

1988

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Repository Citation

Barnard, Jayne W., "Executives Raiding the Corporate Cookie Jar" (1988). *Faculty Publications*. 1047.
<https://scholarship.law.wm.edu/facpubs/1047>

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Many directors and executives are receiving favorable loans from their corporations.

Executives Raiding the Corporate Cookie Jar



by JAYNE W. BARNARD

EVERYONE NEEDS extra cash sometimes. Most people confronted with this need face limited options. They sell, they save, or they borrow. None of the options is easy. Borrowing may be the most difficult, especially where the collateral is chancy, the borrower overextended, and the cost of borrowing high. But business executives frequently find a willing banker right within the walls of their corporate boardroom. Hundreds of millions of corporate dollars annually are diverted away from production and expansion in order to finance personal loans to corporate insiders.

Twenty-five years ago, this was not the case. Corporate loans to officers and directors were prohibited by law, except in the case of incorporated banks. The no-loan statutes were enacted to prevent directors from taking advantage of their position to grant themselves or their

colleagues unwarranted loans and thus dissipate corporate funds in violation of their trust—a seemingly sensible constraint.

Today, however, only two states continue to prohibit executive loans from corporate funds. An additional handful require shareholder ratification for some types of these loans. Most states, however, require only a pro forma determination by the board of directors that making the loan will afford some “benefit” to the corporation. In this context, corporate “benefit” is usually interpreted to include the borrower’s ability to concentrate on the corporation’s affairs undistracted by the need to raise personal cash. Some benefit.

The results of these changes in the law have been predictable. A recent study of 152 randomly selected publicly held corporations found that more than one-third of them had made at least one substantial executive loan during 1986. These loans—ranging from the minimum reportable amount of \$60,000 to millions of dollars—were made to finance home purchases, the ex-

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ercise of stock options, investments in other business ventures, the purchase of commercial property and to cover undisclosed "personal" needs. Many of the loans were made at low- or no-interest rates with indefinite repayment schedules. Some were made with built-in "forgiveness" schedules, rendering them little more than executive bonus advances.

Executive lending in a privately held corporation is not uncommon. After all, one reason entrepreneurs incorporate is to maximize personal gain while minimizing personal risk. So when *The Wall Street Journal* reported that while Crazy Eddie, was still a private company, Eddie Antar, its principal shareholder and CEO, had "virtually [used] the company as a private bank," granting himself \$470,000 in interest-free loans, paying various family members \$75,000 in annual stipends, extending millions of dollars of credit to a son-in-law's business venture (supplying cassettes to Crazy Eddie), and guaranteeing the six-digit (never repaid) borrowings of still another relative, it was no great shock and arguably nobody's business save the IRS's.

But the story should be different in the case of publicly held corporations whose shareholders expect that excess cash will be distributed to them in the form of dividends rather than being distributed to already well-paid executives in the guise of loans. Moreover, executive loans have frequently been an early warning signal of corporate distress. The bankruptcy reporters are full of tales of insolvent corporations whose many misjudgments included the extension of substantial insider loans.

A prime example is Allegheny International, which entered bankruptcy in February 1988 after years of declining fortunes. During fiscal year 1985, in which the company lost a record \$109 million, Allegheny made more than \$32 million in low-interest loans to its officers and directors, to permit the exercise of stock options and for other personal (and undisclosed) purposes.

LTV, during a year in which it lost \$378.2 million and was forced to close its Pennsylvania manufacturing operations, made an interest-free loan of \$965,250 to its chairman/CEO to facilitate the exercise of stock options.

Horn & Hardart Co., which in 1986 lost \$284 million and whose share value had dropped by more than half since 1983, in 1984 made and later extended six-figure personal loans to two of its top executives.

Recently Southmark Corp., whose share value dropped nearly 70 percent during 1987, announced that it would be forced to sell some of its major assets in order to raise cash and reduce its heavy debt burden. Shortly before that announcement, the company disclosed that it had provided an \$8.5 million line of credit to its chairman and vice chairman "so that [they] would be able to meet any loan margin calls resulting from

Call to Action

"None of us likes paying taxes. But all of us recognize the necessity of doing so. And as long as those taxes are levied as fairly as possible, with an intelligent regard for their long-term effect on economic growth, they can give us the resources we need as a community to maintain the schools, hospitals, roads and public agencies that are the framework for free enterprise. I'll go a step further. There are times when instead of opposing tax increases, the business community has a duty to support them.

"Consider, for example, the ruinous federal deficits that are destroying our fiscal stability and credibility. We've doubled the national debt in six years. We've amassed more I.O.U.'s since 1981 than in the entire previous history of the republic. Historians will eventually assign the blame for this debacle. There's plenty to go around.

"In the meantime, we need action, not accusations. And faced as we are with a national fiscal crisis, I think some form of federal tax increase is absolutely justified. In my opinion, the business community should be breathing fire at Congress and the President over this issue."

— J. Richard Munro, chairman
of Time Inc., at the University
of Southern Florida, Tampa,
on November 16, 1987

recent declines in the market price of [Southmark's] common stock. . ." Needless to say, Southmark's public shareholders were not afforded the same privilege.

It is not likely that the state laws authorizing executive loans will revert to their earlier prohibitory form. Every time a state "modernizes" its corporate law, one of the first changes made is the inclusion of a loan-enabling provision. The theory, encompassed in the Model Business Corporation Act, is that loans are a necessary means of attracting top-quality executives. This presumes that worthy candidates for boardroom positions would take a less attractive job for less money rather than endure the hardship of having to borrow money from a flinthearted banker as the other employees do.

In today's business world, the idea that executives should, like their shareholders, confront the trials of commercial borrowing, and use corporate funds for corporate needs, is a heretical notion. □