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The Use of Non-Recourse Loans to Exercise Stock Options Can Cause Variable Expense

The use of employer loans to exercise employee stock options is not a common practice. However, where it does occur, care must be taken in structuring the loan terms to avoid converting what would otherwise be a "fixed" grant under APB No. 25 into a "variable" grant triggering compensation expense. This issue was addressed and resolved by the FASB's Emerging Issues Task Force (EITF) in a logical and useful manner on March 31, 1996[*]. (The EITF is an arm of the FASB that debates and resolves technical issues within generally accepted accounting principles.)

There are two types of loans used to purchase stock: "non-recourse" and "full-recourse." A non-recourse loan is secured only by the stock itself, and may be satisfied, for example, if the stock price declines, by simply turning back the stock. The note holder has "no recourse" to any assets of the borrower, other than the stock, in case of default. A "full-recourse" loan is the opposite. The lender has "recourse" to other assets of the borrower, not just the stock as collateral, so that full dollar recovery can be made in case of default.

The important fact to keep in mind when considering the issue of non-recourse loans to purchase stock is the long-standing principle that, for both income tax and accounting purposes, a non-recourse loan is treated like a stock option because, like an option, there is no risk of ownership. The borrower using a non-recourse note has the *option* of giving the stock back instead of paying off the face value of the note.

A related issue is whether interest on a non-recourse loan to buy stock is a fixed obligation, due and payable even if the stock is returned to satisfy the loan. The other alternatives, which are similar to a non-recourse loan, are situations where (1) accrued interest is a non-recourse obligation which may be satisfied by returning the stock, or (2) any interest paid is refunded if stock is returned to settle the note.

The EITF addressed several issues with respect to employee stock options accompanied by a non-recourse note (secured by the stock) equal to the option price. The note has a fixed term, with interest that is either (1) at a fixed rate and prepayable or (2) at a variable rate.

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[*] EITF Issue 95-16

The issues were:

1. If the option is exercised with the non-recourse note, is this, in effect, the grant of a new option with a new measurement date, possibly triggering compensation expense?

2. Do the terms of the non-recourse note cause the option's exercise price to remain uncertain when the note is issued, hence triggering compensation expense?

Exercise of Option with Non-recourse Note

The EITF concluded that the exercise of an option with a non-recourse note is the grant of a new option. However, whether this new grant has a new measurement date triggering compensation expense depends on the facts and circumstances. For example, if the right to exercise using a non-recourse note was included in the original grant terms, and the term of the note and interest rate were fixed, then there is no new measurement date. The reasons are that both the shares covered by the option and the option price were fixed at the time of original option grant, and the term of the "option" has not been extended.

Even if the ability to exercise the option by use of a non-recourse note was added to the option after grant, it would not cause a new measurement date if the term of the note did not extend beyond the original option term. However, if the ability to exercise with a note was added to the option agreement after grant and the term of the note extends beyond the original option term, then the granting of the right to exercise the option with a note triggers a new measurement date because the option term (including the term of the note) has been extended.

Terms of Interest Payments

The EITF further concluded that if (1) interest accrued on the non-recourse note is itself non-recourse (i.e., secured by stock itself), or (2) any interest paid is refundable if the stock is returned in settlement of the note, then the interest due is considered part of the option exercise price.[*] In these cases, if the interest rate is variable or fixed but prepayable, then the option is deemed a variable grant causing compensation expense. This is because the exercise price is not known until the note is settled. Alternatively, if any interest accrued is a full-recourse obligation or if any interest paid is not refundable, then the terms of interest payments do not convert an otherwise fixed grant to a variable grant.

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[*] Any interest which is deemed part of the exercise price should be accounted for as part of the exercise proceeds, not as interest income

Dividends on Stock Purchased With a Non-recourse Note

The final consensus conclusion of the EITF was that any dividends paid on stock issued for a non-recourse note would not be accounted for as real dividends on stock but rather as additional compensation expense. This follows from treating a non-recourse note as an option since dividends (or dividend equivalents) on an option are deemed compensation.

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If company loans are to be made available to exercise options, the best course is for them to be full-recourse loans with full recourse interest. If non-recourse loans are to be used, it is best if the loan term does not extend beyond the original option term and if any interest paid is non-refundable or any interest accrued is full-recourse.

Questions about specific company applications of EITF 95-16 should be addressed to a company's accounting staff. General questions may be addressed to Fred Cook at (212) 986-6330.