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Non-Recourse Loans Provided to Executives

This position paper sets out some of AICD's views on companies providing non-recourse loans to executives for the purpose of funding share purchases.[1]

Introduction

Some companies provide non-recourse loans to executives in order to fund purchases of their shares. The rationale for this is to try align the interests of executives with those of shareholders, by rewarding executives for improvements in the company's share price. Non-recourse loans are just one way of aligning interests; other ways include the issuance of share options to executives or the promise of share allotments to executives if predetermined performance hurdles are met.

Background

Non-recourse loans to executives for share purchases typically have the following characteristics:

- they are designed to allow the executive to buy shares in the lending company without any monetary outlay by the executive;
- the lending company's recourse to the executive's assets is limited to the value of the shares the executive has bought with the loan;
- any dividends paid in relation to the loan shares is applied towards repaying the loan; and
- the loan must be repaid in full before the executive can access the shares (eg for the purposes of on-sale).

It is not uncommon for companies to use non-recourse loans as a remuneration method for all employees (not just executives); often as part of an employee share plan that has been approved by shareholders[2]. Where such loans are provided to executives, they will form part of a company's related party disclosures[3], and be disclosed in a company's annual remuneration report, which is subject to a non-binding shareholder vote.

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[1] While the paper focuses on executives, the views expressed by AICD would extend to circumstances where non-recourse loans are provided to non-executive directors – though the latter are much less likely to participate in such incentive programs.
[2] Refer to sections 260A(1)(b) and 260B of the *Corporations Act 2001*, which relate to companies giving financial assistance for acquiring shares.
[3] Refer to *AASB 124 Related Party Disclosures*.

The use of non-recourse loans to fund executive share purchases has, in recent years, fallen out of favour with investor groups.[4] In addition, the current Federal Government, as part of its 2007 election campaign[5], stated an intention to prohibit non-recourse loans to senior management and directors.

Link Between Performance and Rewards

AICD has previously said there should be a clear link between performance and rewards for executive equity incentive plans.[6] In this context, the provision of non-recourse loans to executives does not typically represent "best" corporate governance practice, because such loans weaken the link between performance and rewards by diluting the "at risk" aspect of share ownership (i.e., the personal wealth of the executive is not at risk if the company's share price falls). In addition, where there is a dramatic fall in company share price, shareholders can lose out twice – the fall in value of their personal holdings as well as the loss to the company because the loan is not recouped.

Preferred approach to regulation of non-recourse loans

AICD supports disclosure of all non-recourse loans made to executives. However, it does not support a legislative prohibition on such loans for the following reasons.

- As a matter of principle the appropriateness of non-recourse loans should be left to market forces. Further legislative intervention would be at odds with the approach policymakers have taken in respect of other corporate governance matters, and other elements of executive remuneration. It is important to recognise the role played by the ASX Corporate Governance Council, its pronouncements, and the "if not, why not" regime that is in place. This has been a successful alternative to black letter law for corporate governance matters generally.

- There are already controls in place – mandated disclosure and a non-binding shareholder vote on executive remuneration matters.

- There may be circumstances where a non-resource loan is an appropriate part of an overall remuneration package. For example, a struggling company may wish to attract a highly successful executive in an attempt to save the company from

[4] For example, refer to ASA's Monitor Manual 2007, page 13 ("The ASA opposes non-recourse or non-interest bearing loans to executives to purchase LTI Performance equity"); Investment and Financial Services Association "Blue Book" 2006, p29 ("Equity participation should not involve the provision by the company of non-recourse loans"); Australian Council of Super Investors Inc "Corporate Governance Guidelines 2007", p17 ("ACSI does not support loans to be made to executives on a non-commercial basis, so that they may take up shares").

[5] Labor Party, 2007 National Platform, Chapter Five "Fostering Competitive and Innovative Australian Industries", page 47.

[6] Refer to AICD Position Paper No. 2 - Executive Equity Plan Guidelines.

collapse. Through the use of a non-recourse loan to buy shares, the executive can be rewarded if she or he is successful, but will not be personally penalised if, despite the executive's best efforts, the company is beyond saving.

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