Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act

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I. INTRODUCTION

Legislation often has surprising origins. For example, the story is told that Governor Nelson Rockefeller devised his infamous “Rockefeller drug laws” on the slimmest thread of background information.

At a party in March, 1972, Rockefeller had chatted with William Fine, then the president of Bonwit Teller. The two men talked about narcotics—a topic Fine was especially interested in because his son was an addict. Rockefeller asked him to go to Japan and figure out why that nation had the world’s lowest rate of addiction. Fine financed his own trip and returned with an answer: lifetime prison sentences for drug sellers.

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1. JENNIFER GONNERMAN, LIFE ON THE OUTSIDE: THE PRISON ODYSSEY OF ELAINE BARTLETT 52 (2004):

Rockefeller’s staff balked at the news of this proposal, but he refused to listen to any of their doubts. [According to Rockefeller’s former speechwriter,] [h]is drug proposal became an “are you with me or against me” test of loyalty, and staffers quickly realized that if they did not implement the governor’s plan, they would have to start polishing their resumes. “I never fully understood the psychological milieu in which the chain of errors in Vietnam was
Another story has been told of how the word “sex” was included as a protected class in Title VII just hours before Congress passed the statute. According to Congressional folklore, its inclusion was a joke.²

This is the story of another piece of legislation that has surprising origins: the anti-loan provision of the Sarbanes-Oxley Act.³ In this article, I will review the drumbeat of events and political steps that led to the enactment of the anti-loan provision, suggest some of the questions that were neither asked nor answered prior to its enactment, and describe some of the problems that have emerged in its wake.

I tell this story in the shadow of an elegant new book by Malcolm Gladwell called *Blink: The Power of Thinking without Thinking.*⁴ In his book, Gladwell extolls the power of intuitive thinking, the “rightness” of first impressions, and the benefits of snap judgments. According to Gladwell, acting on only the smallest bits of information—what he calls “thin-slicing”—“often delivers a better answer than more deliberate and exhaustive ways of thinking.”⁵

In this article, I will ask whether the “thin slicing” that led to enactment of the anti-loan provision in the summer of 2002 offers an example of Gladwell’s theory. That is, I will ask whether enactment of the anti-loan provision, which occurred virtually overnight, resulted in a “blatantly needed [and overdue] reform”⁶ or, as critics have recently suggested, a classic case of


⁵. Id. at 34. To be fair, Gladwell also discusses some of the perils of “thin slicing” and snap judgments: erroneous judgments based on racial prejudice, hideous mistakes made under stress, and decision making limited by comfort, custom, and familiarity.

“overreaction,”" a case of severe [legislative] overreaching," and a “public policy error.”

II. THE ANTI-LOAN PROVISION OF THE SARBANES-OXLEY ACT

The anti-loan provision of Sarbanes-Oxley is straightforward:

It shall be unlawful for any issuer . . . directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date [. . .].

This provision was as close as Congress was willing to come in the Sarbanes-Oxley Act to reining in what was seen in the decade leading up to the enactment of the statute as excessive executive compensation. Its passage “proved very disruptive of standard arrangements at many corporations.”

Congressional interest in insider loans first surfaced during Senate hearings into the Enron disaster in February, 2002, when former SEC Chairman Richard Breeden testified before the Senate Banking Committee, and recommended both increased disclosure of insider loans and, in some cases, shareholder approval of those loans. But the story leading up to enactment of the anti-loan provision, like the stories underlying many pieces of federal

11. See Janice Kay McClendon, Bringing the Bulls to Bear: Executive Compensation to Realign Management and Shareholders’ Interests and Promote Corporate Long-Term Productivity, 39 WAKE FOREST L. REV. 971, 1001-02 (2004) (“[The anti-loan] prohibition is designed as an indirect means of limiting corporate executives’ ability to acquire equity stakes without out-of-pocket expenditures. . . . This prohibition is also designed to address a disturbing trend of corporate debt forgiveness.”).
13. See Romano, supra note 9, at 150-52 (describing early, very superficial, discussions of insider loans during Senate hearings).
legislation, is not linear. It begins with the unraveling of several large public companies in 2001-2002, all of which had made significant loans to their officers or directors. Then, some unseemly revelations about President George W. Bush’s personal business dealings in the late 1980s, a plummeting stock market, and a grandstanding Senator all converged on a jittery Congress in July, 2002, when the anti-loan provision was proposed and adopted without so much as an intelligent conversation. Here, in a nutshell, are the critical points leading up to enactment of the anti-loan provision.

III. THE ORIGINS OF THE ANTI-LOAN PROVISION

What were the origins of the anti-loan provision? I’d like to claim that a 1988 law review article criticizing insider loans14 played some role. More likely, however, the origins of the anti-loan provision can be traced, as the Act itself can be traced, to the unfolding of the Enron story in the fall of 2001 and the scandals that followed: WorldCom, Tyco, and Adelphia. It can also be traced to a series of bankruptcy filings of high-profile public companies. Between July, 2001, and December, 2002, seven such companies—Comdisco, Enron, K-Mart, Global Crossing, Adelphia, WorldCom, and Conseco—were found to have extended massive loans to their officers and directors, many of them later “forgiven.”15

A. The Back Story

1. The “Big Four” Scandals

The story of the anti-loan provision begins with the disclosure that Ken Lay, Chairman of Enron Corporation, had received some $81.5 million in loans from the company during the period 2000-2001.16 Lay repaid these loans with shares of Enron stock, which permitted him to avoid contemporaneous disclosure of his sales. As described in the report of the Senate Governmental Affairs Committee,

[Enron's] Compensation Committee had already given Mr. Lay a 4 million line of credit which, in August 2001, it increased to $7.5 million. During their interviews, the Committee members said that they knew of the line of credit, but had been unaware that, in 2000, Mr. Lay began using what one Board member called an “ATM

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15. See infra Section III A.
approach” toward that credit line, repeatedly drawing down the entire amount available and then repaying the loan with Enron stock. Records show that Mr. Lay at first drew down the line of credit once per month, then every two weeks, and then, on some occasions, several days in a row. In the one-year period from October 2000 to October 2001, Mr. Lay used the credit line to obtain over $77 million in cash from the company and repaid the loans exclusively with Enron stock. Several Directors confirmed that Mr. Lay still owed the company about $7 million.  

Another company whose insider loans drew widespread attention was WorldCom, Inc. In March, 2002, the company revealed that, beginning in 2000 and throughout 2001, it had loaned its Chairman and CEO, Bernard J. Ebbers, nearly $350 million to cover personal debts. The WorldCom loans required payment of interest at below-market rates (estimated at 2.15%) and were unsecured. “Never before, apparently, had a board of directors lent so much cash to the board’s own chairman . . .”

The loans were later detailed in the company’s proxy statement, concurrent with the announcement of Ebbers’ resignation. They included $198.7 million paid to Bank of America to reduce Ebbers’ personal debts, $35 million deposited to collateralize a letter of credit in favor of Ebbers, and $165 million loaned directly to Ebbers. The proxy explained that the board had approved the loans and related commitments “following a determination that they were in the best interests of WorldCom and our shareholders . . .”

The story behind the loans was this: Ebbers had borrowed privately from Bank of America, using his WorldCom stock for collateral. When WorldCom’s share price began dropping in 2000, Ebbers faced a margin call and sold some three million shares of WorldCom stock. When the share price continued to fall,

22. Id. at 14.
23. Id.
WorldCom’s directors began to worry about what would happen if Mr. Ebbers kept selling stock. They discussed the possibility that the price of WorldCom stock would drop on news that Mr. Ebbers was dumping his shares, according to several board members. Directors also were concerned that if Mr. Ebbers continued to sell his shares it would wipe him out financially and leave him without a stake in the company he ran.\(^{25}\)

Thus, the board decided to guarantee $100 million of Ebbers’ loan and later loaned him an additional $100 million, all with the intention of forestalling an Ebbers sell-off of WorldCom stock.\(^{26}\) Then, without much further thought on the subject, “the guarantee and the loan grew over time.”\(^{27}\) Ultimately, the price of WorldCom stock continued to decline and WorldCom was forced to pay Bank of America $198.7 million to cover the loans it had guaranteed.\(^{28}\) By April, 2002, Ebbers was indebted to the company for $402 million (including accrued interest), with little likelihood that he would ever be able to meet his obligations.\(^{29}\) The company soon thereafter filed for protection under Chapter 11, the biggest bankruptcy in American history.\(^{30}\) It turned out that WorldCom’s financial statements had been overstated by some $11 billion.\(^{31}\) (Bernie Ebbers was ultimately convicted of securities and wire fraud).\(^{32}\)

In addition to the Lay and Ebbers insider loans there was also another rapacious CEO, Dennis Kozlowski of Tyco, International, Inc. Who, in June, 2002, resigned in the face of allegations that he had used company funds—borrowed from a corporate account intended for other purposes—to purchase millions of dollars in artwork for his home.\(^{33}\) Kozlowski was

\begin{itemize}
  \item \(^{25}\) Id.
  \item \(^{26}\) Id.
  \item \(^{27}\) Id.
  \item \(^{28}\) Id.
  \item \(^{29}\) See Colvin, supra note 20; WorldCom, Inc., Proxy Statement, supra note 21 (stating that Ebbers was scheduled to repay the loans on the following schedule: $25 million on Apr. 29, 2003; $25 million on Apr. 29, 2004; $75 million on Apr. 29, 2005, $100 million on Apr. 29, 2006 and all remaining principal on Apr. 29, 2007).
  \item \(^{30}\) Andrew Backover, WorldCom Files for Chapter 11 Protection, USA TODAY, July 22, 2002, at 1A.
  \item \(^{31}\) Christopher Stern, WorldCom Auditors Find More Errors: $3.8 Billion Added to Earlier Total, WASH. POST, Aug. 9, 2002, at A1.
  \item \(^{33}\) Alex Berenson, Tyco Chief Out as Tax Inquiry Picks Up Speed, N.Y. TIMES, June 4, 2002, at A1.
\end{itemize}
ultimately indicted for tax fraud for failing to pay the required sales tax on the artwork. 34

At first, it was reported that the funds Kozlowski had used to purchase his paintings were borrowed from Tyco through an executive loan program that was “supposed to be used for a different purpose helping top employees pay taxes that become due upon the vesting, or taking full ownership, of restricted stock awards.” 35 According to one critic, the fund was not supposed to be used “where the company serves as a bank for employees to use for personal purposes.” 36

As the story unfolded, though, Kozlowski’s misuse of insider loans seemed even more remarkable than had at first been reported. First, Kozlowski was alleged to have borrowed some $270 million—not just $13 million—from a loan program intended to help him pay taxes on restricted stock grants. Prosecutors claimed he had used 90% of the borrowed funds to purchase a yacht, jewelry, fine art, and real estate. 37 Then, they alleged, Kozlowski borrowed an additional $46 million in interest-free “relocation” loans, which he used to buy luxury properties in New Hampshire, Connecticut, Massachusetts, and Manhattan. 38 Other executives, too, were alleged to have abused Tyco’s relocation loan fund. 39 (The criminal case against Kozlowski ended in a mistrial and is currently being retried). 40

One more scandal fed into this sorry mix. On March 27, 2002, Adelphia Communications Corporation, a national cable television provider, filed a report with the SEC in which it revealed for the first time that the family of John J. Rigas, founder and CEO of Adelphia, had extracted billions of dollars from the company for his personal use. 41 Some of the problem involved loans made or guaranteed by the company without the knowledge of the board of directors. 42 The Rigases had also used corporate funds to finance unrelated

38. Id.
41. See Adelphia Communications Corp. v. Rigas, Case No. 02-41729 (REG), U.S. Bankr., S.D. N.Y., Compl. (on file with author).
42. Id. at ¶ 71, 78, 115, 117.
business ventures,\textsuperscript{43} to pay for relatives’ living quarters in New York,\textsuperscript{44} to engage in extravagant family travel,\textsuperscript{45} and to purchase Adelphia stock on the open market.\textsuperscript{46} After a forensic accounting ordered by the firm’s board of directors, the company sued the Rigases, alleging “one of the largest cases of corporate looting and self-dealing in American corporate history.”\textsuperscript{47} The Rigases were also charged by the SEC with securities fraud and “rampant self-dealing.”\textsuperscript{48} And the U.S. Attorney for the Southern District of New York indicted the Rigases, alleging mail fraud, bank fraud, wire fraud, and securities fraud.\textsuperscript{49} The government claimed the family had used the company as its “personal piggy bank”\textsuperscript{50} and engaged in a “wide variety of ... brazen thefts.”\textsuperscript{51} (Ultimately, John Rigas and his son Timothy were convicted of these crimes, and recently agreed to forfeit $1.5 billion to settle the civil claims against them.\textsuperscript{52} The company filed for Chapter 11 protection in June, 2002).\textsuperscript{53}

2. Four More Troubling Bankruptcies

During the period of July, 2001 through December, 2002, not only did Enron, WorldCom, and Adelphia file for protection under Chapter 11, four more high-profile companies did the same, and each one revealed that it, too, had extended significant insider loans to its executives.

The first of these was Comdisco, Inc., a high-tech security company. During the Internet boom, Comdisco had loaned 106 of its employees some $104 million to purchase the company’s stock. When the Internet bubble burst, and the price of the stock plunged, the loans remained outstanding. Not only did Comdisco face bankruptcy (it filed in the summer of 2001), so did many of its employees.\textsuperscript{54}

\begin{enumerate}
\item Id. at ¶ 89.
\item Id. at ¶ 105.
\item Id. at ¶ 104.
\item Id. at ¶ 74.
\item Adelphia Communications Corp., Compl. at ¶ 2.
\item Id.
\item Deborah Solomon, Adelphia Communications Files for Bankruptcy-Court Protection, WALL ST. J., June 26, 2002, at A3.
\item Howard Wolinsky, Ex-Comdisco Execs Sued over Loans: Lawsuits Target 76 Who Borrowed $74 Million to Buy Company Stock, CHI. SUN-TIMES, Feb. 8, 2005, at 43.
\end{enumerate}
K-Mart Corporation filed under Chapter 11 in January, 2002. The press reported that several of its executives had received more than $30 million in "retention loans" just prior to the bankruptcy filing. The idea was that, by offering "retention loans," K-Mart would dissuade its best executives from leaving the company while it was struggling in Chapter 11. In theory, loan repayment would be forgiven if the executives stayed for the duration of the reorganization proceeding. But more than $18 million of the total loan amount went to executives who left the company within weeks of the Chapter 11 filing. K-Mart later sued to recover some of the outstanding loans.

Just one week after K-Mart's bankruptcy filing, Global Crossing Ltd., a telecommunications firm, also filed under Chapter 11. Soon, the press reported that the company had forgiven a $10 million interest-free loan to its CEO, John Legere, just weeks before filing for bankruptcy protection. In this case, the loan had been made as part of a "signing bonus." One more company emerged with insider loan issues during the summer of 2002. Conseco, Inc., a financial services company, revealed that, beginning in 1996, it had guaranteed some $700 million in loans to 155 of its executives to enable them to purchase Conseco shares. Beginning in 2001, the value of the shares began to drop, and the borrowers soon had no reasonable hope of repayment. The company's guarantee obligation contributed to Conseco's bankruptcy filing in December, 2002. (The company later engaged in a bitter lawsuit with its former CEO to recover the unpaid amount of the loan, and is now in the process of executing its $72 million judgment.)

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56. Id.
60. Bill W. Hornaday, Write-Offs Drive Loss at Conseco: CEO Gary Wendt Cites $98.1 Million in Charges in Disappointing Quarter, but Says Turnaround is on Track, INDIANAPOLIS STAR, Feb. 22, 2002, at Bus. 1C.
62. J.K. Wall, Hilbert Ruling Ominous for "Big 11,:: Similarities of Ex-Conseco Brass's Cases Key, INDIANAPOLIS STAR, Nov. 15, 2004, at 1C.
These eight cases—and especially the “big four” scandals—painted an ugly picture of insider loans. It would have been fair on this evidence to assume that insider loans were disproportionately associated with companies on the verge of bankruptcy, companies in which egregious accounting violations and other misconduct was also going on, and companies whose leadership posed a grave threat to public confidence in the capital markets. It might also have been fair to assume that the practice of making insider loans had grown totally out of control.  

B. President Bush’s Response to Concerns about Corporate Greed

The Bush administration responded reluctantly to the clamor for corporate governance reform that emerged following the collapse of Enron. On March 7, 2002, President Bush announced his reform agenda, emphasizing the need for responsible self-governance rather than specific corrective legislation. “The whole design of free-market capitalism depends upon free people acting responsibly,” he said. “Business people must answer not just to the demands of the markets or self-interest but to the demands of conscience.”

That being said, the President did announce his support for a new federal agency that would monitor accounting firms and a ban on public accounting firms performing both audit and non-audit functions for their clients, at least where such work would compromise the independence of the audit. He also called for the return by executives of performance-based compensation awards where a company restated earlier financial statements. Finally, the President called for CEOs to vouch for the “veracity, timeliness and fairness” of the information contained in their financial statements.

There was no mention of outlawing insider loans in President Bush’s Ten-Point Plan, but then again, the revelations about insider loans at WorldCom, Adelphia, and Tyco were still over the horizon.

C. Congress’s Response to Concerns About Corporate Greed

Throughout the spring of 2002, both the Senate and House conducted hearings on Enron and entertained dozens of legislative proposals. House
Democrats pressed for passage of tough regulatory bills called the Comprehensive Investor Protection Act69 and the Corporate Responsibility Act of 2002.70 Ultimately, a far more moderate Republican bill—the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 200271—passed the House on April 24, 2002, with widespread bipartisan support.72

Then, the progress of post-Enron reform legislation seemed to stall.73 The White House was preoccupied with homeland security issues, and Congress was equally preoccupied with issues such as the “patients’ bill of rights.” It almost seemed as if the Congress didn’t notice what was happening in the national securities marketplace, but a simple timeline suggests what in fact was going on. Between April 24, when the House corporate reform bill passed, and the second week of July, when the Senate began moving in earnest on corporate reform, several noteworthy events had occurred: (1) Tyco CEO Dennis Kozlowski resigned in disgrace;74 (2) WorldCom revealed that it had overstated its cash flow by over $3 billion dollars;75 (3) Xerox announced that it, too, would be making a $1.4 billion restatement;76 (4) WorldCom’s CEO Bernie Ebbers and CFO Scott Sullivan declined to testify in front of the House Financial Services Committee;77 and (5) Qwest Communications intimated that it would be making a $1 billion restatement.78

By mid-July, the Dow Jones Industrial Average was down 20% from the first of the year, and other major indexes were down even further.79 Both the S&P 500 stock index and the Dow fell to their lowest levels in five years.80

73. See David S. Hilzenrath, Senate Set for Action to Reform Audit Sector: Corporate Scandals Spur Call for Tougher Rule, WASH. POST, July 7, 2002, at A1 (noting that “[j]ust weeks ago, the legislative fervor that followed the December collapse of Enron Corp. appeared to have cooled, and efforts to impose new discipline on corporate auditors seemed to have sputtered in the Senate”).
77. Simon Romero & Floyd Norris, 2 Former WorldCom Executives Refuse to Testify to Congress, N.Y. TIMES, July 9, 2002, at C1.
78. Simon Romero & Kenneth N. Gilpin, New Executives May Restate Qwest Results for Last Year, N.Y. TIMES, July 13, 2002, at C1.
Throughout this period, no one was advocating the prohibition of insider loans—not even the Democrats. Senator Paul Sarbanes’ reform bill in the Senate—the Public Accounting Reform and Investor Protection Act of 2002—did not contain an anti-loan provision. And the report of the Democrat-controlled Senate Permanent Subcommittee on Investigations issued on July 8, 2002, contained only a recommendation that directors—not the Congress—should take steps to prevent excessive executive compensation, among other things, by “barring the issuance of company-financed loans to directors and senior officers of the company.” The proposal was intended to be exhortative, not mandatory.

D. Embarrassing Disclosures about President Bush

On the same day the Subcommittee’s report was issued, Monday, July 8, 2002, President Bush held a “hastily-announced” press conference whose purpose was to deflect questions about Bush’s conduct while he was a director at Harken Energy Corporation. The press had resuscitated a story just days before about the President’s failure to file the required notice-of-sale documents when he sold some Harken shares in 1990. According to one observer, the press conference was a humiliating performance for Bush—“the President . . . looked [like] a very naughty boy indeed.” According to another observer—this one a conservative Republican—“[h]e just didn’t seem like he was prepared.” His answers about Harken were “vague and dismissive.” It was “the weakest, most inarticulate showing he had made since the early months of his presidency.”

The next morning, Tuesday, July 9, 2002, President Bush appeared before a gathering of some 850 business leaders in New York City, where he announced his latest corporate reform initiatives. Promising “bold, well-
considered reforms," the President announced the creation of the Corporate Fraud Task Force and committed himself to increased penalties for securities law violators. One journalist noted:

[The President] handled the preliminaries with affable aplomb. But the text itself he read in a joyless monotone, without inflection or conviction. The remedies he outlined were the feeblest he could afford to offer. He made no mention of such obvious steps as making corporations count stock options as an expense and preventing accounting firms from doubling as consultants to companies they audit. Some of his proposals (like requiring that a dishonest executive be convicted in criminal court before being barred from future service as an officer or a director of a public company) were weaker versions of measures that have been recommended by the S.E.C.'s professional staff or that are currently being rushed through Congress. Others (like calling for annual reports to describe a C.E.O.'s "compensation package" in plain English) are purely voluntary and therefore close to meaningless. The main emphasis was on tougher—or tougher sounding—enforcement, notably a new "financial crimes SWAT team," an additional hundred million dollars for the S.E.C., and more prison time for wire and mail fraud. Even in this there was less than met the ear. The SWAT team will be essentially an information clearing house, and will involve no new net resources. The extra hundred million for the S.E.C. may be more than the increase that was called for in the President's last budget (i.e., zero), but it's barely a third of what Senate Democrats are proposing.

The President also spoke briefly on the subject of loans. He proposed the immediate cessation of insider loans, as a matter of corporate policy, not as a matter of federal law. Specifically, the President said "I challenge compensation committees to put an end to all company loans to corporate officers." According to his Director of Communications, Dan Bartlett, "President Bush looked at these loans, and the president felt the best way to do it was to draw a bright line; the best way to handle these loans going forward is through a bank."
Then, the first of two critical events occurred. On Wednesday, July 10, just one day after the President’s Wall Street appearance, the Wall Street Journal broke the story that “Mr. Bush himself [had] borrowed money from Harken Energy Corp. while a company director and consultant there.”95 “As of March 20, 1990, he [had] owed $180,375, according to Harken Energy’s 1989 annual report.”96

The next day, Thursday, July 11, both the New York Times and Washington Post also reported on the below-market-rate loans.97 The international press characterized this news as “further embarrassment” for the President98 and “the latest skeleton to emerge from Mr. Bush’s Harken cupboard.”99 The domestic press, too, focused critically on the President’s previous business behavior.100 Suddenly, corporate scandals—and the President’s behavior—was seen as a threat to Republicans’ chances for re-election. Senate Republicans began to soften their resistance to meaningful reform.101

E. Senator Schumer Weighs In

On Friday, July 12, 2002, the second critical event in this story occurred. Senator Charles E. Schumer (D-N.Y.), who had been present at the President’s July 9 speech in New York City, introduced an amendment to the then-pending Senate reform bill (the Sarbanes bill) to outlaw insider loans.102 (Until that moment, the Sarbanes bill had merely required that public

96. Id.
98. Lydia Adetunji, Bush Faces Embarrassment Over Loans: Harken Energy White House Confirms President Received Money from Houston-Based Oil Group to Buy Shares in Compaq, FIN. TIMES, July 12, 2002, at 9.
101. See Alison Mitchell, A New (Election Year) Vigilance on Corporations, N.Y. TIMES, July 11, 2002, at C1 (noting the Republicans’ about-face on many corporate reform issues and observing that suddenly, proposed Senate legislation was “becoming tougher by the hour”).
102. This amendment was one of only three amendments to the Sarbanes bill that was permitted to go to the floor. “Senate staffers made clear that the uproar over Bush’s loans from Harken ensured that the Schumer proposal went to the front of the line.” David Ivanovich, Senate Targets Execs’ Loans: Ban on Aid from Companies OK’d, HOUSTON CHRON., July 13, 2002, at A1.
companies disclose all insider loans). In advancing his amendment, Senator Schumer noted that he had secured the support of the White House before submitting the amendment. He said:

Madam President, I am going to be very brief because I know we do not have too much time and we have other business. I thank both the majority and minority managers, Senator Sarbanes and Senator Gramm, for their work on this amendment. I have also spoken to people in the White House who were supportive of this amendment. It is a very simple amendment. It basically says that with certain narrow exceptions, CEOs and CFOs of companies will not be able to get loans from those companies.

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

With no discussion, the amendment then passed on a voice vote. And on Monday, July 15, 2002, the Senate unanimously passed out the Sarbanes bill, including Senator Schumer’s anti-loan amendment. As Senator Schumer conceded at the time, his amendment “never would have passed two weeks ago.” Indeed, just five days before passage of the bill, the Wall Street Journal had declared insider loans “too popular to disappear anytime soon.”

F. Getting the Deal Done

The White House immediately began applying pressure to House Republicans to work to achieve a compromise between the (less aggressive) House version of the reform bill and the (more aggressive) Senate version. President Bush urged the players to reach agreement quickly: “The two

[chambers] need to get together as quickly as possible and get me a bill that I can sign before the August recess," he said. In response, the House quickly passed a bill that would increase the penalties for economic crimes. While the Senate bill passed just the day before had set a maximum penalty of 10 years in prison, the new House bill set the maximum at 25 years. This signaled a significant change of heart—described by one commentator as a "death bed conversion"—among House Republicans since the House bill had passed on April 24. As Senator Sarbanes noted, "[w]hen the House acted three months ago, we did not yet know the full depth and extent of the problems.

Between July 16 and July 25, the Senate and House conferees, in consultation with the White House, worked to reach an acceptable compromise. Since the first of July, the Dow Jones Industrial Average had fallen 1000 points, and public opinion polls increasingly echoed the public's concern over corporate scandals. On Friday, July 12, the Office and Management and Budget had announced that, instead of running a small surplus in FY 2002, the government now expected a deficit of $165 billion. Suddenly, it became obvious to even the toughest of Republicans—including those in the White House who were leery of the Sarbanes bill—that the free-market ideologues would have to give way.

"We've got to look out for ourselves first and foremost," a top House Republican strategist told The Washington Post. "We have to go home in a week and say we've done something. People have to wake up and realize the political nature of this fight."

In a report distributed on Capitol Hill, a prominent Republican polling firm found that "the bottom has fallen out on the mood of the country." In the pollsters' view, "WorldCom's [bankruptcy] announcement may have been the straw that broke the camel's back." It certainly broke the stock market's back.

113. See William Booth, Economic Anxiety Worries Politicians; As Elections Approach, Voters May Be Looking for Someone to Blame, WASH. POST, July 21, 2002, at A1 (citing polling data showing that 35 percent of respondents in July listed the economy as the nation's most important issue, compared with 24 percent a month earlier).
“Voters’ attitudes toward corporate offenders are hostile,” the report warned. “Legislation punishing wrongdoers can’t be too tough.”

According to one Republican member of Congress,

By the time it got to conference, Republicans were under instructions from the speaker of the House and most political operatives to get a bill and get it now. There was a mad dash to embrace the Sarbanes bill. They didn’t want to get into a fight where Republicans were arguing for a weaker bill. None of the troops in the House were prepared to support that effort.

At this point, even protectionist lobbying faltered. Where once the lobbyists had counted on a stalemate between the House and the Senate, deferring a vote at least until 2003, now they scrambled to carve out just “a few strategic changes” in the Sarbanes bill. “The enormity of pressure to get this done before the weekend suggests anyone like me had better narrow down the scope of things they’re going to try to influence,” said Bruce Josten, the Chamber of Commerce’s chief lobbyist.

Finally, on Thursday, July 25, 2002, a deal having been hammered out, a consensus bill based on the Sarbanes bill passed overwhelmingly in both chambers. The vote in the House was 422-3; the Senate passed it by 99-0. Loan prohibition was part of the package. The President signed it into law on Tuesday, July 30, 2002.

IV. THE DELIBERATIVENESS NORM IN THE SENATE

Legislation in the United States is ideally described as having three salient characteristics: “deliberativeness, representativeness, and accessibility.” The key word here for our purposes is “deliberativeness.” In a perfect world, legislation is the product of a process that involves the balancing of competing views, considerations of numerous alternatives, and above all, time during which important ideas can percolate.

118. Id.
119. Id.
121. ABNER J. MIKVA & ERIC LANE, AN INTRODUCTION TO STATUTORY INTERPRETATION AND THE LEGISLATIVE PROCESS 69 (1997).
The entire structure of the Congress encourages deliberativeness in the development of federal legislation. Recall that the framers of the Constitution built many speed-bumps into the legislative process—two houses of Congress, the Presidential veto, and supermajorities in both houses for a veto override. They also created incentives for robust “speech and debate.”

The origins of the notion that legislation is legitimate only where it is the product of a deliberative process traces (at a minimum) to the Federalist Papers. Federalist 63 expressed concern that, left unchecked, any legislative body “[might] be warped by strong passions or momentary interest.” Federalist 62 advocated a Senate with longer terms than the House, in part for the sake of continuity, but in part because of a concern that members of the House, “if left wholly to themselves, [might make] a variety of important errors in the exercise of their legislative trust.”

The importance of a deliberative process focused particularly on the Senate:

Most popular histories of Congress include an exchange, very likely apocryphal, in which Washington and Jefferson discuss the difference between the House and Senate. “Why did you pour that coffee into your saucer?” Washington asks. “To cool it,” Jefferson replies. “Even so,” Washington says, “we pour legislation into the senatorial saucer to cool it.”

We also see adherence to the deliberativeness norm in the Senate today. Senator Joseph Biden (D-Del.) has described the Senate as “[a place where] you can always slow things down . . .”

Thus it is a surprise when the Senate acts precipitously, as it did in the case of the anti-loan provision. The lack of deliberativeness on this, and other provisions of the Sarbanes-Oxley Act, was both atypical and, in terms of

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124. Id.
126. THE FEDERALIST NO. 63 (James Madison).
Indeed, the bicameral system established by the Founders and encapsulated in the Constitution was a response to the concern that a hasty and potentially tyrannical majority in the House of Representatives would act “too quickly and chaotically” if left to its own devices; the Senate, an indirectly elected upper house, would “use reason and judgment to temper the lower house’s expected haste and extremism.
128. Jeffrey Toobin, Blowing up the Senate, NEW YORKER, Mar. 7, 2005, at 42.
129. Id.
public policy, regrettable. Why? First, deliberativeness fosters incrementa-

lism rather than abrupt or sweeping change. Second, deliberativeness ensures

that all voices—formed or otherwise—may be heard.

Deliberativeness is not a synonym for debate, although debate may be

one of its elements. Rather the term defines those steps of the

legislative process that slow legislative decision-making and distance

it from the passions and immediacy of the prevailing desires of

individual legislators and of various constituencies. Deliberativeness

is intended as an anchor against change, protecting the status quo

from precipitous upset. . . . Affirmatively, deliberativeness works

toward assuring that enacted legislation is based on a public consen-
sus on the need for, as well as the type of, change.\textsuperscript{130}

Adherence to the deliberativeness norm typically means that time must

be spent ascertaining other legislators' values, considering alternatives,

receiving input from constituents and various interest groups, and forging a

genuine consensus. As much as deliberativeness was important in the 1780s,

it is even more so now, given our polarized national values and an increasingly

diverse electorate. In such a setting, says Eric Lane, legislators must often

slow down to consider competing ideas and values beyond the immediate

issue or their personal experience:

[l]egislators . . . must consider an array of factors in arriving at their
decisions, including: the views of their colleagues and constituents,
the historical setting for the proposal; the impact on other regulatory
or redistributive schemes; and internal politics.\textsuperscript{131}

None of these items had time to surface in the minutes between introduction
and passage of the anti-loan provision.

Critics, of course, have recognized many exceptions to the deliberat-

ness norm. Spending limitation riders,\textsuperscript{132} so-called “Christmas tree” legisla-

tion,\textsuperscript{133} and the appropriations process itself\textsuperscript{134} all elude the type of measured

\textsuperscript{130} Mikva & Lane, supra note 121, at 677.

\textsuperscript{131} Eric Lane, Essay, \textit{Men Are Not Angels: The Realpolitik of Direct Democracy and What We Can}


\textsuperscript{132} See Neal E. Devins, \textit{Regulation of Government Agencies Through Limitation Riders}, 1987

\textit{Duke L. J.} 456 (1987) (criticizing the use of spending limits or threatened budget cuts as a means of

shaping policy without adequate public input).

\textsuperscript{133} See Brannon P. Denning \& Brooks R. Smith, \textit{Uneasy Rider: The Case for a Truth-in-Legislation}

\textit{Amendment}, 1999 \textit{Utah L. Rev.} 957, 971, 998 (describing the process by which members of Congress

trade favors and add special interest provisions to a “must-pass” bill at the last minute).

\textsuperscript{134} Devins, supra note 132, at 458 (“appropriations are often acted on quickly, providing little

opportunity for thoughtful deliberation of the issues raised by such measures.”). See also Michelle V.
deliberation that serious legislation deserves. Still, these devices are “not a favored vehicle for public policymaking in a representative democracy.”135

V. WHAT DELIBERATIVENESS MIGHT HAVE REVEALED

We know from the legislative history of the Sarbanes-Oxley Act that Congress did not deliberate at all about the anti-loan provision. As a thought exercise, however, let us assume that the provision had been proposed in, say, March, 2002. Indeed, let us assume that President Bush had made statutory loan prohibition one of the elements of his corporate governance reform proposal in March, 2002. What might a thoughtful Congressional inquiry have revealed?

First, as a backdrop, it would have been clear that, after a rich and fitful history,136 corporate loans in 2002 were treated in four different ways, depending on a company’s state of incorporation: (1) some states prohibited insider loans;137 (2) some states required specific procedures for the approval of insider loans;138 (3) 29 states, including Delaware, permitted insider loans only where the board (at least in theory) could identify a corporate benefit from making the loan;139 and (4) 19 states, following the most recent version of the Model Business Corporation Act, had totally deregulated insider loans. Of the eight “problem companies” whose stories led up to enactment of the anti-loan provision, three—WorldCom, Tyco, and Global Crossing—were incorporated in a “deregulated” jurisdiction.140 This evidence might have


136. See Barnard, supra note 14, at 240-50 (tracing history).
137. See, e.g., IDAHO CODE § 30-3-82 (Michie 2004).
138. See, e.g., CAL. CORP. CODE § 315 (West 2005) (requiring shareholder approval of loans to directors, or for corporations with 100 or more shareholders, requiring shareholder approval of a bylaw authorizing loans); S.D. CODIFIED LAWS § 47-2-65 (Michie 2003) (requiring shareholder approval of loans to directors).
139. See, e.g., DEL. CODE ANN. tit. 8, § 143 (2005) (permitting loans to officers and directors, “whenever, in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation”); FLA. STAT. ANN. § 607.0833 (West 2005).
140. WorldCom was incorporated in Georgia. Tyco and Global Crossing were incorporated in Bermuda. Quite apart from anti-loan sentiment, the offshore incorporation of Tyco and Global Crossing was a subject of widespread condemnation. See Christopher Lee, Companies That Relocate to Avoid Income Taxes Come Under Fire, DALLAS MORNING NEWS, July 14, 2002, at 15A (discussing proposed legislation to punish offshore companies).
suggested that unwise and permissive state laws had played some role in the growth and abuse of insider loans.

Second, it would have been clear that the use of insider loans had burgeoned during the 1990s, in part due to the “arms race” of executive compensation during that period, and in part due to some quirks of the federal income tax law. (Specifically, receiving a loan rather than a direct cash payment permits an executive to avoid short-term income tax obligations.) As of 2002, “more than one-third of the largest publicly traded corporations [had entered] into over $4 billion in low interest loan agreements with [their] corporate executives.”

Third, it would have been clear that the nature and magnitude of insider loans had changed dramatically since the 1980s. For example, the descriptions of insider loans in a 1988 study included simple cash advances against salary, loans made to purchase life insurance, loans made to purchase a new house, loans made to purchase stock, loans made to facilitate the exercise of stock options, and “expense advances.” The amounts involved ranged from less than $5000 to $2.5 million. In contrast, by 2002, insider loans often ran into the tens of millions of dollars. One study of these loans found the mean amount for loans made to facilitate the purchase of company shares alone to be $2.5 million.

Fourth, it might have been possible for the Congressional staff to do some empirical data-gathering to see if insider loans were associated disproportionately with failing companies or were spread more broadly across the market. I did a shirrtail version of such a study in the spring of 2003. Looking at the 50 public companies identified by Business Week as the “Best Performers” of 2002, I found that 10 of them, or 20% of the total, reported having made or retained insider loans to their officers and directors during the preceding year. Then, looking at the 195 public companies that entered

141. McClendon, supra note 11, at 998. (Other consultants’ studies reported different numbers, but all agreed that the trend of making insider loans was strongly upward.). See Joann S. Lublin, Loan Dangers: Companies Are Having Second Thoughts About Lending Money to Their Top Executives, WALL ST. J., April 12, 2001, at R6 (“Nearly 14% of 214 major public companies extended credit for executive officers’ stock purchases in 1999, up from 8.4% in 1994, according to a proxy-statement analysis by New York compensation consultants William M. Mercer Inc.”); Joann S. Lublin, Loans to Corporate Officers Unlikely to Cease Soon, WALL ST. J., July 10, 2002, at A8 (“About 412 of 1,000 U.S. corporations lent money to certain top executives from 1991 to 2000—up from the 225 doing so in 1981 to 1990, concludes an analysis by consultants Executive Compensation Advisory Services in Alexandria, Va.”).

142. Barnard, supra note 14, app. II.

143. Id.


Chapter 11 in 2002, I found that 49 of them, or 25% of the total, reported having made or retained insider loans during the preceding year. These findings suggest that companies regarded as “winners” were just about as likely to have made an insider loan as companies regarded as “losers.”

With a little more time, empirical data-gathering might have revealed additional important facts. Two studies published some months after enactment of the Sarbanes-Oxley Act examined insider loans using rigorous methods. One study detailed the use of insider loans from 1996-2000 and concluded that loans made to facilitate stock purchases were often diverted to other uses. Another study found a “strong negative relationship between industry-adjusted returns and [the presence of insider] loans.”

Fifth, Congressional hearings—and a thoughtful analysis of the data presented—might have reinforced the recognition that not all insider loans were harmful, or even suspect. Hundreds of such loans each year were repaid in full by the borrowers, or were being repaid over time pursuant to a repayment schedule. Other loans were made in small amounts, or to facilitate desirable corporate transactions. Many insider loans facilitated the purchase of company shares, which scholars have argued is a desirable method of aligning management’s interests with those of shareholders. Many of these loans, in short, were totally harmless and/or advanced a legitimate corporate purpose.

With time, it would have been possible—and it still is possible—to consider insider loans along six dimensions: (1) the terms of the loan; (2) the purpose for the loan; (3) the size of the loan; (4) the company’s expectations for repayment of the loan; (5) the manner of approval of the loan; and (6) whether or not the loan was adequately disclosed to investors.

A. Terms of the loan

Insider loans may be categorized by their terms. These range from fully-competitive market terms (including interest rate, duration of the loan, and covenants) of the sort that a borrower could negotiate from a bank or finance company to fully uncompetitive (non-interest bearing, indefinite term, unsecured) loans of the sort that a legitimate bank would never make.

146. The identity of these companies was provided by BankruptcyData.com research.
147. Shastri & Kahle, supra note 144, at 25.
149. See, e.g., Charles M. Elson, The Duty of Care, Compensation, and Stock Ownership, 63 U. CIN. L. REV. 649, 695 (1995) (suggesting that directors be paid primarily in stock rather than cash, because doing so aligns their interests with that of shareholders).
B. Purpose of the loan

Loans may represent purposes intrinsic to the corporation's business (such as loans made to facilitate executive relocation) or involving some form of reward for executive performance (loans made to facilitate the "cashless" exercise of stock options). They may also include more generalized forms of incentives (short-term loans made to facilitate the purchase of life insurance) or they may advance a purpose that is, frankly, not even vaguely related to the corporation's business (loans, such as those made to Bernie Ebbers, made to facilitate outside investments).

C. Size of the loan

Loans may be measured by the amount of money involved. Loans that are proportionate to the borrower's base salary (such as travel advances or modest relocation loans) are at one end of this spectrum and multimillion dollar loans far in excess of the borrower's base salary are at the other.

D. Expectation of repayment

Insider loans may also be categorized by the company's expectations for repayment. In most cases, the expectation is for complete repayment pursuant to the terms of the loan, whatever those terms might include. In other cases, repayment may be nominally expected, but may also be forgiven if certain events occur. In still other cases, there is the wholly illusory loan for which no repayment is expected. Such loans, according to the IRS, should be treated as straight compensation.

E. Manner of approval

There is yet a fifth dimension to insider loans, having to do with the manner in which the loan is approved. This ranges from thoughtful authorization by disinterested members of the board of directors (in possession of full information), to a casual rubber stamp by the board, to outright misappropriation by the borrower without authorization by or notice to the board. (Significantly, this last type of transaction is not really a loan at all).

150. See, e.g., E. Scott Reckard, Big Perks Put Seven CEOs in a Whole "Other" Club, L.A. TIMES, June 6, 2004, at C4 (describing the "golden hello" given the new CEO of Mattel, Inc. in 2000, when he was given a $5.5 million loan "with an agreement to erase the debt if he lasted three years on the job"); In re Integrated Health Servs., 2001 Bankr. LEXIS 100 (D. Del.) (noting that the CEO of the company had been given a $34.5 million loan, which would be "forgiven over time according to a set formula").

151. See Joseph E. Bachelder III, Tax Treatment of Loans to Executives, 2001 HOT ISSUES IN EXECUTIVE COMPENSATION, 719 (describing IRS treatment of some executive loans as compensation).
F. Disclosure

The sixth dimension for assessing an insider loan has to do with how and to what extent the loan relationship is disclosed to investors. Some loans of the pre-Sarbanes-Oxley period were fully disclosed and carefully described in public filings. Others were alluded to somewhere, though often buried in a footnote to the financial statements, rather than described in plain English in the compensation section of the document. Others were not disclosed at all.

As shown below, by plotting these considerations graphically, it would have been easy to see that some types of insider loans—those described in Column #1—were likely to be entirely legitimate exercises of business judgment which would present no problems to the integrity of the market. Other loans—those described in Column #2—might be more questionable and might require some legislative response. But only the “Column #3” loans would be the sort of loans for which federal prohibition might be appropriate.

<table>
<thead>
<tr>
<th></th>
<th>Column #1</th>
<th>Column #2</th>
<th>Column #3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terms</td>
<td>Bank-like terms</td>
<td>Below-market interest rates, etc.</td>
<td>&quot;Sweetheart&quot; terms (No-interest loans)</td>
</tr>
<tr>
<td>Purpose</td>
<td>Key to a corporate objective</td>
<td>Indirectly supportive of a corporate objective</td>
<td>Unrelated to any corporate goals</td>
</tr>
<tr>
<td>Magnitude</td>
<td>Proportionate to salary</td>
<td>Generous</td>
<td>Outlandish</td>
</tr>
<tr>
<td>Repayment</td>
<td>Intent to collect</td>
<td>Pro forma approval after the loan is disbursed</td>
<td>Funds are misappropriated without notice to the board</td>
</tr>
<tr>
<td>Approval</td>
<td>Advance approval by disinterested members of the board</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disclosure</td>
<td>Fully disclosed</td>
<td>Obfuscated</td>
<td>Undisclosed</td>
</tr>
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</table>

Finally, had they been given the opportunity to do so, Congressional staffers might have developed one additional set of data. An important study published after the passage of Sarbanes-Oxley suggests that insider loans were


153. See, e.g., Microsoft’s Failure to Disclose Loan May Be a Violation of the Law, S.F. CHRON., Sept. 10, 2002, at B1 (noting that a $15 million loan to the company’s chief operating officer was disclosed in a footnote, though in impenetrable terms that did not include the word “loan”).

154. Apparently, the loans at Tyco were not included in the firm’s public filings. Ben White, Tyco Reports Paints Picture of Greed: CEO Kozlowski Allegedly Deceived Firm’s Board, WASH. POST, Sept. 17, 2001, at E1.
only one of several value-reducing practices at public companies in 2000-2001. Other types of “related party transactions” occurred more than three times as often as insider loans. As Mark Lowenstein has pointed out, “[w]hether [insider] loans were the most abused form of compensation, and thus a logical place for Congress to start, is questionable.”

Here’s the bottom line: had Congress in the spring of 2002 taken a hard look at the universe of insider loans (or even a quick look), it would have identified several alternatives to a statutory prohibition of insider loans at public companies. These included, in ascending order of invasiveness: (1) enforcing existing disclosure laws so as to discourage the making of “Column #3”-type loans; (2) toughening the disclosure laws by federal statute or regulation to capture more fully the problems of “Column #3”-type loans; (3) imposing new federal regulations on insider loans—such as mandating pre-approval or collection procedures—in addition to the existing disclosure requirements; (4) prohibiting certain types of “Column #3”-type loans (for example, non-interest bearing loans or loans in an amount of more than 20% of the executive’s annual base pay); and (5) prohibiting insider loans with specific undesirable characteristics. Some or all of these approaches might well have made more sense than the “death penalty” approach that Congress ultimately selected.

VI. OPPORTUNISM AND IMAGERY

There is much one might say about successful politicians. They are typically gregarious; need little sleep; can tolerate endless, repetitive encounters with strangers; and are often quick to identify “signature” issues with which to enhance their public visibility. Good politicians know the value of language, too. Not only do they perfect the art of the “sound bite,” they also seize...
upon powerful imagery in the bills they introduce\textsuperscript{159} and the campaign slogans they use in their campaigns.\textsuperscript{160}

Senator Chuck Schumer is a very successful politician. In his most recent re-election campaign in November, 2004, he received over 70\% of the vote.\textsuperscript{161}

There are many reasons Senator Schumer is successful. According to one Democratic consultant, "[n]o one works harder. He travels incessantly. He's well-liked upstate. He understands the value of money in politics. He is the consummate politician."\textsuperscript{162}

But there is more to Senator Schumer’s success than hard work and well-honed skills. Senator Schumer “has distinguished himself by his persistent cultivation of media attention for populist-style fights.”\textsuperscript{163} This instinct for a popular issue, coupled with his ability to command media attention at precisely the right moment in the news cycle, both contributed to Senator Schumer’s embrace of the anti-loan provision.

VII. CONCLUSION AND REGRET

Since the passage of the Sarbanes-Oxley Act, confusion has arisen on a number of issues arguably governed by the anti-loan provision. For example, what is the relationship between the anti-loan provision and state indemnification laws that permit the advancement of attorneys’ fees and expenses? Is it possible that the (routine) practice of advancing legal fees to officers and directors to defend lawsuits against them may now constitute an unlawful loan in violation of the anti-loan provision?\textsuperscript{164}

Or, what is the impact of the anti-loan provision on the practice of facilitating arrangements by which executives can easily exercise their accu-


\textsuperscript{160} See, e.g, Presidential Campaign Slogans, at http://www.presidentsusa.net/campaignslongs.html ("Putting People First" (William Clinton); "A Leader, for a Change" (Jimmy Carter); and “Reformer With Results” (George W. Bush)).


\textsuperscript{162} Dionne Searcey, Schumer Looking Ahead: Confident in His Bid for Re-election, the Incumbent Senator May Have Sights Set on Gubernatorial Race, NEWSDAY, Oct. 21, 2004, at A20 (quoting Democratic consultant Hank Sheinkopf).

\textsuperscript{163} Mike Dorning & Rick Pearson, Blagojevich Finds Role Model: N.Y. Senator’s Ways Followed, CHI. TRIB., May 2, 2004, at C1.

\textsuperscript{164} Sean Carnathan, Will the Company Cover an Ex-Officer’s Legal Costs? The New World of Sarbanes-Oxley, 13 BUS. LAW TODAY 33 (2003).
mulated stock options? When officers or directors engage in a "cashless exercise" of their options—an exercise of the options followed by an immediate sale of some portion of the stock to cover the exercise price—is that a violation of the anti-loan provision? 165

Or, what is the impact of the anti-loan provision on the once-common practice of purchasing so-called "split-dollar" life insurance coverage for senior-level executives? When a company pays the premium for a life insurance policy that is later reimbursed by the executive when she retires (for a while, this was a tax-favored strategy), is that a violation of the anti-loan provision? 166

In the immediate aftermath of Sarbanes-Oxley's passage, these and other questions quickly surfaced. 167 Practitioners were hard-pressed to give useful advice to their clients, and often conflicting advice was the result. 168 The insurance industry sought interpretive guidance from the SEC, 169 which the Commission refused to supply. 170 It also sought assistance and corrective legislation from Congress, which the Congressmen, too, refused to supply. 171

Then, something remarkable happened. Lacking any useful guidance from the SEC or from Congress, a self-appointed group of lawyers from twenty-five law firms across the country decided to draft their own guidance document. 172 Though this project has been criticized as a possible violation...


166. See Jeremy Kahn, Suddenly Some Perks Aren't Worth the Pain, FORTUNE, Nov. 11, 2002, at 40 (noting that both the law's sponsors, Senator Paul Sarbanes and Congressman Michael Oxley, "never intended to bar split-dollar insurance policies," but that most companies had ceased to provide them).


168. See Sarbanes-Oxley Should Not Preclude All Broker-Assisted Cashless Option Exercises by Insiders, at http://www.reedsmith.com/library/publicationView.cfm?itemid=3744 (noting that "[a]lthough some law firms have advised public issuers to suspend broker-assisted cashless stock option exercises for executive officers and directors in light of Section 402 of the Sarbanes-Oxley Act, we believe, subject to certain limitations, that such suspension is not necessary").

169. See Industry Battling Multiple Reverses on Split-Dollar, COLI Life Sector Products, INS. CHRON., Sept. 2, 2002 (noting that the insurance industry was seeking an SEC interpretation of the anti-loan provision that would exempt split-dollar insurance products from its coverage).

170. Lybecker et al., supra note 167, at 1 ("[S]enior members of the [SEC] staff have made it clear that the Commission is not likely to issue any interpretive guidance regarding [the anti-loan provision] (at last not in the near future, and that they expect members of the practicing bar to resolve the questions").

171. See Split-Dollar Fix Eyed on Pension Bill, INS. CHRON., Sept. 9, 2002 (noting lobbyists' efforts to secure statutory protection for split-dollar life insurance products); Hill Pressure Threatens Split Dollar, INS. CHRON., Sept. 30, 2002 (noting that the industry's efforts secure an exemption for split-dollar life insurance products "appeared doomed to failure").

of the antitrust laws, it was in fact an inspired act of self-preservation on the lawyers' part. With no useful legislative history to guide them, and many unanswered questions, the lawyers tried to craft a coherent interpretation of the statute that would withstand judicial scrutiny and also permit critical corporate transactions to go forward. Specifically, the document suggested that routine travel advances and relocation loans should not be treated as "personal loans." It also encouraged certain types of retention loans and suggested that the advancement of fees and expenses in litigated proceedings should not be subject to the anti-loan provision. "While the SEC didn't sanction the memo, it didn't criticize it either, leading some lawyers to believe their take on the [anti-loan provision] was correct."177

Still, questions remained. One year after the statute was passed, Congressman Oxley expressed "trepidation" about the anti-loan provision "and said he would like to see Congress clarify what it meant."178 Senator Sarbanes "[didn't] share Mr. Oxley's concerns." And both agreed it was still too soon to make any legislative changes.180

Ultimately, the SEC did provide some clarification as regards the legitimacy of foreign bank loans to bank executives. And the Department of Labor provided some clarification as regards the application of the anti-loan provision to ERISA plans. With those exceptions, however, there has been no official clarification of the scope and reach of the anti-loan provision. Thus, questions remain as to hundreds of millions of dollars in outstanding loans to officers and directors. Some of these loans are being forgiven pursuant to pre-arranged schedules. Others are being paid off with the passage of time.


175. Id. at 4-5.

176. Id.


178. Id.

179. Id.

180. Id. ("They said corporate America needs more time to digest the rules before a final verdict on the law’s effectiveness can be reached and potential weaknesses spotted").


VIII. What Next?

Some critics have decried the Sarbanes-Oxley Act as imposing "quack corporate governance" rules on thousands of U.S. public companies. Others have faulted the Act for failing to disrupt the "social status quo" of U.S. corporate hierarchies and boards of directors. Still others have raised federalism concerns, worried that the Act just imposes more of the same kind of regulations that failed to work in the past, and lamented the Act's impact on a dwindling pool of qualified corporate directors. Executives complain constantly about the difficulty of meeting the Act's requirements.

I am more optimistic about the Act as a whole than some of these critics, but wary of some of the smaller pieces of the Act that were poured into it at the last minute—"cobbled together" as one critic says—without the kind of thought and deliberation we should reasonably expect of our lawmakers. The anti-loan provision is one such piece.

So, what to do now? Roberta Romano has urged that the anti-loan provision (along with several other provisions of the Sarbanes-Oxley Act) be made a default rule which could be waived by individual corporations. Others would suggest outright repeal.

I suggest two other alternatives. First, Congress should conduct a thoughtful study of the three issues that have generated the most pressing concerns among public company executives and their lawyers: advancement of fees and expenses in derivative litigation, cashless exercise of stock

184. Romano, supra note 9, at 8.
190. See Ribstein, supra at 186, at 19 (noting that the Sarbanes-Oxley Act "was passed in a hectic environment in which politicians played on public misperceptions of risk and eschewed careful balancing of costs and benefits").
191. Veasey, supra note 188, at 1451.
192. Romano, supra note 9, at 206.
options, and split-dollar life insurance. After careful study and public hearings, specific amendments to the anti-loan provision might prove to be in order, or not.

Second, Congress should consider a more global approach to the question of insider loans and explore the possibility of re-authorizing such loans, with a strong “corporate benefit” limitation.

A. Give Meaning to “Corporate Benefit”

As noted above, the current state of the law governing insider loans is scattered—literally—all over the map. The statutory language in 29 states limits insider loans to those circumstances where the board of directors can affirmatively find that making the loan will provide a “benefit” to the corporation. The problem is that the states have developed almost no useful guidance on what is meant by the term “corporate benefit.” As noted in my 1988 study, insider loans were often made without regard to this statutory requirement. And these loans were rarely subject to litigation, because most of them were repaid.

When issues relating to abusive insider loans were presented in litigation, moreover, the question of whether the statutory requirement of a “corporate benefit” had been met, was often not raised or decided. Thus, in Aronson v. Lewis, the question of whether $225,000 in interest-free loans to a director had been properly approved by the board under Delaware law was never considered, because the plaintiffs failed to meet the demand requirement. And in Technicorp International v. Johnston, a challenge to $6 million in interest-free loans was subsumed in a much larger case involving outright looting of the corporation. In Integrated Health Services, Inc. v. Elkins, the question was whether the plaintiff had properly alleged that the grant and later forgiveness of several loans to the CEO was the product of a “conscious and intentional disregard” of the directors’ fiduciary duties as defined in the Disney case. (The court concluded that, with respect to some of the loans,

193. The split-dollar life insurance issue may be less pressing than the other two, since some of the tax advantages of such plans have been reduced since passage of the Sarbanes-Oxley Act. See Joseph B. Treaster, New Treasury Rule Taxes Some Insurance Policies, N.Y. TIMES, Sept. 12, 2003, at C5.
194. See supra note 139 and accompanying text.
198. The court characterized the defendants’ conduct in that case as a “pattern of massive fraudulent diversions of [the corporation’s] assets and concealment of the same.” Id.
the answer was "yes."). So, even in Delaware, there has been little useful guidance on which loans are likely to satisfy the "corporate benefit" requirement.

Insider loans have sometimes surfaced in bankruptcy cases, but there the question has been whether the loans should be treated as fraudulent conveyances with respect to the corporation’s creditors, and not whether the loans have passed the "corporate benefit" test. Similar issues are occasionally found in federal income tax cases, where the issue is typically whether the insider loan was actually a loan or whether in fact it represented taxable compensation or a constructive dividend. Sometimes, insider loans play a role in decisions to pierce the corporate veil.

Only a handful of cases, however, have ever addressed the issue of "corporate benefit" directly, and even those that have done so, have done so inadequately. Significantly, since 1988, I have found only two cases in which insider loans have been challenged on their merits.

So, Congress might consider adopting a federal provision, applicable to public companies, that would compel corporate boards to make a specific finding that any insider loan is likely to provide a discernible "corporate benefit." Fact-gathering and hearings might generate some clear guidelines as to what is meant by a "corporate benefit" and what types of transactions are presumptively illegitimate.

Congress might decide, for example, to exclude from the "corporate benefit" rule any loans made for the purpose of purchasing stock. Or it might decide that retention loans and any other loans subject to an automatic "forgiveness schedule" are presumptively illegitimate. It might decide that only interest-bearing loans can satisfy a "corporate benefit" rule, regardless

201. See, e.g., In re Flutie N.Y. Corp., 310 B.R. 31, 49 (S.D. N.Y. 2004) (treating as fraudulent transfers several purported "loans" to the corporate debtor's chief executive).
202. See, e.g., Katsaros v. Comm'r, 77 T.C.M. (CCH) 1295 (holding that payments characterized by the taxpayer as "loans" should be treated as compensation).
203. See, e.g., McCurley v. Comm'r, 74 T.C.M. (CCH) 318 (holding that payments characterized by the taxpayer as "loans" should be treated as constructive dividends).
204. See, e.g., In re Flutie N.Y. Corp., 310 B.R. at 71 (holding that CEO who received regular loans from the debtor in lieu of salary was the "alter ego" of the debtor and subject to individual liability).
205. See, e.g., Oberhelman v. Barnes Inv. Corp., 236 Kan. 335, 690 P. 2d 1343 (1984) (holding without explanation that the loan in question could not reasonably have been expected to benefit the corporation); Roxbury State Bank v. The Clarendon, 129 N.J. Super. 358, 324 A.2d 24 (App. Div. 1984) (finding no basis to support the proposition that the corporation could reasonably be expected to benefit from a loan).
206. See Group Inmobiliario Morales Franco v. Garcia, 1999 Tex. App. LEXIS 5845 (finding that two corporate officers who had taken out a $100,000 loan had offered no evidence to show that the loan benefited the corporation in any way); Dupuis v. Pierre's Sch. of Beauty Culture, Inc., 1995 Me. Super. LEXIS 515 (finding that outstanding loans had "provided no benefit to the corporation").
of the purpose of the loans. I express no opinion on these issues here.\textsuperscript{207} These are matters for the deliberative process.

\textbf{B. Deal with Procedural Issues}

If Congress is to revisit the question of insider loans, it not only should consider the substantive issue of when insider loans should be made, but also address procedural issues governing the grant of insider loans. These issues include (1) whether retroactive board approval of an insider loan is legitimate, or whether all such loans should be approved in advance; (2) whether any sort of "loan plan" is permissible in public companies and, if so, whether such plans must be subject to advance shareholder approval; (3) whether real-time disclosure of insider loans should be required, or whether annual disclosure adequately protects investors; (4) whether the terms of the loans (including loan forgiveness schedules) should be disclosed and, if so, using what format; and (5) what documentation—and forms of security—should be required in connection with insider loans.

In any event, it is time for Congress to revisit the anti-loan provision. In comments during the question-and-answer session at this Symposium, Congressman Oxley revealed that he had encouraged Senator Schumer to initiate that process.

\textbf{IX. CONCLUSION}

In the immediate aftermath of Sarbanes-Oxley's passage, here's what one critic had to say about the anti-loan provision:

Section 402 was adopted in haste and anger, without the normal give and take of the legislative process that would have occurred with hearings, committee reports, and debates on the floors of the House or Senate. The actual language used to effect the Congressional purpose, such that it is, has adversely affected a broad sweep of standard compensation practices. In applying Draconian penalties, Congress made no apparent attempt to distinguish between the outrageous on [the] one hand, and the immaterial and customary on the other hand. The result has been a great deal of distress and chaos among directors and executive officers . . . \textsuperscript{208}

Should we care about the alleged distress today, nearly three years later? I suggest the answer is yes. First, the anti-loan provision is overbroad—far in

\textsuperscript{207} In previous work, I have suggested some guidelines for determining when a "corporate benefit" is likely to be achieved. Barnard, \textit{supra} note 14, at 261.

\textsuperscript{208} Lybecker et al., \textit{supra} note 167, at 10.
excess of what's necessary to curb misconduct. Second, corporations have already found numerous ways of circumventing the provision at shareholders' expense. Third, if Congress intended by enacting this provision even indirectly to curb increases in executive compensation, that effort has failed. Finally, legislation like this, which emerges without the benefit of a deliberative process, casts doubt on the seriousness with which members of Congress approach their important legislative work. In the case of the anti-loan provision, they can do better.

209. For example, even though retention loans may have disappeared, retention bonuses have not. That is, rather than making a loan with a forgiveness schedule, public companies since Sarbanes-Oxley have been paying retention bonuses. The only difference is in the timing of the taxable event. The same thing has happened with split-dollar life insurance. See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn, supra note 7, at 961 (noting that, instead of utilizing split-dollar life insurance policies, "[t]he emerging solution . . . is to classify [the payment of premiums] as a bonus . . . "). As for loans to facilitate the purchase of stock, "[e]xecutive compensation committees are using cash bonuses, restricted stock grants, and phantom stock grants to replace stock purchases financed with loans." Ashlea Ebeling, The Lending Game, FORBES, May 10, 2004, at 182.