Executive Loans from Corporate Funds

Jayne W. Barnard
William & Mary Law School, jwbarn@wm.edu
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The author surveys the laws affecting loans made by a corporation to its executives, including the state loan enabling statutes, the applicable tax laws, and any disclosure requirements. Also discussed is the applicability of Regulation G to loans made by a corporation to facilitate share purchases by its executives. Finally, the author enumerates the risks inherent in executive lending and makes suggestions for risk minimization.

Since commentators last addressed the topic of executive loans,¹ the state laws, tax law, securities law, and banking law applicable to the subject have changed appreciably. While corporate loans to officers and directors used to be disfavored, if not absolutely prohibited by most state laws,² today, the majority of the states permit such loans through enabling provisions modeled generally on the Delaware General Corporation Law³

* Member, Illinois and Virginia Bars, and Associate Professor, Marshall-Wythe School of Law, College of William & Mary, Williamsburg, Virginia. She was assisted in the preparation of this article by Catherine S. Wooledge, a third-year law student at William & Mary.


³ The Delaware statute provides:

Any corporation may lend money to, or guarantee any obligation of, or otherwise assist any officer or other employee of the corporation or of its subsidiary, including any officer or employee who is a director of the corporation or its subsidiary, whenever, in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the
or the Model Business Corporation Act. While federal tax treatment of executive loans until recently encouraged liberal use of such loans in lieu of compensation, the case today is precisely the opposite. Federal and (some) state financial disclosure requirements now mandate disclosure to shareholders of loans to executives and members of their families. Loans made for the purpose of facilitating executive stock purchases may be governed by the margin rules contained in Regulation G.

State Law

The primary source of authority on the propriety of executive loans from corporate funds is the law of the incorporating state.

corporation. The loan, guaranty or other assistance may be with or without interest, and may be unsecured, or secured in such manner as the board of directors shall approve, including, without limitation, a pledge of shares of stock of the corporation.


The Model Business Corporation Act provides:

A corporation shall not lend money to or use its credit to assist its directors without authorization in the particular case by its shareholders, but may lend money to and use its credit to assist any employee of the corporation or of a subsidiary, including any such employee who is a director of the corporation, if the board of directors decides that such loan or assistance may benefit the corporation.

Model Business Corporation Act § 47 (1969). This provision was later amended both in substance and in form to provide:

[A] [The] corporation may not lend money to or guarantee the obligation of a director of the corporation unless:

(1) the particular loan or guarantee is approved by a majority of the votes represented by the outstanding voting shares of all classes, voting as a single voting group, except the votes of shares owned by or voted under the control of the benefited director; or
(2) the corporation’s board of directors determines that the loan or guarantee benefits the corporation and either approves the specific loan or guarantee or a general plan authorizing loans and guarantees.

Revised Model Business Corporation Act § 8.32 (1984). This formulation was not adopted by any state and has since been deleted from the Model Act.

5 See notes 34-45 infra and accompanying text.
6 See notes 58-64 infra and accompanying text.
7 See notes 66-79 infra and accompanying text.
Forty-five states currently include within their business corporation statutes express provisions relating to executive loans. Of these, only two prohibit such loans while the rest variously define the circumstances and standards under which executive loans may be authorized.

The most common format is an enabling provision permitting executive loans to be authorized by the board of directors where the board finds that granting the loan "may reasonably be expected to benefit the corporation." Seven "restrictive" states
require shareholder approval of some\textsuperscript{10} or all\textsuperscript{11} executive loans, and six "liberal" states expressly permit the extension of executive loans with no statutory limitations.\textsuperscript{12} Two other states authorize corporate lending generally with no discussion of executive loans specifically.\textsuperscript{13}

The common ancestor of the "benefit" statutes is Section 143 of the Delaware General Corporation Law.\textsuperscript{14} enacted in 1967.\textsuperscript{15}


\textsuperscript{10} Alaska Stat. § 10.06.485 (1989) (loans to directors—including inside directors—require approval of two thirds of the voting shares); Cal. Corp. Code § 315 (West Supp. 1987) (corporations with fewer than 100 shareholders require shareholder approval of loans to directors or officers); Colo. Rev. Stat. § 7-3-101(1)(f) (1986) (requires affirmative two-thirds vote of shareholders to authorize a loan to a director, unless articles of incorporation dictate otherwise); N.J. Stat. Ann. § 14A:6-11 (West Supp. 1986) (loans to directors are limited to those granted pursuant to employee benefit plans adopted by the shareholders or reflected in the certificate of incorporation or bylaw adopted by the shareholders); N.Y. Bus. Corp. Law § 714 (McKinney 1986) (any loan to a director must be approved by the shareholders).

\textsuperscript{11} N.C. Gen. Stat. § 55-22 (1983) (any loan to a director, officer, or dominant shareholder must be approved by the shareholders); Utah Code Ann. § 16-10-43 (1987) (loans to directors or officers require shareholder consent).


\textsuperscript{14} See note 3 supra.

\textsuperscript{15} This provision was regarded as a "financial plum" for managers. Comment, "Law for Sale: A Study of the Delaware Corporation Law of 1967," 117 U. Pa. L. Rev. 861, 873 (1969). Prof. Ernest Folk, who served as reporter for the 1967 revision, later commented that, even though he regarded himself as "pro-management," he thought the loan enabling provision of § 143 was "overly liberal." Id. at 865, 874 n. 102.
Reconstruction of the legislative history of Section 143 suggests that it was adopted initially as a means to accommodate the temporary needs of "salaried officers and officer-directors who [were] being moved about the country with greater frequency and often upon short notice by management. . . ."16 The perceived need for this provision derived from the notion that corporate executives served effectively as "trustees" and—withstanding the availability of advances or loans to nonexecutive employees faced with comparable demands—could not accept loans absent express statutory authorization.17

Other states quickly followed Delaware’s lead, and it was not long before the common understanding of the scope of executive lending authority was substantially broadened. Just two years after the enactment of Section 143, the Model Business Corporation Act was amended to authorize executive loans,18 with the attendant commentary observing:

Contemporary business requirements of moving officers from one place to another, the development of stock purchase plans, and other ways of creating financial needs, justify the making of loans to officers in many cases.19

By the time Minnesota adopted a loan enabling provision in 1981, the statutory commentary observed:

[T]he power of the corporation to loan money to those persons or businesses connected with the corporation is a useful tool


17 See generally Barnard, note 2 supra, at n. 19 and accompanying text. The practical need to make such loans can easily be satisfied in most cases without the cumbersome requirements of most loan enabling statutes. For example, two states, Minnesota and North Dakota, have chosen this simple approach: "A corporation may, without a vote of the directors, advance money to its directors, officers, or employees to cover expenses that can reasonably be anticipated to be incurred by them in the performance of their duties and for which they would be entitled to reimbursement in the absence of an advance.,” Minn. Stat. Ann. § 301A.505 (West 1985); N.D. Cent. Code § 10-19.1-90 (1985).

18 See note 4 supra.

for the protection of the economic interest of that corporation and a useful incentive with which to attract top management or assure future growth.

* * *

The loan or guaranty can be a valuable factor in the retention of experienced management or the hiring of promising personnel. The board may make these loans for any purpose, as long as it reasonably expects the corporation to directly or indirectly benefit from the transaction through better performance by current employees or better personnel.20

Few cases have directly tested the scope of the "benefit" statutes.21 Many have explored the consequences of executive loans improvidently made.22


21 Oberhelman v. Barnes Inv. Corp., 690 P.2d at 1348 (unsecured and non-interest-bearing loans to the president and dominant shareholder of a closed corporation held to violate the Kansas "benefit" statute where the company itself was indebted (and paying interest on its debts) at the time it made the loans and where "[the borrower's] purpose was not the welfare of Barnes Investment and its other stockholders but his own personal benefit"); Roxbury State Bank v. The Clarendon, 324 A.2d 24, 34 (App. Div. 1974) (mortgage secured by a bank loan to a corporation, with bank's knowledge of the promoters' intent to divert a portion of the proceeds to unrelated business ventures, is invalid and cannot be foreclosed; court refuses to treat the diverted funds as a "loan" by the corporate borrower where there is "no basis for a finding that the corporation, as distinguished from [its promoters], could reasonably be expected to benefit from the transaction"). The fact that only a handful of cases directly addresses the statutory "benefit" requirement is testament to the view that such matters are effectively off limits in the courts. See, e.g., Sullivan & Young, "The Proposed Michigan Corporation Act: Officers and Directors," 18 Wayne L. Rev. 951, 969 (1972) ("The prerequisite standard is obviously elastic; it is certainly doubtful that any court would challenge the determination by directors that a loan to a particular director-officer could reasonably be expected to benefit the corporation").

22 See, e.g., American Nat'l Bank v. MortgageAmerica Corp. (In re MortgageAmerica Corp.), 714 F.2d 1266, 1268 (5th Cir. 1983) (creditor sues controlling shareholder of a corporation in chapter 7, asserting a right to recover from him personally under the "trust fund" doctrine; among the plaintiff's allegations are that the defendant had caused the company to make various loans, to defendant and entities controlled by him, totaling $2.3 million); Robertson v. White, 633 F. Supp. 954, 960-961 (W.D. Ark. 1986) (general manager of in-
The success of the loan enabling statutes is evidenced by the widespread use of executive loans. They commonly occur (as one might suspect) within closed corporations, often without regard to corporate formalities. They also occur in publicly held corporated agricultural cooperative secured board approval for low-interest, unsecured loans to his speculative personal business venture amounting to $3.8 million; they also granted themselves no-interest loans; ultimately the co-op filed for reorganization under the bankruptcy act, the general manager was convicted of tax fraud, and the co-op members resorted to suit under the federal securities laws; Levy v. Runnells (In re Landbank Eq. Corp.), 66 Bankr. 949, 962 (Bankr. E.D. Va. 1986) (trustee’s suit against controlling shareholders of a second mortgage company alleges loans to them and relatives totaling $1.6 million plus foregone points totaling $629,344: court finds that the defendants “took, moved property around, favored themselves, and bled the company to death for their own selves’ sake. If exemplary damages are not here clearly proper, there has never existed a case where they were’’); McLemore v. Olson (In re 13&1. Labs., Inc.), 62 Bankr. 494, 505, 510 I Bankr. M.D. Tenn. 1986) (suit by trustee in bankruptcy to pierce the corporate veil and recover losses from director/shareholders was successful, the court noting that defendants had “plundered the assets of [the corporation].” leaving it with liabilities in excess of $2 million, by a variety of means, including making loans to directors and officers without formal shareholder approval).

23 In a sampling of 152 corporations reporting to the SEC in 1987, 55, or 36.2 percent, were found to have made material executive loans (those in excess of $60,000) during the preceding fiscal year. Barnard, note 2 supra, at text accompanying nn. 58-60. In a sampling of 44 corporations that went public in 1986, 43.2 percent had made material executive loans in the 3 years preceding going public. Barnard, “Curbing Management Conflicts of Interest—The Search for an Effective Deterrent,” 40 Rutgers L. Rev. 369 (1988).

24 See, e.g., Bricklin v. Stengol Corp., 1 Conn. App. 656, 660, 476 A.2d 584, 587 (1984) (closed corporation’s $10,000 loan to start-up business owned by directors’ wives found to be “unfair” to the corporation and voided); Levin v. Levin, 43 Md. App. 380, 389, 405 A.2d 770, 777 (1977) (president of a closed corporation was shown to have “borrowed almost $100,000 from [the company], drawing checks upon the corporate funds either to himself or in payment of personal obligations. He stated that the borrowings were without the knowledge or approval of the directors of the corporation [his wife and daughter] and without any form of corporate resolution or authority’’); Speer v. Dighton Grain, Inc., 229 Kan. 272, 274, 276, 624 P.2d 952, 954, 955 (1981) (manager-director of closed corporation had “written some $87,000 in corporate checks to himself and had restored only a portion of that amount to the corporate account”; only after the auditors protested did he tender a $54,000 unsecured note for the remaining balance); Newton v. Hornblower, Inc., 224 Kan. 306, 518, 582 P.2d 1136, 1145–1146 (1978) (officers of closed corporation were found to have utilized corporate funds for payment of insurance premiums on themselves and members of their families, excessive travel expenses, and other personal expenses totaling $90,000; “during the course of
corporations, sometimes with embarrassing consequences or worse. They are made to facilitate relocation, facilitate share purchases, and support a wide range of executive financial needs ranging from college tuition and unpaid tax liabilities to investments in private business ventures and coverage of margin calls.

Few state statutes require any form of security for executive loans, and the Delaware statute and its progeny specifically provide that such loans may be made secured or unsecured as

the trial, the defendants admitted some 100 payments had been made by error from the corporation or partnership but contended they were honest mistakes and defendants were willing to account for them”).

During fiscal year 1985, in which Allegheny International, Inc., lost a record $109 million, it made $32.3 million in loans to its officers and directors, repayable at a 2 percent rate of interest. Of this amount, $21.9 million was loaned for purposes of stock acquisition while $10.4 million was loaned “for other things.” “Big Trouble at Allegheny,” Bus. Wk., Aug. 11, 1986, at 60. Press disclosures of these and other self-dealing transactions ultimately led to shareholder litigation alleging, among other things, that the loans represented a violation of prudent business operating procedures, waste, and mismanagement (Complaint, Allegheny Int'l Inc. v. Haig, Dkt. No. 86-1648, ¶ 39 (W.D. Pa. 1987)) and to SEC enforcement proceedings. SEC v. Allegheny Int'l, Inc., Litig. Release No. 11533 (Sept. 9, 1987).

LTV, Inc., 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 enable him to exercise his stock options. One observer sneered that “he apparently had not been able to save enough on his annual salary of $743,315.” Olasky, “The Public Relations Scams of 1985,” 56 Bus. & Soc’y Rev. 52 (1986).

Horn & Hardart Company, which in 1986 lost $28.4 million and whose share value had dropped by more than half since 1983, in 1984 made (and later extended) a $100,000 “personal loan” to its executive vice president and a $154,700 loan to its vice chairman to permit his investment in a casino. “Why Didn’t They Pay Him to Stay Home?” Forbes, June 15, 1987, at 120-121: Horn & Hardart Co. Proxy Statement, May 14, 1987, at 12.

De Laurentiis Entertainment Group (DEG), whose stock sold at $12 in its initial public offering in 1986 and now sells at less than $1 per share, is reportedly $174 million in debt to banks, debenture holders, and trade creditors. Film distribution has been suspended. Nonetheless, DEG continues to hold outstanding unpaid notes from its CEO ($8.4 million) and from two of his independent business ventures ($27 million). “No, Thank You, Paine Webber,” Forbes, March 7, 1988, at 52, 56.

Barnard, note 2 supra, text accompanying nn. 58-60.


The states using the Delaware format include Florida, Kansas, Maryland, Massachusetts, Minnesota, and Oklahoma.
the directors see fit.\textsuperscript{28} Therefore, judicial suggestions that unsecured loans to corporate executives are inherently "unfair"\textsuperscript{29} are undoubtedly hyperbolic. By the same token, only one state statute makes any reference to the factors to be considered in "pricing" the loan,\textsuperscript{29a} and the Delaware statute expressly permits corporations to make non-interest-bearing loans.\textsuperscript{30} Here, however, there is a somewhat more compelling argument that executive loans made at below-market interest rates should be adjusted\textsuperscript{31} or at least carefully considered, particularly where the corporation itself is paying high rates of interest for its funds. This view has recently been reinforced by changes in federal tax law penalizing the use of below-market loans.\textsuperscript{32}

\textbf{Tax Treatment}

Until quite recently, federal tax law favored the use of executive loans in lieu of compensation. Specifically, employees in receipt of the loaned funds were not taxed as receiving income. Occasionally and particularly in the context of closed corporations, putative loans were deemed constructive dividends.\textsuperscript{33}

\textsuperscript{29a} S.C. Code Ann. § 33-13-170 (loans must be at prevailing rate for "quotes of like character").
\textsuperscript{31} See Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118, 1133-1134, 435 N.E.2d 712, 722-723 (1982). See also Hill v. Hill, 279 Pa. Super. 154, 159, 420 A.2d 1078, 1080-1 (1980) (corporate loans to businesses wholly owned by the lending corporation's president at rates "substantially below the rate charged unrelated businesses" constitute grounds for an accounting in favor of minority shareholders); Maxwell v. Northwest Indus., Inc., 339 N.Y.S.2d 347, 356 (1972) (subsidiary corporation that loaned funds to its 97.2 percent shareholder was entitled to "at least what [the borrower] would have had to pay an outsider to borrow the money"); this was held to include not only the applicable prime rate but also the value of compensating balances that would have been required by a bank lender and that would have increased the effective rate of interest); Washington Nat'l Trust Co. v. W.M. Dary Co., 116 Ariz. at 174, 568 P.2d at 1072 ($150,000 loan to corporation's president, repayable at 4 percent, is unfair to the corporation given what would have been available to it in the money market).
\textsuperscript{32} See notes 38-45 infra, and accompanying text.
\textsuperscript{33} See, e.g., Busch v. Comm'r, 728 F.2d 945, 947-948 (7th Cir. 1984) (sole shareholder of corporation withdrew $300,000 and tendered non-interest-bear-
More frequently, however, executive loans were made bearing little or no interest, and neither the employer nor the executive experienced adverse tax consequences.\textsuperscript{34}

The Deficit Reduction Act of 1984 (DEFRA)\textsuperscript{35} began the trend toward reform of this practice, which was completed with the Tax Reform Act of 1986 (TRA '86).\textsuperscript{36}

First, Congress enacted Section 7872 of the Internal Revenue Code, which recharacterized below-market loans\textsuperscript{37} as arm’s-length transactions. In the case of corporate loans to executives, this resulted in the following:


\textsuperscript{37} Characterization of interest rates as "below market" was based, in the case of a demand loan, on the applicable federal rate (AFR) in effect as of the date the loan was made. I.R.C. § 7872(f)(2); I.R.C. § 1274(d).
(1) [T]he lender [being] treated as if he [had] transferred foregone interest to the borrower in the form of compensation.
(2) [T]he foregone interest [then being] treated as being repaid from the borrower to the lender.
   a. The lender includes foregone interest in income and takes a deduction for compensation paid.
   b. The borrower treats foregone interest as interest actually paid subject to the normal rules for deducting interest.
   c. The foregone interest is subject to FICA and FUTA taxes, and must be reported on Form W-2 as compensation. However, it is not subject to wage withholding.

The timing of these taxable events depends on whether the loan is a demand loan or a term loan. These imputation rules do not apply to loans aggregating less than $10,000. Section 7872, as illuminated by frequently revised "temporary" regulations, remains in effect.

In 1986, Congress again revised the Code and (perhaps unintentionally) further circumscribed the favorable tax treatment of certain executive loans, whether made at below-market interest rates or at competitive rates. Beginning with taxable year 1987 and becoming fully effective in 1990, Congress advanced the proposition that interest paid or accrued when the character of the interest is "personal" should not be deductible.

The Code does not affirmatively define or describe what constitutes "personal" interest. Rather, Section 163(h) defines it

39 Comment, note 34 supra, at 857.
40 I.R.C. § 7872(c)(3); Salzberg, note 38 supra, at 49.
42 Comment, note 34 supra, at 887.
43 I.R.C. § 163(h)(6).
44 Comment, note 34 supra, at 885; I.R.C. 163(h)(1).
45 O'Connor, "The Tax Functions, Effects and Other Business Uses and Benefits of Debt Under the New Interest Deduction Rules and Tax Rates:
in the negative as including any interest expense not previously
enumerated. The primary enumerated interest expenses—all
which are deductible in some form—include "investment in-
terest," trade or business interest," "passive activity in-
terest," and "qualified residence interest."

This configuration requires borrowers to trace the use of their
loan proceeds to determine if the interest payments made (or, in
the case of below-market loans, imputed) to the lender represent
enumerated interest expenses (thus permitting the appropriate
interest deduction) or a "personal" interest expense (thus ren-
dering their interest payments nondeductible).

Therefore, where a corporation makes an executive loan, in
the context of a company-ordered relocation or otherwise, to
support the purchase of (and the loan is secured by) the borrow-
er's principal or secondary residence, the interest is fully de-
ductible pursuant to the "qualified residence interest" (QRI)
provision of the Code. Loans made to support financial obliga-
tions incurred in the conduct of a trade or business invoke the
"trade or business interest" provision, also permitting full de-
ductibility.

Where the loan is made to facilitate share purchases, the inter-
est is deductible only to the extent allowed by the "investment
interest" provision of the Code. Interest paid on loans made to
facilitate investment in a "passive activity," such as owner-

Some Guideposts Through the Mazes of the Code," 40th U. Chi. L. School

46 Id.; I.R.C. § 163(h)(2).
51 Id. The underlying debt may not exceed the fair market value of the
taxpayer's qualified residence or residences. O'Connor, note 45 supra, at 961.
or business interest" does not include interest expense incurred in the trade or
business of performing services as an employee." O'Connor, note 45 supra, at
963; I.R.C. § 163(h).
§ 163(d)(3)(A). Investment interest is deductible only to the extent of net in-
vestment income for the year. O'Connor, note 45 supra, at 960, 963.
activity is "passive" if it involves the conduct of any trade or business and the
ship of a commercial building, will be treated as a passive loss, deductible only to the extent of the taxpayer’s passive activity income for the year.

Loans made generally as compensation substitutes—to finance the purchase of automobiles, payment of tuition, “repayment of personal obligations,” and the like—will be wholly nondeductible.

**Disclosure Requirements**

In companies subject to the oversight of the SEC, executive loans aggregating to $60,000 or more in a given year must be disclosed in both the Form 10-K annual filing and in the annual proxy solicitation. Disclosure must include the borrower’s name as well as the following information:

[T]he nature of the person’s relationship by reason of which such person’s indebtedness is required to be described, the largest aggregate amount of indebtedness outstanding at any time during [the period since the beginning of the registrant’s last] fiscal year, the nature of the indebtedness and of the transaction in which was incurred, the amount thereof outstanding as of the latest practicable date and the rate of interest paid or charged. . .

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55 Passive activities presumptively include rental activities and limited partnership participations (Storrer, note 54 supra, at ¶ 104.2) but not working interests in oil and gas production (id.).

56 O’Connor, note 45 supra, at 962. “Any unused loss deductions may be carried forward to be offset against the excess passive income, if any, in the following years. Any still-unused loss deductions will be analyzed on an activity-by-activity basis and will be allowed in full only in the year in which the taxpayer disposes of his entire interest in the activity.” Id.


The disclosure need not include the purported "benefit" resulting to the corporation as a consequence of granting the loan.\(^{59}\)

Only California requires disclosure of executive loans in annual reports to shareholders,\(^{60}\) with the threshold of materiality at $40,000 rather than the $60,000 employed in the federal statute.\(^{61}\) This requirement is imposed on California domiciliary corporations with 100 or more shareholders of record unless the companies already report to shareholders pursuant to SEC disclosure requirements\(^{62}\) and also on any foreign corporation having its principal executive office in California and customarily holding meetings of its board in California.\(^{63}\)

**Federal Reserve Limitations on Margin Loans**

The most common reason stated by public companies for making executive loans is to facilitate share purchases.\(^{64}\) Executive loans made for this purpose may be governed by Regulation G of the Board of Governors of the Federal Reserve System.\(^{65}\)

Regulation G applies to the following:

> [P]ersons other than banks, brokers or dealers, who extend or maintain credit secured directly or indirectly by margin stock.

... Credit extended by such persons [for the purpose of

\(^{59}\) See Mann, note 1 \textit{supra}, at 1306 ("There is a requirement, of course, that you disclose loans to management in excess of $10,000; but I don't read that as saying you disclose the rationale of the board in deciding to make the loan. There is no requirement of such qualitative information, and in reports filed under the Exchange Act, I've not gone on behind the requirements of the form to make the disclosure of the reason why the board has made the loan, and other details that the ethical investor might be concerned about").


\(^{64}\) Barnard, note 2 \textit{supra}, at text accompanying nn. 58-60.

\(^{65}\) 12 C.F.R. §§ 207.1-207.7 (1987). Regulation G is issued pursuant to Exchange Act § 7(a), 15 U.S.C. § 78g(a) (1982), which authorizes the Federal Reserve Board to promulgate rules governing "the amount of credit that may be initially extended and subsequently maintained on any security." Corporate (or individual) lenders may be subject to the statute just as are brokers (governed by Reg. T, 12 C.F.R. §§ 220.1-220.18 (1987)) and banks (governed by Reg. U, 12 C.F.R. §§ 221.1-221.8 (1987)). 15 U.S.C. § 78g(d) (1982).
facilitating the purchase of margin stock] is regulated by limiting the loan value of the collateral securing the credit. . . .

Assume that a corporation makes a loan to facilitate share purchases by its executives. In the absence of an "eligible [stock acquisition] plan," the corporation as a Regulation G lender is limited to lending the Federal Reserve Board-defined "maximum loan value" of the margin stock to be acquired, which currently is 50 percent of the stock's current market price. Corporations that have adopted an "eligible plan" may lend up to the "good faith loan value" of the margin stock, which may be as much as 100 percent of the current market price. In the case of stock option plans, the Regulation G lender may additionally

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66 12 C.F.R. § 207.1(b) (1987). "Margin stock" is broadly defined to include any equity security traded on a national securities exchange or in the OTC market. 12 C.F.R. § 207.2(i) (1987). "Indirectly secured" is defined as including any arrangement with the borrower under which (1) the borrower's right or ability to sell, pledge, or otherwise dispose of margin stock is in any way restricted while the credit remains outstanding or (2) the exercise of such right is or may be cause for accelerating the maturity of the credit. 12 C.F.R. § 207.2(f)(1) (1987); Board Rulings and Staff Opinions Interpreting Regulation G—Indirectly Secured—Acceleration Clause Fed. Res. Reg. Serv. 5-354. Margin stock is not directly or indirectly secured "if the lender, in good faith, has not relied upon the margin stock as collateral in extending or maintaining the credit." 12 C.F.R. § 207.2(f)(2)(iv) (1987).

67 See note 68 infra.

68 12 C.F.R. § 207.3(b) (1987).


70 This section includes "any employee stock option, purchase, or ownership plan adopted by a corporation and approved by its stockholders that provides for the purchase of margin stock of the corporation, its subsidiaries, or affiliates." 12 C.F.R. § 207.5(a)(2) (1987). Note that shareholders are not required specifically to approve the credit features of the plan. Board Rulings and Staff Opinions Interpreting Regulation G—Employee Stock Option Plan—Shareholder Approval of Credit Terms, Fed. Res. Reg. Serv. 5-347.19 (Mar. 12, 1984).

71 "Good faith loan value" is defined as "that amount (not exceeding 100 percent of the current market value of the collateral) which a lender, exercising sound credit judgment, would lend without regard to the customer's other assets held as collateral in connection with unrelated transactions." 12 C.F.R. § 207.2(e) (1987).
loan funds sufficient to pay the income tax due upon the exercise of the option.  

Regulation G may apply not only to direct extensions of credit but also, under some circumstances, to corporate guarantees of bank loans made to facilitate the exercise of stock options. Regulation G lenders cannot "arrange for" the extension of credit by other lenders to an extent greater than the Regulation G lender could lend itself. Regulation G does not apply to wholly unsecured loans, regardless of the use to which the borrower puts the proceeds, nor to margin loans aggregating with respect to all borrowers less than $200,000.

Regulation G lenders are required to register with the Federal Reserve within thirty days after the end of any calendar quarter during which the amount of margin credit extended equals $200,000 or more and to file annual reports.

The statutory foundation for Regulation G provides that it shall not apply to loans made by a person "not in the ordinary course of his business." However, this language has been recast in the regulation to encompass corporate loans "reasonably expected to occur in carrying out or furthering any business purpose. . . ." The Federal Reserve Board has construed this language specifically to encompass the making of loans pursuant to stock option plans, utilizing reasoning that would govern loans made to facilitate purchases of the lending company's shares even when they are made outside of such plans. It is questionable whether loans made to facilitate share purchases in companies other than the lender ought to be governed by Regulation G;

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73 12 C.F.R. § 207.103 (1987).
74 12 C.F.R. § 207.3(d) (1987).
77 12 C.F.R. § 207.3(a) (1987).
78 12 C.F.R. § 207.3(o) (1987).
80 12 C.F.R. § 207.2(g) (1987).
81 12 C.F.R. § 207.103(e) (1987).
82 The Federal Reserve Board has commented:
but, in any event, these loans may run afield of the state law-imposed "corporate benefit" standard. 83

**Risks Inherent in Executive Lending**

Extension of credit to any borrower is an inherently risky undertaking. Even after substantial deregulation, federal banking law continues to recognize the special risks presented by insider lending. 84 Indeed, recent scholarly inquiry has identified the presence of executive loans as a "major warning sign that a bank may eventually fail." 85 This correlation is not a direct one in the sense that unrepaid insider loans are the primary cause of bank insolvency. Rather, the presence of these loans in excessive amounts reflects an overall management failure of control that is conducive to bank failure. 86 A similar argument might be made about corporate lenders that made excessive executive loans.

Certainly, corporate lenders can appropriate from conventional lenders risk-reducing strategies, such as floating interest rates, specific term lending, security agreements, protective covenants, and per-person and aggregate lending limits. Corporate lenders are well advised to articulate systematically the circumstances in which executive loans will be made rather than considering loan requests on an ad hoc basis. 87

In general, stock option plans are designed to provide a company’s employees with a proprietary interest in the company in the form of ownership of the company’s stock. Such plans increase the company’s ability to attract and retain able personnel and, accordingly, promote the interest of the company and its stockholders, while at the same time providing the company’s employees with additional incentive to work toward the company’s future success. An arrangement whereby participating employees may finance the exercise of their options . . . is . . . designed to promote the company’s interest and is, therefore, in furtherance of a business purpose.

12 C.F.R. § 207.103(e) (1987).

83 See notes 9, 14-21 supra, and accompanying text.
84 See Barnard, note 2 supra, at nn. 135-138.
86 The study’s authors found that "high insider borrowing banks" have higher loan losses, larger operating expenses, greater risk, lower returns on equity, and a greater failure rate than "low or medium borrowing banks." Kummer, Arshadi & Lawrence, Valuation Consequences of Bank Insider Borrowing 20 (unpublished draft).
87 For examples of corporate lending policies, see Barnard, note 2 supra, at n. 139.