supra* note 19, at 2117 (criticizing Congress for not taking time to carefully consider language of statute before enactment); Mitchell, *supra* note 81, at 1203 (2003) (describing section 402 as response to ineffective state law); Roe, *supra* note 2, at 634 (arguing Federal Government exerts great influence on major corporate issues). An ongoing debate in corporate law is whether state competition for corporate charters is a "race to the top" or a "race to the bottom." See Roe, *supra* note 2, at 591. Each new scandal spurs discussion as to whether the governing state corporate law was too permissive and catered to managers (race to the bottom theory) or whether efficiency in state corporate law will prevent similar scandals in the future by systematically advancing shareholder interests (race to the top). Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 473-74 (1987); see Roe, *supra* note 2, at 593. The debate remains unresolved, as statistical data and convincing analysis support both positions. See, e.g., Lucian Bebchuck et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1779 (2002) (questioning validity of race to the top theory); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663-92 (1974) (arguing competition for charters creates laws favoring management); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 533 (2001) (detailing data supporting race to the top theory). SOX's intrusion into corporate law makes state competition less important. See Roe, *supra* note 2, at 600-34 (discussing federal incursions on state corporate law).

154. S. REP. NO. 107-205, ¶ 5039 (2002) (requiring immediate disclosure of insider loans). The original loan provision required corporations to disclose all loans to executives and directors within seven days. *Id.* The purpose of disclosure was to give investors information regarding outstanding loans and conflicts of interest so they could make more informed investment decisions. *Id.* In fact, many experts still insist that increased disclosure would have been a more effective means of dealing with loan abuses than an outright prohibition. Joann S. Lublin et al., *Corporate Governance: What's Your Solution? We Asked Some Experts, and Here's What They Said*, WALL ST. J., Feb. 24, 2003, at R8 (discussing adequate disclosure sufficient to curb executive loan abuses); Matt Murray, *The Bottom Line: Have Corporate-Governance Changes Helped or Hurt? And Where Do We Go From Here? Two Experts Square Off*, WALL ST. J., Oct. 27, 2003, at R10 (sharing opinions of experts who claim abuse stemmed from poor disclosure and "few rotten apples").

155. David S. Hilzenrath & Helen Dewar, *Senate Votes to Curb Insider Lending; Provision Targets Terms That Companies Set for Directors, Executives*, WASH. POST, July 13, 2002, at A13 (discussing last-minute changes to section 402's requirements).

restore investor confidence, Congress settled on a rigid bright-line standard.¹⁵⁶

Section 402's broad and undefined terms has generated significant controversy over which loans, if any, are permitted.¹⁵⁷ In the absence of legislative or regulatory guidance, private practitioners have strived to find a consensus in order to advise their clients.¹⁵⁸ Many argue that section 402 permits common loans such as travel advances, relocation loans, and retention bonuses because corporations grant them for business purposes and thus, such transfers do not constitute personal loans.¹⁵⁹ Section 402 arguably permits cashless option exercise loans because the company or an "arranged" broker provides the short-term loans to all employees and they further the business purpose of the company's option program.¹⁶⁰ In contrast, while state law authorized corporations to indemnify officers and directors in legal actions, section 402 might not allow corporations to advance legal expenses, even though they constitute a business purpose.¹⁶¹ Due to uncertainty, many companies have completely terminated all executive loan practices.¹⁶²

Following SOX's ban of executive loans, companies have begun searching for new ways to compensate executives, promote share ownership, and handle transactions previously made possible through loans.¹⁶³ Many companies are turning to outright share grants and increased use of stock options.¹⁶⁴ Unlike the executive loans used to purchase company stock, however, share grants subject executives to greater tax burdens.¹⁶⁵ Opponents criticize stock option grants because companies often fail to properly account for them on balance

156. Mike Allen, *Bush Took Oil Firm's Loans as Director; Practice Would be Banned in President's New Corporate Abuse Policy*, WASH. POST, July 11, 2002, at A1 (indicating President Bush's preference for strict prohibition of executive loans).

157. See Deligiannis, *supra* note 24, at 24 (describing present uncertainty surrounding section 402).

158. See generally Interpretive Issues White Paper, *supra* note 145 (arguing many loans still permissible despite broad prohibitory language).

159. Interpretive Issues White Paper, *supra* note 145, at 3-4 (classifying as permissible under section 402 loans involving ancillary personal credit issues).

160. Interpretive Issues White Paper, *supra* note 145, at 8-11 (examining permissibility of cashless exercise of stock option loans under section 402). *But see* John C. Coffee, Jr., *An Introduction to the Sarbanes-Oxley Act*, in FEDERAL SECURITIES LAW: SARBANES-OXLEY ACT (SPECIAL SUPPLEMENT) 15 (2002) (arguing cashless option exercise loans prohibited by policy to eliminate "hidden compensation").

161. 8 DEL. CODE ANN. tit. 8, § 145(a) (2001) (authorizing indemnification of officers for legal costs incurred in connection to service of corporation); Sean T. Carnathan, *Will the Company Cover an Ex-Officer's Legal Costs?: The New World of Sarbanes-Oxley*, BUS. L. TODAY, Oct. 2003, at 33 (analyzing legality of legal expense advancement under Sarbanes-Oxley); *see also* Interpretive Issues White Paper, *supra* note 145, at 4-5 (arguing corporate advancement of officer and director's legal expenses permissible under section 402).

162. Deligiannis, *supra* note 24, at 24 (noting many companies forcing executives to use own money to exercise company stock options).

163. See Jason Kirby, *We Owe You: Corporate Loans to Executives Were Supposed to Have Gone the Way of the Dodo*, NAT'L POST (Canada), Nov. 1, 2004, at 28 (presenting loan alternatives utilized by companies since adoption of SOX).

164. *See id.* (noting trend among Canadian corporations).

165. *See* Kirby, *supra* note 163, at 28 (stating outright share grants lead to greater tax burden).

sheets.¹⁶⁶

VI. ALTERNATIVE METHODS OF REGULATING EXECUTIVE LOANS

The broad scope of section 402 and its vague language fails to suitably regulate a limited problem. Although liberal state laws resulted in a few major scandals, most executives repaid corporate loans without incident.¹⁶⁷ Loan programs allowed companies to conveniently facilitate business transactions, structure performance incentives, and encourage executive stock ownership.¹⁶⁸ Without substantial investigation, Congress banned even beneficial loans in reaction to high-profile abuses and poor disclosure laws.¹⁶⁹ Section 402's indefinite language has forced companies to expend substantial time and money interpreting its provisions while many have curtailed beneficial loan programs simply as a precautionary measure.¹⁷⁰ Furthermore, alternatives to loans such as outright money or share grants and stock options do not solve the problems of excessive compensation and poor disclosure.¹⁷¹ Several less restrictive and perhaps less costly methods of regulating executive loans could achieve the stated objectives of section 402 while permitting beneficial loans.¹⁷² To this end, Congress should consider the regulatory options discussed below.

A. Disclosure Requirements

Stringent disclosure requirements rather than full prohibition would satisfy SOX's principal objective of restoring investor confidence by providing the transparency that earlier law could not attain.¹⁷³ The scandals at WorldCom, Adelphia, and Tyco are representative of the harm to investors when corporations fail to properly make disclosures.¹⁷⁴ These companies did not disclose executive loans until months, in some cases years, after the loans were made, allowing loan amounts to skyrocket before being subject to public

166. *See id.* (acknowledging governance advocates criticize companies' poor disclosure of stock option plans).

167. *See supra* note 93 and accompanying text (suggesting loan abuse limited to few extreme cases).

168. *See supra* notes 58-59 and accompanying text (discussing positive aspects of executive loans).

169. *See supra* notes 153-155 and accompanying text (exposing limited legislative history of SOX's executive loan ban).

170. *See* Deligiannis, *supra* note 24, at 24 (noting reaction of companies to section 402's unclear language).

171. *See supra* notes 165-166 and accompanying text (pointing out disadvantages of loan alternatives such as outright share grants and increased stock options).

172. *See* Kim, *supra* note 67, at 249-50 (stressing some executive loans may serve many useful purposes to corporations).

173. *See* Allen, *supra* note 20, at A4 (noting President and Congress intended to restore investor confidence with SOX); Murray, *supra* note 154, at R10 (discussing disclosure as best means to handle loan abuses).

174. *See supra* Part IV (highlighting loan abuse scandals).

scrutiny.¹⁷⁵ When these companies did disclose the loans, they did so surreptitiously in footnotes that contained inconspicuous boilerplate language, preventing investors from accurately gauging the gravity of the situation.¹⁷⁶

Congress was on the right track in its first draft of section 402, which only required loan disclosure.¹⁷⁷ The draft mandated disclosure of all loans granted to an officer or director, the amounts paid, balances owed on such obligations, and any conflicts of interest.¹⁷⁸ It required companies to publish this information in 8-K reports within seven days of the loan.¹⁷⁹ Unlike the previous law that merely demanded annual disclosure, such timely reporting would eliminate the delay between a loan and investor awareness, subjecting companies to heightened scrutiny.¹⁸⁰

A critical component of a disclosure law would demand that companies provide detailed descriptions of loan purposes.¹⁸¹ Although previous disclosure law required a description of the loan, studies indicate that most companies failed to provide such information and that regulators generally failed to enforce the law.¹⁸² Mandatory disclosure would likely force directors to be more critical of loans because public scrutiny of improper loans, such as those granted for purely personal reasons, could cause a decline in the company's stock price and lead to shareholder derivative suits.¹⁸³ Subjecting corporations to fines and penalties for failing to provide detailed disclosure might also effectively motivate directors to scrutinize loans.¹⁸⁴ The SEC and the investing public will surely take notice of abusive practices, such as loans given to purchase hockey teams or million-dollar birthday parties, if corporations properly disclose such expenditures.¹⁸⁵

A simple disclosure law would eliminate the many unresolved

175. See *supra* Part IV (noting inadequate loan disclosures at WorldCom, Adelphia, and Tyco).

176. See *supra* notes 85-86, 106-109, 123-126 and accompanying text (highlighting deficient disclosure practices of many large corporations).

177. See S. REP. NO. 107-205, ¶ 5039 (2002) (setting forth enhanced disclosure of loans provision).

178. See *id.* (mandating disclosure of insider loans).

179. See *id.* (explaining purpose of loan disclosure provision).

180. See Oversight Hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies, 107th Cong. (Feb. 12, 2002) (statement of Richard Breeden, Former Chairman of Securities and Exchange Commission) (recommending immediate disclosure of loans); Lublin, *supra* note 154, at R8 (quoting expert recommending loan disclosure allowing shareholders to scrutinize company loan practices).

181. See Oversight Hearing on Accounting and Investor Protection Issues Raised by Enron and Other Public Companies, 107th Cong. (Feb. 12, 2002) (statement of Richard Breeden, Former Chairman of Securities and Exchange Commission) (advocating for enhanced loan disclosure requirements).

182. See *supra* notes 85-86 and accompanying text (describing failure of companies to comply with federal loan disclosure requirements).

183. See *supra* notes 107-112 and accompanying text (describing WorldCom's disclosure of executive loans leading to derivative lawsuit challenging the loans).

184. See Carnathan, *supra* note 161, at 36 (discussing directors need for counsel due to penalties for granting illegal executive loans).

185. See *supra* Part IV.A-C (describing major loan scandals at WorldCom, Adelphia, and Tyco).

interpretations of section 402 and reduce the cost of compliance.¹⁸⁶ Although new disclosure requirements would impose new costs on corporations, they would replace substantial costs associated with interpreting and complying with the current law.¹⁸⁷ Corporations would no longer be forced to search for alternatives to replace innocuous loan practices like those encouraging executives to purchase company stock.¹⁸⁸ Under the disclosure requirements, company boards would once again use their business judgment to determine whether a loan would benefit the company, but boards would also be subject to greater public scrutiny and accountability.¹⁸⁹

B. Amount Limitations

Supporters of SOX's ban on executive loans recognized the potential benefit of a bright-line standard.¹⁹⁰ Congress' decision to limit executive loans to zero, however, went too far.¹⁹¹ As much of the controversy surrounding executive loans focused on large-scale dissipation of corporate assets, a modest amount limitation would prevent executive loans from severely draining company coffers while still allowing beneficial loan practices.¹⁹² A bright-line limitation would provide investors assurance that executive loans would not become excessive.¹⁹³

Identifying the maximum amount a corporation could loan to an executive would provide boards with much needed boundaries.¹⁹⁴ Unlike the situation at WorldCom where the board rationalized multi-million dollar loan grants even after Mr. Ebberts' financial condition began to wane, corporations would be barred from going beyond a certain point regardless of their justification.¹⁹⁵ With a federally mandated limitation, Congress could return low-value loans to the realm of state law and their "benefit" standards.¹⁹⁶ Although subject to weaker regulatory standards, the law would limit loan amounts while state

186. See Barnard, *supra* note 6, at 274 (noting minimal cost disclosure imposes on corporations).

187. See Eaddy & Falis, *supra* note 25, at 22 (commenting on increased costs of complying with SOX).

188. See *supra* notes 163-166 (discussing corporations' search for alternatives to executive loans).

189. See *supra* notes 80-88 and accompanying text (highlighting defects in federal and state loan disclosure law).

190. Allen, *supra* note 156, at A1 (noting President Bush's support for rigid loan prohibition).

191. See Solomon, *supra* note 151, at C1 (interviewing SOX sponsors agreeing loan prohibition possibly too broad).

192. See *supra* notes 136-139 and accompanying text (noting Congress enacted SOX in response to highly publicized corporate scandals).

193. See Hodgson, *supra* note 14, at 1-6 (analyzing multi-million dollar executive loans issued by many United States corporations).

194. See *supra* notes 48-51 and accompanying text (discussing Delaware's loan enabling statute granting directors extremely broad authority to make loans).

195. See *supra* notes 99-105 and accompanying text (describing WorldCom's procedure for granting loans to CEO Bernard Ebberts).

196. See *supra* notes 61-79 and accompanying text (highlighting state fiduciary duty limitations on executive loans).

enforcement would allow the SEC to focus on more difficult corporate issues.¹⁹⁷

Amount limitations might take the form of a specific dollar cap or a figure tied to an executive's compensation.¹⁹⁸ Prior to SOX's adoption, at least one state enacted a law that placed limitations on the amount a corporation could loan to an officer.¹⁹⁹ Texas' loan enabling statute for non-profit corporations permits corporations to lend money to an officer provided the loan does not exceed one hundred percent of the executive's annual salary in the first year of employment or fifty percent of his or her salary for subsequent years.²⁰⁰ Tying executive loans to salaries would relieve Congress from having to adjust its loan limit in future years to account for inflation.²⁰¹ On the other hand, placing specific dollar limits on executive loans would remove loans from market pressures that caused executive compensation to soar in recent years.²⁰²

C. Collateral Requirements

Another proposal would require corporations to obtain security interests in executive's non-stock assets prior to making any loans.²⁰³ Such a provision would shift the focus of company directors away from discussions of corporate benefit and towards consideration of the risks involved in granting executive loans.²⁰⁴ A fundamental practice in the lending industry, collateralization would reduce the risk that a corporation would not be able to collect on the loan.²⁰⁵ By demanding that corporations obtain security interests before loans are granted, shareholders can be assured that the corporation has priority over

197. Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 244 (2004) (discussing SEC's need for additional resources to monitor corporate behavior). In response to the SEC's shortage of resources, one of SOX's provisions authorizes the appropriation of additional funds. *See id.*; Sarbanes-Oxley Act of 2002 §601, Pub. L. No. 107-204, 116 Stat. 745 (2002) (to be codified at 15 U.S.C. § 78kk).

198. *See infra* notes 199-203 and accompanying text (indicating potential types of amount limitations).

199. TEX. BUS. ORG. CODE ANN. § 22.055 (Vernon 2002) (permitting loans to officers of nonprofit corporations subject to certain limitations).

200. *Id.* (setting forth loan limitations). If statutes had limited executive loans to fifty percent of salaries back in 1999, CEOs at WorldCom, Tyco, and Adelphia only would have received maximum loans of \$467,500, \$675,000 and \$677,477, respectively. *See* WORLD COM INC., FORM 10-K/A ANNUAL REPORT, at 77 (Mar. 30, 2000); TYCO INTERNATIONAL LTD., FORM 10-K/A AMENDMENT TO THE ANNUAL REPORT, at 10 (May 1, 2000); ADELPHIA COMMUNICATIONS CORP., FORM 10-K/A AMENDMENT TO THE ANNUAL REPORT, at 6 (Feb. 1, 2000).

201. *Cf.* Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, § 31001(s) 114 Stat. 221 (amending Federal Civil Penalties Adjustment Act, 28 U.S.C. § 2461 (1990)) (requiring federal agencies to adopt regulations to adjust civil monetary penalties for inflation).

202. *See generally* Charles Elson, *What's Wrong With Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68 (discussing problems associated with escalating executive compensation).

203. *See* Barnard, *supra* note 6, at 267-68 (recognizing need for adequate collateral to secure executive loans).

204. *See* Barnard, *supra* note 6, at 267-68 (criticizing loan enabling statutes for taking focus away from loan risks).

205. *See* Barnard, *supra* note 6, at 267-68 (identifying common banking practices corporations fail to consider when making executive loans).

other lenders.²⁰⁶

A non-stock collateral requirement would protect corporations from fluctuations in the company's stock price.²⁰⁷ For example, WorldCom's loans to CEO Bernard Ebbers were initially secured by company stock, which were worth considerably less than the amount of the loan after news of the accounting fraud sent the stock price plummeting.²⁰⁸ Incidentally, the non-stock requirement would also create a modest amount limitation.²⁰⁹ As most executive wealth is concentrated in company stock, executive loans would be limited to the value of more tangible assets such as homes.²¹⁰ The collateral requirement would be especially appropriate for home relocation, a once common loan purpose.²¹¹

VII. CONCLUSION

Executive loans humbly began as a departure from the strict *ultra vires* standard of early corporate law. Recognizing that loans might serve valid business purposes, states gave company boards wide discretion to approve loans. This discretion led to substantial abuse at several major corporations. In response to the alleged crisis, the Federal Government stepped in and sent the regulation pendulum back to the days when state statutes strictly prohibited executive loans and held directors personally liable for improper loans. In haste and under public pressure, Congress enacted a harsh rule that goes beyond its stated objectives.

Section 402 of SOX completely prohibits all executive loans with broad and imprecise terms. The provision appears to prohibit even those loans thought to be beneficial to corporations. In light of the tense environment following corporate scandals, most companies have ceased all loan programs until the SEC provides further guidance. Congress has the power to eliminate the harsh consequences facing beneficial loans and the present uncertainty by replacing section 402 with less restrictive regulatory measures, such as disclosure obligations, amount limitations, and collateral requirements. The methods suggested above, or any combination thereof, are more effective means of avoiding loan abuses while allowing loans that serve legitimate business

206. See BERESFORD, *supra* note 100, at 307 (criticizing WorldCom board for delaying receipt of proper security interests for executive loans).

207. See Hodgson, *supra* note 14, at 12 (recognizing problem of using company stock as collateral for executive loans). One company, Consec Corporation, faced this when declines in the company's stock price rendered collateral for millions of dollars in executive loans practically worthless. *Id.* Two Consec executives owed the company over \$33 million, while their collateral was worth a mere \$37,000. *Id.*

208. See *supra* Part IV.A (discussing WorldCom loan scandal).

209. See *supra* Part VI.B (analyzing benefits of amount limitations as means to regulate executive loans).

210. See Colvin, *supra* note 105, at 48 (noting WorldCom's Ebbers and Adelphia's Rigases invested majority wealth in company stock).

211. See Hodgson, *supra* note 14, at 3 (finding large percentage of companies grant executive loans for home relocation purposes).

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purposes.

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