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The Pirates Will Party On! The Nonqualified Deferred Compensation Rules Will Not Prevent CEOs from Acting Like Plundering Pirates and Should Be Scuttled

William A Drennan
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“I laughed so hard I almost fell overboard.”

William A. Drennan*

TABLE OF CONTENTS

I. INTRODUCTION .................................................. 1
II. CEOs PIRATICAL PRACTICES ..................................... 6
   A. Swashbuckling Stock Option Schemes for Scallywag CEOs ............................................. 11
   B. Severance Pay Pirates .................................................. 13
   C. Fringe Benefit Bandits .................................................. 16
III. WHY THE PIRATES PLUNDER WITH IMPUNITY .............. 18
IV. THE LAW OF UNINTENDED CONSEQUENCES, COLLATERAL DAMAGE, AND 409A .......................... 20
V. OFF COURSE: ERRORS TRIGGERED 409A’s UNFORESEEN CONSEQUENCES .................... 24
   B. Error #2 – The Government Failed to Address the Key Enron Problems ............................. 27
   C. Error #3 – The Government Focused on an Irrelevant Tangent -- NQDC .............................. 29
   D. Error #4 – The Government Applies 409A to Small Businesses and Charities .................... 33
VI. 409A WILL HAVE NO IMPACT ON SAVVY CEO PIRATES ......................... 35
VII. THE COLLATERAL DAMAGE 409A INFlicTS ON SMALL BUSINESSES, CHARITIES, AND THEIR EMPLOYEES .......................................................... 37
   A. Vacation and Sick Leave .................................................. 38
   B. Teachers, Construction Workers, and Other Part-Year Employees ..................... 42
   C. Legal Settlements, Including an Employee Signing a Waiver on Termination of Employment 45
   D. Noncompete Agreements .................................................... 47
   E. Reimbursement of Business Expenses ....................................... 49
   F. Anti-Abuse Rule – You Can Never Be Sure 409A Does Not Apply .......................... 51
VIII. CONCLUSION .................................................. 52

I. INTRODUCTION

CEOs and their sidekicks resemble swashbuckling pirates emptying the coffers of vulnerable prey. Although some argue that CEOs, like


1 The quote would be appropriate for a corporate CEO gloating over his or her excessive compensation, but a book reviewer said it. http://www.talklikeapirate.com/book.html (quoting Jamaica Rose).
professional athletes, must be worth their compensation or corporations would not pay it,\(^3\) structural deficiencies at publicly held corporations impede natural market forces. A Delaware Chancery Court judge stated, “executive compensation seems . . . to have come spectacul\(^5\)\(^\text{arly unhinged}\) from the market for corporate talent.”\(^4\) In comparison to their counterparts, U.S. CEOs take home twice as much as Canadian top dogs, three times more than English bigwigs, and quadruple the compensation of Germany’s big cheeses.\(^5\)

The government’s latest attempt to use income tax rules to eradicate the thievery began with a study of the egregious compensation practices at Enron Corporation.\(^6\) The study revealed that Enron’s top executives hijacked the company through a stock option program that paid them over

\(^2\) See e.g., Dan Whitcomb, *Corporate Pirate Ken Lay Finds God Upon Conviction!!!*, available at \url{http://propagandapress.org/2006/05/25/corporate-pirate-ken-lay-finds-god-upon-conviction}.


$1 \textit{billion} \text{ in the year before Enron went bankrupt.}^{7} \text{ The executives gorged themselves with compensation, and soon thereafter, “[thousands of] Enron’s rank-and-file employees [lost] virtually all of their retirement savings”}^{8} \text{ and their jobs.}

After Congress authorized this study in an effort to bring calm to the high seas of executive compensation, everything went off course. Although the Enron study revealed treachery and mercenary mischief, the Joint Tax Committee chose to ignore the stock option shenanigans that accounted for almost 75\%^{9} \text{ of the top executives’ compensation.}^{10} \text{ Instead, the Joint Tax Committee focused on nonqualified deferred compensation (“NQDC”), which was a trivial trinket of the compensation booty. NQDC accounted for less than 5\% \text{ of the executives’ compensation.}^{11} \text{ The government continued to drift off course as Congress enacted Internal Revenue Code § 409A (“409A”), which ignores all other types of compensation, and merely imposes \textit{timing} rules on NQDC. And shiver me timbers, 409A applies to all employers and employees, rather than just the top executives at publicly held}

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7 In 2000, Enron paid its top 200 executives $1.424 billion in total compensation, and $1.063 billion of that amount was stock option compensation. \textit{Id.} at 547. Enron declared bankruptcy on December 3, 2001. \textit{Id.} at 575.
8 \textit{Id.} at 37.
9 \textit{Id.} at 547.
10 Enron Compensation Report, \textit{supra} note 6, at 41. The Joint Tax Committee stated, “In implementing its stock-based compensation programs, Enron appeared generally to follow IRS guidance. Thus, no recommendations are made with respect to such programs.” \textit{Id.}
11 \textit{See infra} note 132.
The government continued on its rudderless course as the IRS generated regulations, notices, and press releases that will have no practical impact on the piratical practices of top executives.

Rather than making the pirates walk the plank, or at least restricting their marauding, 409A will attack the following arrangements used by small businesses, charities, and their employees:

- Vacation policies that allow an employee to carry over unused vacation days to the next year.
- Sick leave policies that allow an employee to carry over unused sick leave days to the next year.
- Settlement agreements with employees who are fired.
- Noncompete agreements with former employees.
- Annualization agreements for school teachers, construction workers, fishermen, and other part-year employees.
- Agreements to reimburse business expenses.

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12 Only two 409A rules apply exclusively to publicly held corporations, and they are trivial. First, IRC § 409A(a)(2)(B)(i) provides that if a publicly held corporation will make an NQDC payment to a key employee upon separation from service, the first payment must be delayed at least six months. Second, a publicly held corporation can delay a NQDC payment to a top executive if the corporation would not be allowed to claim a tax deduction for the payment because of the $1 million restriction of IRC § 162(m). Treas. Reg. § 1.409A-2(b)(7) (2007). Under IRC § 162(m), in any one year, a public corporation cannot claim a tax deduction for fixed compensation in excess of $1 million paid to its CEO, or any of its next four highest-ranking officers. This opportunity to re-defer is actually an extra benefit to top executives because it allows them additional flexibility in timing NQDC payments. Under 409A, normally to further extend the payment of NQDC benefits, the parties must agree to the extension at least one year before the payment is due, and extend the payment for at least five years. IRC § 409A(a)(4)(C).

16 See infra Part VII.B. for an explanation of an annualization agreement.
Two examples vividly demonstrate the failure of 409A.

**EXAMPLE #1.** During the calendar year, Jolly Roger,\textsuperscript{18} the CEO of a large publicly held corporation, defers $30 million to his NQDC plan,\textsuperscript{19} receives a $100 million gain from stock options, and receives a $50 million severance payment when he is fired in December for his poor performance. If the corporation observes certain timing rules, 409A will have no impact on Jolly Roger.

**EXAMPLE #2.** Sam Small is a high-school teacher who makes $36,000 a year. Sam only teaches from September through May because the school is closed in the summer. Sam signs an “annualization” agreement with the school to spread his compensation over twelve months.\textsuperscript{20} Sam signs the annualization agreement on the second day of school. Because Sam failed to sign and turn in the form on or before the first day of school, under 409A, Sam automatically must pay an extra $800 of income tax!!!\textsuperscript{21} Neither the IRS regulations nor the IRS New Release\textsuperscript{22} on this topic indicate that Sam can avoid the extra tax caused by his tardiness by bringing a note from his mother.

Acclaimed sociologists Robert Merton, in his influential work on the “law of unintended consequences,” observed that actions often have unintended consequences – including collateral damage – particularly when the actor makes errors.\textsuperscript{23} In this case, the government failed to keep its eyes

\textsuperscript{17} See infra Part VII.E.
\textsuperscript{18} “The Jolly Roger is the traditional name for the flags of European and American pirates, and a symbol for piracy that has been adopted by filmmakers and toy manufacturers.” http://en.wikipedia.org/wiki/Pirate.
\textsuperscript{19} As a historical note, Enron CEO Ken Lay deferred $32 million into his nonqualified deferred compensation plan in 2000 (the year before Enron went bankrupt). Enron Compensation Report, supra note 6, at 14, 604 n.1817.
\textsuperscript{20} See infra Part VII.B. for an explanation of an annualization agreement.
\textsuperscript{21} See infra note 182 and accompanying text.
\textsuperscript{23} See infra Part IV.
on the prize of preventing piracy on the high seas of executive compensation at publicly held corporations. As a result, small businesses, charities and their employees will need to structure and administer routine compensation arrangements in compliance with outrageously complex new rules, or face confiscatory additional taxes. The government should repeal 409A retroactively and chart a new course in its battle against CEO pirates.

II. CEOs PIRATICAL PRACTICES

Enron’s collapse in 2001 created great interest in savvy CEO pirates who raid corporate treasuries.24 The government has enacted a few laws in an attempt to limit the looting,25 but studies demonstrate that the pirates continue to raze, ravage, plunder, pilfer, seize, and assail.

24 “Executive compensation has come under particular public and government scrutiny as a result of the substantial compensation, option gains, and perquisites paid to executives of companies, such as Enron and Worldcom, that went bankrupt . . . .” Frank P. VanderPloeg, Legal Standards for Adoption of Executive Compensation Programs and Contracts, 775 PLI/Tax 891 (Oct-Nov. 2007) (Practicing Law Institute, Tax Law and Practice), available at http://web2.westlaw.com/result/documenttext.aspx?vr=2.08rp=%fsearch%2fdefault.w/&e; Jack Z. Smith, The Platinum Helicopters, Ft. Worth Star Telegram, Jan. 19, 2007, at B13, available at 2007 WLNR 1065215 (“Enron was . . . the undisputed champ at high-level corporate chicanery.”).

• “Average CEO compensation for large U.S. companies in 2005 was 369 times the pay of the average U.S. worker, compared to only 36 times the average worker’s pay in 1976. In other words, the gap between the CEO [pay and the] average worker pay has jumped TENFOLD in less than 3 decades . . . .”

• “In 2006, the average Fortune 250 CEO was paid over 600 times the average worker.”

• According to a worldwide pay report, “U.S. CEOs are paid more than twice as much as Canadian CEOs, nearly three times as much as British CEOs, and four times as much as German CEOs.”

• “The . . . CEOs of the 250 largest U.S. companies . . . received an average of $18.8 million each in 2006, an increase of 38% in just one year.”

• “In 2004, CEO income grew 30% after gains of 15% in 2003 and 9.57% in 2002, . . . . [while] working stiffs see their income go up by 2% or 3% a year . . . .”

Stock Options: Hearing Before the Senate Homeland Security and Governmental Affairs Subcommittee, 110th Cong., at 3 (statement of Jeffrey P. Mahony, General Council, Council of Institutional Investors), available at 2007 WLNR 10466107 (June 5, 2007) (Part 1). “Through this strange but very tempting little loophole, truckloads of option grants were delivered to executives with no expense to the companies granting them. Because of this same loophole, hundreds of billions [in] shareholder value were transferred to executives with virtually no controls or limitations.” Id. at 2, available at 2007 WLNR 10466088 (Part 2).

26 Smith, supra note 24, at B13. See also Donna Jablonski, Outrageous CEO Pay Costs Workers, AFL-CIO Tells Congress, available at http://blog.aflcio.org/2006/05/25/outrageous-ceo-pay (“Today the average pay for the CEO of a major company is 431 times the worker’s average pay, up from 42 times in 1980 . . . .”). “[T]he spread between the pay of Cisco’s CEO John Chambers and that of his average employee is 2,300:1.” Leo Hindery, It Takes a CEO, 79 (2005).

27 Majority Staff, U.S. House of Rep. Committee on Oversight and Government Reform, Executive Pay: Conflict of Interest Among Compensation Consultants 1 (Dec. 2007) [hereinafter Compensation Consultants’ Conflict of Interest Report]. “Up through the 1970’s, a [CEO’s] pay was generally linked to that of his underlings in a geometrically proportional relationship known as the ‘golden triangle.’ Now CEOs have their own alchemy triangle of golden handshakes, golden parachutes and golden retirements.” Sklar, supra note 5. “The ratios of compensation that served the nation so well for so many decades should not have changed to the degree they have, and they must be corrected by a combination of tax policies and regulatory and shareholder resistance.” Mark Fortier, Former Telecom CEO Leo Hindery on CEO Responsibilities, Pay, and Ethics, available at http://www.frugalmarketing.com/dtb/leo-hindery.shtml. (quoting Leo Hindery) (emphasis added).

28 Sklar, supra note 5 (Towers Perrin prepared the report).

• “[T]he compensation of the five highest-paid executives at public companies climbed to 9.8% of the companies’ aggregate earnings in the 2001-2003 period, from 5% of . . . aggregate earnings in the 1993-1995 period.”

• “If the average pay for factory workers had grown at the same rate as it has for CEOs, their 1999 earnings would have been $114,035, rather than $23,753.”

• “If the minimum wage had risen as fast as CEO pay, it would now be $24.13 per hour, instead of $5.15 . . . .”

• “[In the 1950’s] your typical CEO made twice as much as your typical president of the United States. . . . Today, your average CEO makes more than sixty-two times as much as your average U.S. president.”

• “75% of major institutional investors [surveyed] said that CEO compensation at large companies was excessive.”

This piracy has victims. Three consequences are especially disturbing. First, a study links excessive CEO compensation with the likelihood that a corporation will default on its credit obligations. The
resulting corporate bankruptcies mean unemployment and evaporated retirement plans for rank-and-file employees.\textsuperscript{37}

Second, even when the excessive compensation does not drive the company into bankruptcy, “excessive pay packages tied to the company’s stock price or operating performance . . . encourage executives to take greater risks.”\textsuperscript{38} The structure of a CEO’s compensation package can lead to wild swings in the company’s financial position, triggering layoffs for employees and greater volatility in stock prices for shareholders.

EXAMPLE #3. Bob Bluebeard ("Bluebeard") is CEO of Scurvy Dog Inc. Scurvy Dog pays Bluebeard $1 million in fixed salary\textsuperscript{39} and a bonus based on the excess of current year earnings over the previous year earnings. Also, Bluebeard holds stock options to buy 20 million shares of the corporation’s stock. In addition, Scurvy Dog will pay Bluebeard a huge severance amount if it fires him.\textsuperscript{40} As a result, Bluebeard has powerful incentives to greatly inflate the year-end stock price and earnings,\textsuperscript{41} but his incentive to promote long-term stability is comparatively minor. If Bluebeard’s get-rich-quick schemes for Scurvy Dog fail and he

\textsuperscript{37} When Enron declared bankruptcy, thousands of “Enron’s rank-and-file employees [lost] virtually all of their retirement savings,” and their jobs. Enron Compensation Report, supra note 6, at 37. \textit{See also} Leslie Cauley, \textit{Rigas tells his side of the Adelphia story}, USA Today, Aug. 6, 2007, at 2B (The government “laid out the complaint that accused the Rigases of ‘systematically looting’ Adelphia and costing investors more than $60 billion.”). WorldCom declared bankruptcy after loaning its CEO Bernie Ebbers $408 million. Seattle Times staff and news services, \textit{2002 will be remembered as the year executives paid the price for cooking their books; Wall Street shame}, Seattle Times, Dec. 29, 2002, at E1, available at 2002 WLNR 1685755.

\textsuperscript{38} Cove, \textit{supra} note 36, at 12 (referring to comments from Moody’s Investor Service).

\textsuperscript{39} Under IRC § 162(m)(1), a corporation can only deduct the first $1 million of fixed compensation it pays to its CEO each year.

\textsuperscript{40} Corporations often agree to pay mega-severance packages to “supercharge the offer . . . to create an incentive for a [new CEO] to come in.” Claudia H. Deutsch, \textit{Executive Pay; My Big Fat C.E.O. Paycheck}, N.Y. Times, April 3, 2005, at 31, available at 2005 WLNR 5181447. In these situations, “rich severance” provides a “soft landing.” \textit{Id}.

\textsuperscript{41} Stock options “prompted some managers to time decisions to pump up the stock just when their options vested.” \textit{Id}.
is fired, Scurvy Dog will pay him an enormous amount under
the severance plan. Although Scurvy Dog’s employees and
shareholders likely desire steady growth and fiscal
responsibility, Bluebeard desires either huge returns
immediately that generate a stock option fortune and a bonus
bonanza, or complete failure and a fast termination that allow
him to receive a severance plan windfall.42

Third, “[s]kyrocketing executive pay . . . has an overall effect on our
regard for the market and economy, and our sense of whether America
operates by the principles of fair play and just reward.”43 “Wretched excess”
is “socially corrosive.”44 Professors Bebchuk, Fried, and others have
examined the negative impacts of excessive executive compensation in
depth.45

Savvy CEO pirates use multiple weapons to abscond with a
corporation’s cargo.

- If the company’s stock price goes up, stock options allow the CEO
pirate to salt away riches even if the corporation’s stock does not keep
pace with the market or the industry average.

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42 See John M. Connor, Thinking Creatively About Remedies? How High Do Cartels Raise Prices?
Implications for Optimal Cartel Fines, 80 Tul. L. Rev. 513, 520 n.37 (2005) (“[T]he reward structure of
executive compensation contracts typically give short-term personal enrichment a greater weight in
executive decisions than the long-run interests of stockholders.”).
43 Pavia, supra note 30, at 8.
44 Hindery, supra note 26, at 78 (“wretched excess”); Nocera, supra note 31, at B1 (“socially corrosive”).
45 See Lucian Bebchuk and Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive
Compensation, 8-9 (2004) (“[P]aying executives hundreds of times what other employees get is inherently
unfair and unacceptable . . . [but we] would accept compensation at current or even higher levels as long as
such compensation, through its incentive effect, actually serves shareholders.”); Mark A. Clawson, Indexed
31, 43 (1997) (“[T]he effect on morals and morale . . . is the problem.”); Susan Lorde Martin, The
executive pay is the main reason for the loss of American jobs in the last decades.”).
• If the company’s stock price goes down, the CEO may ravage the company’s reserves under a severance arrangement.

• In addition, savvy CEO pirates can use various fringe benefits to personally pocket the corporation’s money.

A. Swashbuckling Stock Option Schemes for Scallywag CEOs.

According to investment wizard Warren Buffet, “[t]here is no question . . . that mediocre [executives] are getting incredibly overpaid. And the way it’s being done is through stock options.”46 Stock options may allow a CEO to make out like a bandit even when the company’s performance is miserable compared to the rest of the industry, or even the stock market in general.47

EXAMPLE #4. When Davy Jones became the CEO of Skull-and-Cross-Bones Inc. nine years ago, the corporation’s stock price was $100 a share, and Davy was given stock options on one million shares. Skull-and-Cross-Bones Inc. has performed poorly. If Skull-and-Cross-Bones Inc. had kept pace with its competition, its stock price would be $170, and if it had merely kept pace with the stock market in general, its stock

46 Bebchuk & Fried, supra note 45, at 143 (2004). “[E]xercised stock options are still the main component of [executive] pay. In 2006, stock gains (value realized from exercised stock options) accounted for 48% of $7.5 billion earned by the 200 bosses [Forbes] tracked.” Year By Year: The Highest Paid Bosses, available at http://www.forbes.com/2007/05/03/historical-ceo-pay-lead-07ceo-cx_sd_0503historypay.... “CEO pay has been skewed upward enormously by the huge increase in the frequency, scale, and value of options awards.” Leo Hindery, supra note 26, at 72-73.

47 Professors Bebchuk and Fried state:

[C]hanges in share price are not a good indicator of a manager’s own performance. A company’s stock price can increase for reasons that have nothing to do with its managers’ own efforts and decision making. Falling interest rates, for example, can cause stock prices to increase considerably without managers lifting a finger. Indeed, one study of U.S. stock prices over a recent ten-year period reported that only 30 percent of share price movement reflects corporate performance; the remaining 70 percent is driven by general market conditions. If performance is measured by changes in share price, managers who perform poorly relative to their peers might still be rewarded when the market or sector rises as a whole.

Bebchuk & Fried, supra note 45, at 139.
price would be $150. Under Davy’s leadership, the stock price for Skull-and-Cross-Bones Inc. has only increased to $120. Nevertheless, in year 9, Davy exercises the options, sells the stock he acquires, and reaps a $20 million bonanza.\footnote{48 Davy will pay income tax on the gain when he exercises the stock options. Treas. Reg. § 1.83-7(a) (2003); Neal A. Mancoff & David M. Weiner, Nonqualified Deferred Compensation Arrangements, § 4.05, page 4-13 (2001).}

The amounts plundered with stock option schemes are staggering.


- Walt Disney’s CEO Michael Eisner must have thought he was in the Magic Kingdom when he received about $600 million from stock options in one year.\footnote{Susan Chandler, \textit{‘Golden Hellos' Still Glitter}, Chi. Trib., July 19, 2005, at C1.}


- Fidelity National Financial’s CEO William P. Folley should have felt secure in 2006. Most of his $180 million in compensation was from exercised stock options.\footnote{Scott DeCarlo, \textit{supra} note 53.}
• Yahoo’s CEO Terry Semel must have shouted and laughed all the way to the bank in 2006. Most of his $174 million in compensation was from exercising stock options.\textsuperscript{56}

• Coach CEO Lew Frankfort received something better than a bucket of Gatorade over his head in 2004 -- new stock options worth approximately $130 million.\textsuperscript{57}

• “Bank of America CEO Kenneth Lewis bolstered his take-home pay of $23 million by exercising $77 million of stock options [in 2006].”\textsuperscript{58}

• Wells Fargo CEO Richard Kovacevich stashed $62 million in his personal wagon train from the exercise of stock options in 2006.\textsuperscript{59}

• Advance Auto Parts CEO Michael Coppola can buy a new car, and need not bother repairing an old clunker. He drove away with $42 million in stock option profits in 2005.\textsuperscript{60}

B. \textit{Severance Pay Pirates}.

Severance pay plans allow a CEO pirate to grab a fortune as he sails off into the sunset, even if the price of the company’s stock has declined. Departing CEOs can sneak away with staggering amounts.

• “UnitedHealth Group CEO William McGuire will get an estimated $1.1 \textit{billion} retirement package when he steps down.”\textsuperscript{61}

\begin{flushleft}
\textsuperscript{56} \textit{Id.}
\textsuperscript{58} Farrell & Hansen, \textit{supra} note 53, at 2B.
\textsuperscript{59} \textit{Id.} at 3B.
\textsuperscript{60} Council on International and Public Affairs, \textit{supra} note 57.
\end{flushleft}
• Exxon Oil executive Lee Raymond slipped away with an “outrageous” $400 million retirement package that included stock options.  

• Home Depot’s former CEO Robert Nardelli has plenty of cash for those home improvement projects. He grabbed a $210 million severance package when he left after 6 years. During his reign, Home Depot’s stock price dropped 7.9%.  

• “The contract of L. Dennis Kozlowski at Tyco International called for an immediate payment of about $135 million if he was dismissed, and a retainer of $3.4 million annually for the rest of his life.”  

• Disney’s Michael Ovitz danced away with a severance package of $130 million after his 14-month term as president. Apparently his wish-upon-a-star came true!  

• Morgan Stanley’s former CEO Phillip Purcell has a nice investment portfolio to manage these days – his own! He ran out the door with a severance package of $113 million.  

• American Express’s Kenneth Chenault should be able to pay his credit card bills if he becomes unemployed. He will receive $109 million when he walks away if the company is acquired.  

• Gillette CEO James M. Kilts can afford one of those fancy electric shavers with the rotating blades. He personally pocketed approximately $95 million when he helped sell the company to Proctor & Gamble.  

62 Larry Elder, It’s the debate on profits that’s obscene, Daily Breeze (Torrance, CA), May 14, 2006, available at 2006 WLNR 8324875.  
63 Smith, supra note 24, at B13 (“[H]e waltzed away with a mind-boggling good-bye gift worth more than $30 million for each year he worked there.”).  
64 Id.  
65 Deutsch, supra note 40, at 31. Kozlowski ultimately resigned and released Tyco from the terms of the agreement. Id.  
68 Farrell & Hansen, supra note 53, at 1B.  
• Pfizer’s CEO Henry McKinnel should not need anti-depressants if he becomes unemployed. He will be “eligible for an $83 million lump sum payment when he leaves.”

• Hewlett-Packard reportedly paid CEO Carly Fiorina $42 million in severance pay, even though HP’s equity dropped 60% during her term. The arrangement has been described as a “pay for failure” contract.

• Morgan Stanley’s Steve Crawford, age 41, can begin saving for retirement. He waltzed out the door with $32 million of severance pay after he served as president of the company for three months.

• Citigroup CEO Chuck Prince will get more than a gold watch, a pat-on-the-back, and an “atta-boy” when he departs. Prince will be treated like royalty, receiving “an estimated $29.5 million when he retires.”

• Fannie Mae paid CEO Franklin Raines $26 million when he left. Fannie Mae lost almost $9 billion during his term.

• May Department Stores CEO Gene Kahn left with more loot than most shoplifters. He raced out the door with a $12 million severance package, although the company’s profits fell 50% in five years while he was in charge. Apparently, no alarm went off, and no security guards chased him.

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70 Jablonski, supra note 26.
71 Pavia, supra note 30, at 8 (“I guess there’s nothing better than collecting for a job not well done.”); but see H. D. Maynard, Editorial, Failure Shouldn’t Pay, St. Louis Post Dispatch, July 22, 2005, at B8 (reporting that HP paid Fiorina $21 million).
72 Deutsch, supra note 40, at 31.
73 Gasparino & Joseph, supra note 67 (“Many big Morgan shareholders – who’ve watched the firm’s stock fall from more than $100 a share to about $54 in recent years – are outraged particularly about the pay for Crawford who was never a star banker or big moneymaker at the firm.”).
76 Maynard, supra note 71, at B8.
• Nike paid CEO William Perez $5.5 million in severance when he resigned after a little over a year on the job.\textsuperscript{77}

C. Fringe Benefit Bandits.

Many CEOs substantially supplement their treasure with fringe benefits. “[T]he amount of money paid to CEOs in the form of perks spiked 130% from 2005 to 2006.”\textsuperscript{78}

• Citigroup Inc. of New York “stuffed [Chairman Stanford I. Weill’s] pockets with $21.5 million in pay [in 2005].”\textsuperscript{79} In addition, the company paid his income taxes (likely costing the company approximately $17.5 million),\textsuperscript{80} the cost of his personal use of a private jet (worth $524,000); and the fees for his personal financial advice ($85,714).\textsuperscript{81}

\textsuperscript{77} Michael Brush, \textit{Most outrageous CEO perks of 2006 – so far}, available at http://articles.moneycen\textsuperscript{tral.msn.com/Investing/CompanyFocus/MostOutrageousCEOPerk}. . .

\textsuperscript{78} Farrell & Hansen, \textit{supra} note 53, at 2B. The Corporate Library, a “corporate governance monitoring group,” provided the statistic. \textit{Id}.

\textsuperscript{79} Pavia, \textit{supra} note 30, at 8.

\textsuperscript{80} The formula for calculating the total amount of compensation that a company must pay for the employee to receive a fixed amount plus the income tax on that amount (and the income tax on each subsequent tax reimbursement payment) is the fixed amount divided by 1 minus the tax rate. \textit{See} Boris Bittker & Lawrence Lokken, \textit{1 Federal Taxation of Income, Estates, and Gifts}, \textsection{5.8.2}, at page 5-71 (3d ed. 1999). For example, if the corporation agreed to pay the executive $21.5 million plus the federal and state income taxes on the initial amount and on all tax reimbursements, the company would pay the employee over $39 million based on a 45% combined federal and state income tax rate [$21.5 million divided by (1-45%) = $39,090,909]. Commentators are especially critical when a company pays an executive’s tax bill.

Sticking shareholders with a CEO’s tax bills generated by perks strikes some as a bit over-the-top. “Tax gross-ups for perks seem farcical to me . . . . I’d love for my boss to pay my tax. It’s not as though they’re getting nothing for it. They’re receiving a benefit.”


The use of tax gross-ups . . . has gotten out of control . . . “It’s the Leona Helmsley provision,” . . . referring to the hotel magnate who once said, “only the little people pay taxes.”

“‘It’s the ultimate in pigginess . . . . It adds insult to injury, and then adds a little more injury.’”


\textsuperscript{81} Pavia, \textit{supra} note 30, at 8.
• Tyco allowed its CEO Dennis Kozlowski to use an $18 million Manhattan apartment. Tyco also provided Kozlowski with a pair of $30,000 opera glasses, a $16,000 dog-shaped umbrella stand, and a $6,000 shower curtain. In addition, Tyco paid for a $2 million birthday party for Kozlowski’s spouse on the Italian island of Sardinia.  

82 Jimmy Buffet was flown in to sing “Happy Birthday.”

83 Under his reign, Tyco shareholders lost $80 billion in value on their stock.

• Starwoods Hotels & Resorts Worldwide helps its CEO rest, relax, and travel in style. The company pays $1.5 million annually for his air travel so that he can live in California and commute to work in New York.

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• General Electric’s former CEO Jack Welch enjoys posh housing, including a Manhattan apartment for life, country club memberships, wine and laundry services, the use of a corporate jet, and Red Sox tickets, all at the company’s expense, even though he is retired.

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• Tyson Foods’ former CEO Don Tyson may be dining on filet mignon, instead of chicken nuggets. The company helps him enjoy a champagne and caviar lifestyle by providing “more than $1 million in perks, including a vacation home in the English countryside; a home and yacht in Cabo San Lucas, Mexico; housekeeping services totaling $203,000; and $84,000 in landscaping.”

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83 Farrell & Hansen, supra note 53, at 2B.

84 Carter, supra note 82, at A46; Mike Drummond, Firms with Solid Ethical Footing can Still Recover when Leaders go Astray, The Charlotte Observer, May 2, 2005; Ellen Frank, The Great Stock Illusion, Dollars & Sense, Nov. 1, 2002, at 14 (“By the time Kozlowski quit Tyco under indictment for sales tax fraud in 2002, $80 billion of Tyco’s shareholder wealth had evaporated.”).

85 Brush, supra note 77.


87 Farrell & Hansen, supra note 53, at 2B.

• “Qwest CEO Richard Notebaert [found riches, getting] $332,000 for personal use of a corporate jet, $62,000 for financial and tax-consulting services, and $56,000 for a personal assistant and office expenses. Because those perks generated extra income tax liability for him, Qwest paid him another $197,000 to cover those taxes.”

• Nike paid $579,649 for remodeling the CEO’s home.

III. WHY THE PIRATES PLUNDER WITH IMPUNITY

Analysts have identified several reasons why the normal competitive forces of supply and demand fail to keep CEO compensation reasonable. At publicly held corporations, the board of directors is responsible for reviewing the top executives’ compensation. A director has “various economic incentives to support, or at least go along with, arrangements favorable to the company’s top executives.” These incentives include:

• The top executives can direct business, either now or in the future, to the enterprise that the director regularly works for.

• The top executives can influence how much the directors are paid for serving as directors.

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89 Farrell & Hanson, supra note 53, at 2B.
90 Brush, supra note 77.
91 Id. at 4. “Boards of large public companies delegate to compensation committees the task of working out the critical details of executive compensation arrangements.” See Bebchuk & Fried, supra note 45, at 24.
92 As an example, “Verizon’s 2001 board [of directors] included an executive director of Boson Consulting Group, which received $3.5 million from Verizon for services [rendered] in 2000; the CEO of a railroad that was paid $650,000 for services and products; and two attorneys from law firms that provided Verizon with legal services.” Id. at 27.
93 Director compensation can be substantial. “Pearl Meyer [& Partners]’s data show that average total compensation of directors at 200 large companies probably topped $200,000, up from an average of $176,000 the previous year.” Deutsch, supra note 40, at 31. “The total annual compensation (including equity awards) per director in S&P 500 companies, according to a 2005 Spencer Stuart study, was on
• The top executives can influence whether an individual will be re-elected as a director. “There is no such thing as an independent director if C.E.O.’s are picking them.”

• The top executives can direct charitable contributions to institutions that a director supports.

• “Various social and psychological factors – collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes loyalty and friendship” – can prevent a director from challenging top executive compensation.

• Many directors are current (or retired) highly-paid executives, and may experience cognitive dissonance on compensation decisions. “Individuals are know to develop beliefs that support positions consistent with their self-interest. These beliefs enable individuals to avoid the discomfort of enjoying benefits that they believe to be undeserved.”

• “[L]imitations on time and resources have made it difficult for even well-intentioned directors to do their pay-setting job properly.”

average $136,360.” Robert C. Pozen, If Private Equity Sized Up Your Business, Harv. Bus. Rev., Nov. 1, 2007, available at 2007 WLNR 25827141. “In 2002, director compensation averaged $152,000 in the largest 200 companies and $116,000 in the largest 1,000 companies.” Bebchuk & Fried, supra note 45, at 25. In 2002, directors at the Fortune companies spent an average of 190 hours on board service, resulting in compensation of approximately $508 per hour. Id. at 37. “As the Company leader, usually as a board member, and often as board chair, the CEO has some say over director compensation . . . . [D]irectors who are generous with the CEO might reasonably expect the CEO to use his or her bully pulpit to support higher director compensation.” Id. at 30.

94 Nocera, supra note 31, at B12 (quoting Nell Minow of The Corporate Library, a shareholder watchdog group). “Boards [likely will not] nominate a director clearly opposed to the CEO. At a minimum, CEOs have had considerable power to block nominations. Thus, sparring with the CEO over . . . compensation could only hurt a director’s chance of being renominated . . . .” Bebchuck & Fried, supra note 45, at 26 (quoting Daniel Nasaw, Opening the Board: The Fight Is on to Determine Who Will Guide the Selection of Directors in the Future, Wall St. J., Oct. 27, 2003, at R8).

95 For example, Oracle made contributions to Stanford while three Stanford University professors were on the Oracle board of directors. Bebchuck & Fried, supra note 45, at 28.

96 Id. at 4.

97 Bebchuck & Fried, supra note 45, at 33 (A 2002 study reported that 41% of directors on compensation committees are active executives (approximately 20% are active CEOs), and 26% are retired and most them are former executives. Id. (citing Burke, Davis, Loayza, Murphy and Schuchner, Board Structure/Board Pay 2002, 47 (2002)).

98 Id.
- Frequently publicly held corporations hire compensation consultants to provide comparative data and other information to the board of directors, but over 60% of the time these consultants have a conflict of interest. “In many cases, the consultants who are advising on executive pay are simultaneously receiving millions of dollars from the corporate executives whose compensation they are supposed to [analyze].”

As a result, “[e]xecutives and boards often form cozy cabals that shortchange shareholders because they allow executives to put their own interests first.” Thus, although it may be persuasively argued that a professional athlete deserves his or her elephantine compensation package because it results from arm’s length bargaining between unrelated parties with adverse interests, analogous arguments are not applicable to executive compensation at publicly held corporations.

IV. THE LAW OF UNINTENDED CONSEQUENCES, COLLATERAL DAMAGE, AND 409A

Influential sociologist Robert Merton’s “law of unintended consequences” provides that “actions of people – and especially of

99 Compensation Consultants’ Conflict of Interest Report, supra note 27, at i; id. at 4 (“In 2006, 113 of the [179 corporations reporting] paid the same consultant to provide other services for the company in 2006.” If the consultant received $10,000 or less for other services, that was not considered a conflict of interest. Id. at 4 n.16.
101 In law and economics analysis, this failure of directors to bargain at arm’s length with executives is an example of the “agency problem” in which the agents (in this case, the directors) do not share the same economic incentives as their principals (the shareholders). See T.P. Gallanis, The Trustee’s Duty to Inform, 85 N.C.L. Rev. 1595, 1615 (2007) (“The agent’s incentives are not aligned with the principal’s incentive because it is the principal’s wealth, not the agent’s, at stake . . . . The result is that the agent will not work as hard as he would if he were the principal . . . . The losses that result from this misalignment are known in the law and economics literature as agency costs.”).
government – always have effects that are unanticipated or ‘unintended.’”

Merton’s related four-step method of analysis can assist in evaluating a law or other action, such as 409A.

First, one must identify the purpose or goal. After unintended consequences arise, there is a risk people will engage in post-facto rationalizations rather than acknowledging the intended purpose or goal. “Rationalizations may occur in connection with nation-wide social planning just as in the classical instance of the horseman who, on being thrown from his steed, declared that he was ‘simply dismounting.’”

Second, after identifying the purpose or goal, one considers the consequences – both the intended consequences and the unintended consequences.

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102 “The law of unintended consequences, often cited but rarely defined, is that actions of people – and especially of government – always have effects that are unanticipated or ‘unintended.’” Rob Norton, The Concise Encyclopedia of Economics – Unintended Consequences, available at http://www.econlib.org/LIBRARY/Enc/UnintendedConsequences.html; see also Margaret Howard, The Law of Unintended Consequences, 31 S. Ill.U. L.J. 451, 451 (2007) (“[T]he law of unintended consequences . . . holds, quite simply, that actions have unforeseen effects.”). Professor Merton described his method of analysis in his breakthrough article. Robert K. Merton, The Unanticipated Consequences of Purposive Social Action, 1 Am. Soc. Rev., 894, 896 (1936), available at http://www.compilerpress.atfreeweb.com/Anno%20Merton%20Unintended.htm. Although not denying that unintended consequences occur, its status as a “law” has been challenged. The Law of Unintended Consequences has a feeble linguistic claim on the term “law.” It is hardly a scientific law; even Murphy’s law and natural law claim specific outcomes with some certainty. But this term persists as a solemn warning against certain disorder, that almost all human actions have at least one unintended consequence . . . . In other words, each cause has more than one effect, and will include unforeseen effects. Less of a law or rule itself, it is more a call to decision makers to beware. Wikipedia, Unintended Consequences, available at http://en.wikipedia.org/wiki/Unintended_consequence.

103 Merton, supra note 102, at 896.

104 Id.
Third, the unintended consequences are assigned among three categories.

- **Beneficial Consequences** -- unintended consequences that help achieve the purpose.

- **Unrelated Consequences**, including **Collateral Damage** – unintended consequences that have no bearing on the achievement of the purpose (for example, a law intended to curb an abusive activity impacts individuals or entities not engaged in the abusive activity).

- **Perverse Consequences** – unintended consequences that not only fail to advance the goal, but actually exacerbate the problem. For example, in an attempt to reduce CEO compensation, “Congress passed a law [in 1993] eliminating the tax deduction for any executive salary that exceeded $1 million . . . . [The law actually increased executive salaries because] it made $1 million the new salary floor.”

Fourth, according to Professor Merton, rather than always attributing unintended consequences “to the inscrutable will of God or Providence or


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105 The following illustrates collateral damage.

**EXAMPLE #5. Quotas on Steel Imports.** “[T]he United States has imposed quotas on imports of steel in order to protect steel companies and steelworkers from lower-priced competition. The quotas . . . help steel companies. But they also make less of the cheap steel available to U.S. automakers. As a result the automakers have to pay more for steel than their foreign competitors . . . . So [a] policy that protects one industry from foreign competition makes it harder for another industry to compete . . . .”


106 See Wikipedia, *Unintended Consequences*, supra note 102 (discussing the different types of consequences). An example of a “perverse” consequence is the “Streisand Effect [which] occurs when an attempt to censor or remove a certain piece of information (such as a photograph, file or website) instead causes the information in question to become widely known and distributed in a very short time.” *Id.*

107 “In the hall of unintended consequences . . . that has to rank right near the top.” Nocera, *supra* note 31, at B12 (quoting Nell Minow of The Corporate Library, a shareholder watchdog group).
Fate,”\textsuperscript{108} we can trace unintended consequences to one of the following five factors:

(i) Ignorance.\textsuperscript{109}

(ii) Error.\textsuperscript{110}

(iii) The “imperious immediacy of interest” – the actor is so concerned with the short-term consequences that potential long-term consequences are ignored or disregarded.

(iv) Basic values – actions are taken because of “certain fundamental values” without considering further consequences. As an example, “[t]he Protestant ethic of hard work and asceticism . . . paradoxically leads to its own decline through the accumulation of wealth and possessions.”\textsuperscript{111}

(v) Self-defeating prophecy -- Fear about an anticipated consequence results in an action that prevents the anticipated problem from developing. As an example, fear of over-population and mass

\textsuperscript{108} Merton, supra note 102, at 894. Researchers have traced the principle back to the “Scottish Enlightenment and consequentialism.” Wikipedia, Unintended Consequence, supra note 102.

\textsuperscript{109} Professor Merton notes that because of the “exigencies of practical life” people frequently must act in the absence of complete information. As a result, people act on “opinion and estimate.” Merton, supra note 102, at 899.

\textsuperscript{110} Professor Merton states that “[e]rror may intrude itself . . . in any phase of purposive action: we may err in our appraisal of the present situation; in our inference from this to the future objective situation; in our selection of a course of action; or finally in the execution of the action chosen.” Merton, supra note 102, at 900.

\textsuperscript{111} Id.
starvation inspired “scientific breakthroughs in agricultural production” that has diminished the risk of over-population.\footnote{Courses/CS 461/Museum of Unintended Consequences, available at http://cs.calstatela.edu/wiki/index.php/Courses/CS_461/Museum_of_unintended_consequences.}

This Article asserts that although the government’s original purpose was to curb outrageous CEO compensation with income tax rules, 409A will fail to advance that purpose. The government made several errors, and instead of achieving the original purpose, 409A will trigger unintended consequences for innocent bystanders – namely small businesses, charities and their employees. The particular type of unintended consequence will be collateral damage. Military analysts often use the term “collateral damage” to describe damage to the property of non-combatants.\footnote{Wikipedia, Collateral Damage, available at http://en.wikipedia.org/wiki/Collateral_damage. “The term ‘collateral damage’ has also been borrowed by the computing community to refer to the denial of service to legitimate users when administrators take blanket preventative measures against some individuals who are abusing systems.”.} 409A will inflict needless costs on small businesses and charities, and will impose unfair taxes on their employees.

V. OFF COURSE: ERRORS TRIGGERED 409A’s UNFORESEEN CONSEQUENCES

In analyzing 409A in the context of the law of unintended consequences, the initial action was the congressional call to study the problem of outrageous executive compensation at publicly held
The purpose was to curb CEO piracy and eliminate the resulting hardship on the victims – employees, shareholders, and society in general. This Part discusses four key errors the government made along the voyage that resulted in the 409A shipwreck.


In early 2002, Enron was an easy starting point for gathering information on corporate excess. Enron was a huge publicly held corporation. It was seventh in the Fortune 500 with over 25,000 employees. Enron declared bankruptcy on December 3, 2001, and the government prosecuted Enron’s top executives on various criminal charges. These proceedings provided the Joint Tax Committee with substantial information. The Joint Tax Committee produced a 732-page report.

It appears that the government did not gather data on other publicly held corporations in developing 409A. The legislative history refers only to

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114 Senators Max Baucus and Charles Grassley of the Senate Committee on Finance requested that the Joint Tax Committee study executive compensation at Enron in February of 2002. Enron Compensation Report, supra note 6, at 1.
115 See supra notes 36 - 45 and accompanying text.
116 Enron Compensation Report, supra note 6, at 5.
117 Id. at 575.
119 The report discusses Enron’s compensation practices and its strategies to save income taxes. See Enron Compensation Report, supra note 6, at 5-11.
the Enron Compensation Report, stating “[t]he staff of the Joint Committee on Taxation made recommendations similar to [409A] in the [Enron Compensation] Report.”

Enron was a bad example for Congress to use in designing rules for all publicly held corporations because Enron was not typical. The government brought criminal charges against approximately twenty Enron executives, and the corporate culture at Enron was notorious. The behavior at Enron was so remarkable that it inspired some particularly inventive people to create “ENRON THE MUSICAL!” Although Enron was an interesting page in corporate America’s history book, Enron represents a better example of executives behaving badly than business as usual.


121 One commentator states,

Alex Gibney’s documentary “Enron: The Smartest Guys in the Room” – based on the book of the same title – gives a precise history of the characters and events that lead up to the collapse of the mammoth energy trading company. Forget Johnny Depp [star of the “Pirates of the Caribbean” movies] – if you want a real tale of audacious thievery, this one is ripe with skullduggery as the film shows a crew of bloated egos in pricy suits ravish the United States for extreme profit.


If Congress wanted to rewrite the compensation tax rules for all publicly held corporations, the empirical research should have stretched far beyond Enron. The government could have analyzed SEC filings, which can provide valuable information about executive compensation, including NQDC and other benefits paid to top executives.\textsuperscript{123} The government also could have studied survey reports prepared by consultants who regularly assist publicly held corporations in establishing compensation arrangements, such as Clark Consultants, Buck Consultants, or WatsonWyatt.\textsuperscript{124}

B. \textit{Error #2 – The Government Failed to Address the Key Enron Problems.}

The pirates at Enron used a stock option scheme to fleece the company. The year before Enron went bankrupt, Enron’s 200 highest-paid executives took a total of over $1 billion in stock option compensation, an average of over $5 million per executive.\textsuperscript{125} Stock options represented almost 75\% of the total compensation Enron provided to these top

\begin{footnotes}
\item[123] Information on NQDC plans may be reported on SEC Form S-8, and information on NQDC benefits for “named executive officers” may be listed in proxy statements. See OptCapital, Securities Law, \textit{available at} http://www.optcapital.com/content66.html.
\item[125] Enron’s top 200 executives received $1.063 billion from stock options in 2000. Enron Compensation Report, \textit{supra} note 6, at 547.
\end{footnotes}
executives. Nevertheless, the Joint Tax Committee merely states that Enron’s stock option plan appears to comply with existing law, and makes no recommendation for change or study. Thus, the Joint Tax Committee tacitly blesses a key tool that CEO pirates use to loot publicly held corporations.

Another key problem was that Enron’s board of directors failed to negotiate the top executives’ compensation at arm’s length.

[The investigation] reveals a process which rested approval of executive compensation packages almost entirely with internal management. Although the Compensation Committee of the Board of Directors formally approved both the total amount of compensation paid to executives and the form of such compensation, the Committee’s approval generally was a rubber stamp of recommendations made by Enron’s management.

Enron’s compensation consultants (including Towers Perrin) were also part of the problem. Enron’s board of directors hired the consultants to prepare studies analyzing whether the top executives’ compensation was reasonable. “[I]n some cases, the studies appeared to be designed to justify whatever compensation arrangement management wanted to adopt.” In summarizing the procedures for reviewing executive compensation, the Joint

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126 In 2000, Enron paid its 200 highest-paid executives $1.424 billion, id. at 547, and $1.063 billion of that amount was from stock options. Id.
127 Id. at 41.
128 See supra Part II.A. regarding the use of stock options by top executives.
129 Enron Compensation Report, supra note 6, at 19 (emphasis added).
130 Id. at 36. The Committee on Oversight and Government Reform held hearings on the problem of compensation consultants’ conflicts of interest in December of 2007. See supra note 27.
Tax Committee stated, “Enron’s top executives essentially wrote their own compensation packages.” Nevertheless, the Joint Tax Committee made no recommendations for addressing the absence of arm’s-length bargaining.

C. Error #3 – The Government Focused on an Irrelevant Tangent – NQDC.

Rather than addressing the key problems, the Joint Tax Committee went off on a tangent. The Committee chose to focus its recommendations on nonqualified deferred compensation (“NQDC”), which was a particularly bizarre choice for three reasons. First, NQDC represented less than 5% of top executive compensation at Enron.132

Second, the Joint Tax Committee was outraged that certain Enron executives convinced the corporation to accelerate NQDC payments, but those accelerations did not benefit the executives.

EXAMPLE #6. Imagine that Bill Bilgewater, a top Enron executive, voluntarily elected to defer a portion of his salary each year into the Enron NQDC plan. Under the terms of the plan, Bilgewater would receive the deferred amounts (plus accrued interest) when he terminates employment. In addition, the Enron NQDC plan included a “haircut” provision.

131 Enron Compensation Report, supra note 6, at 36.
132 William A. Drennan, Enron-Inspired Nonqualified Deferred Compensation Rules: “If You Don’t Know Where You’re Going, You Might Not Get There,” 73 Tenn. L. Rev. 415, 434 n.94 (2006). From 1998 through 2000, NQDC represented only 4.72% of total compensation for Enron’s 200 highest-paid executives. For that period, total compensation (including NQDC) was $2.119 billion, and deferrals under the NQDC plans totaled $100 million. Id.
133 Several of the names used in this Article appear in, or are adopted from, a brochure titled “Captain Memo’s Pirate Cruise 2007.” The brochure is on file with the author and related information is available at www.captainmemo.com.
134 Under Enron’s NQDC plan, employees earning over $120,000 ($130,000 in 1999) could defer up to 35% of their salary and up to 100% of their bonus. Enron Compensation Report, supra note 6, at 606.
135 Id. at 608.
If Bilgewater requested to receive part or all of his NQDC benefits before terminating employment, and the company agreed, Bilgewater would receive 90% of the requested amount, and would forfeit the 10% balance. A month before Enron declared bankruptcy (on December 3, 2001), Bill Bilgewater requests his entire $100,000 balance out of the Enron NQDC plan. Enron consents and pays Bill Bilgewater $90,000. Bilgewater forfeits the $10,000 balance.

The Joint Tax Committee was incensed that Enron made special accelerated cash NQDC payments to its top executives shortly before thousand of Enron’s rank-and-file employees lost their jobs, and Enron shareholders saw their retirement savings disappear. The Committee recommended prohibiting accelerations of NQDC benefits, and recommended allowing employers to distribute NQDC benefits only upon an employee’s death, disability, separation from service, or other specified events.

Although the Enron 11th-hour distributions sound egregious, the Joint Tax Committee ignored a bankruptcy statute that prevents the executives from benefiting. Under the bankruptcy laws, because Enron’s top executives were “insiders,” the Enron bankruptcy trustee can recover all the

136 Id.
137 The Enron Compensation Report states that 181 of the 295 participants in Enron’s NQDC plan requested accelerated distributions, id. at 604, 622, and the company approved 109 of those requests. Id. at 611, 624.
138 The Joint Tax Committee asserted that these 11th-hour distributions prove that the executives had too much control over their NQDC benefits to justify the income tax deferral. Id. at 20 (“Changes should be made to the [NQDC] . . . rules . . . to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control, and flexibility with respect to deferred compensation.”).
139 Id. at 636.
140 Id.
accelerated NQDC payments made within one year of the date Enron declared bankruptcy.\footnote{See 11 U.S.C. § 547(b)(4) (2000); \textit{id.} § 101(31) (defining “insider”); \textit{see also} Drennan, \textit{supra} note 132, at 442-43.} In fact, the Enron bankruptcy trustee recovered over 20\% of the accelerated NQDC payments merely by mailing demand letters.\footnote{The bankruptcy trustee recovered $11 million of the $53 million paid merely by sending demand letters. EmployeeCommittee.com: Deferred Compensation, Update July 23, 2004, \texttt{www.employeecommittee.com/sr-deferred comp.asp} (last visited January 25, 2008).} The balance can be recovered through litigation.\footnote{\textit{See Current Issues in Executive Compensation,} 3 N.Y.U. J. of Law & Bus. 519 (Spring 2007) (“[Congress] failed to realize that $30 million or so . . . was recaptured in the Enron bankruptcy pursuant to existing law.”); Kathryn Kennedy, \textit{A Primer on the Taxation of Executive Compensation,} 35 J. Marshall L. Rev. 487, 520 (2002) (“[T]he bankruptcy court should have no problem treating these withdrawals as voidable and using the proceeds for Enron creditors.”). \textit{See also} Drennan, \textit{supra} note 132, at 442-43 (discussing \textit{In re} Bank Building & Equip Corp. of Am., 158 B.R. 138 (E.D. Mo. 1993), in which the bankruptcy trustee recovered NQDC payments made by the corporation to one of its directors within one year of the corporation’s bankruptcy).}

Third, although NQDC at Enron was trivial, typical corporations likely use NQDC even less than Enron. Enron was a uniquely fertile environment for NQDC benefits. As the Joint Tax Committee wrote in a 1987 report, a “usual tension”\footnote{\textit{Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986,} 654 (1987). The Joint Tax Committee discussed the “usual tension between an employee’s desire to defer tax on compensation and the employer’s desire to obtain a current deduction for compensation paid,” and concluded that this “usual tension” is absent if the employer is a tax-exempt entity. \textit{Id.}} normally restricts the use of NQDC. However, this usual tension was absent at Enron. The usual tension flows from the basic income tax rules that govern NQDC.

- A corporation cannot claim an income tax deduction for compensation until the amount is included in the employee’s taxable income.\footnote{\textit{IRC} § 404(a)(5).}

Thus, the corporation cannot claim a tax deduction until the
corporation pays the compensation. If the corporation and the employee agree to defer the payment of the compensation under a NQDC arrangement, the corporation cannot claim a tax deduction in the current year. As a result, a corporation generally will prefer to pay compensation to an employee in the current tax year and not enter into an NQDC arrangement.

- As a cash-basis taxpayer, an employee need not pay income tax on compensation until he or she receives the payment. If the employee does not need the compensation currently and plans to save the compensation for his or her retirement (or for the benefit of his or her heirs), the employee will prefer to enter into an NQDC arrangement with the employer and defer the receipt of the payment until a future year.

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146 The corporation can deduct the compensation payment if the amount is reasonable. IRC § 162(a).
147 Generally, an individual is a cash-basis taxpayer. See IRC § 446(a) (Taxable income “shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.”).
148 A cash-basis taxpayer generally need not include an amount in taxable income until he or she actually or constructively receives the amount. Treas. Reg. § 1.451-1(a) (1957). For a discussion on structuring a NQDC plan so that the employee is not taxed on the compensation before he or she actually receives the cash payment (before Congress enacted IRC § 409A), see Michael G. Goldstein, Michael A. Swirnoff, and William A. Drennan, Taxation and Funding of Nonqualified Deferred Compensation: A Complete Guide to Design and Implementation, 44-62 (1998).
tax year. The deferral will allow the employee’s savings to grow tax-free.

This “usual tension” did not exist at Enron. Enron had no incentive to pay compensation in the current year because the income tax deduction was meaningless to Enron. Through various income tax maneuvers, Enron developed a huge net operating loss (“NOL”) which could be used to offset taxable income that Enron otherwise might generate. As a practical matter, during the years involved, Enron was tax-exempt, and the availability of an income tax deduction was unimportant. Thus, even among publicly held corporations, Enron was peculiar. The government acted recklessly in developing rules for all publicly held corporations merely by studying Enron.


149 This assumes the employee is confident that the corporation will make the payment at the agreed upon time. If the employee believes the corporation will declare bankruptcy before the deferred payment date, or within one year of the deferred payment date, see supra notes 133-43, the employee will not agree to defer the compensation.


151 Enron Compensation Report, supra note 6, at 5-6, 634 (“Enron demonstrates that the theoretical tension between the employer’s interest in a current tax deduction and the employee’s interest in deferring tax . . . [had] little, if any, effect on the amount of compensation deferred by executives . . . because of [Enron’s] net operating loss carryovers . . . ”). IRC § 172 allows a corporation to carry an operating loss forward into a future tax year (for up to 20 years) to reduce the tax that the corporation otherwise would pay in that future year.

152 If Enron generated great amounts of taxable income over a period of years, the net operating loss would eventually be exhausted, and Enron would then begin paying tax on its income.
The report on Enron was the only empirical evidence Congress relied on\textsuperscript{153} in enacting 409A. In the past, Congress specifically limited the application of certain income tax rules on compensation to publicly held corporations.\textsuperscript{154} Nevertheless, 409A applies to all employers and employees that defer compensation, including closely-held corporations, subchapter S corporations, partnerships, and charities.\textsuperscript{155}

The compensation practices of small corporations and tax-exempt organizations are very different from large publicly held corporations because (i) the owners of closely-held corporations tend to bargain at arm’s length with unrelated executives,\textsuperscript{156} (ii) tax-exempt employers are subject to the detailed provisions of the “excess-benefit” rules when structuring executive compensation arrangements,\textsuperscript{157} (iii) closely-held corporations and tax-exempt organizations may spend less time and effort in designing complex compensation programs, including NQDC; and (iv) closely-held corporations and tax-exempt organizations are different because the board of directors (who set the compensation for the officers) typically own a majority of the corporation’s stock. In effect, every dollar paid to unrelated corporate officers reduces the return for the owner-directors.

In contrast, with a publicly held corporation, the directors typically own a tiny percentage of the corporation’s outstanding stock, and therefore lose almost nothing personally if the corporate officers are over-paid. Bebchuk & Fried, supra note 45, at 34 (“[D]irectors commonly bear only a negligible fraction of the cost imposed by flawed compensation arrangements.”).


\textsuperscript{154} See e.g., IRC § 162(m)(1) (the $1 million cap on tax deductions for fixed salary is applicable only to “publicly held corporations”); IRC § 280G(b)(5)(A)(ii)(I) (the “golden parachute” rules only apply if the stock of the corporation is “readily tradeable [sic] on an established securities market or otherwise”).


\textsuperscript{156} The dynamics of a closely-held corporation are different because the board of directors (who set the compensation for the officers) typically own a majority of the corporation’s stock. In effect, every dollar paid to unrelated corporate officers reduces the return for the owner-directors.

\textsuperscript{157} See IRC § 4958.
corporations and tax-exempt organizations may not utilize highly sophisticated consultants, attorneys and accountants to design compensation plans.

Rather than relying exclusively on information about Enron, the government could have used *information reporting requirements* to gather empirical data (on IRS Form W-2) about small businesses and charities. The government could have used that information to evaluate whether new compensation laws for small businesses and charities were needed.\(^{158}\)

Unfortunately, the government chose to apply 409A to small businesses and charities, and several unfortunate consequences are discussed in Part VII.

VI. 409A WILL HAVE NO IMPACT ON SAVVY CEO PIRATES

409A imposes mere timing rules. Basically 409A prohibits the employee (or the employer) from changing the date on which the employer deferred compensation.

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\(^{158}\) The IRS could gather the following types of valuable data with information reporting requirements:
- The types and percentages of employers actually allowing employees to defer a portion of their salary or bonus. For example, are S corporations, partnerships, and LLCs using NQDC? *See* Goldstein, *supra* note 148, at 213-4 (discussing the reasons these types of entities have little incentive to use NQDC arrangements for their owner-employees).
- The income level of employees who typically defer a portion of their salary or bonus, and the amounts deferred.
- The percentage of employees of tax-exempt entities who defer a portion of their salary or bonus, and the amounts deferred.
- The percentage of NQDC arrangements that are account balance plans, and the percentage that are defined benefit plans.
- The percentage of NQDC arrangements that are subject to a substantial risk of forfeiture, and the amounts involved.
- The percentage of NQDC arrangements in which the employee elects to defer compensation, and the percentage in which the employer defers supplemental compensation for the employee.
will pay a deferred amount. It has no impact on the *amount* of compensation the employer can pay.

**EXAMPLE #7.** Mike Mutiny is the CEO of Walk-the-Plank Inc., a publicly held corporation. Walk-the-Plank pays Mike Mutiny an annual base salary of $1 million and an annual performance bonus of $10 million if the company merely maintains its level of performance. Walk-the-Plank also contributes $5 million each year to a NQDC plan for Mike Mutiny’s benefit, and Mike Mutiny will receive his accrued NQDC benefit six months after he terminates employment. As long as the payments are made as scheduled, Mike Mutiny will incur no additional tax liability because of 409A. In fact, Walk-the-Plank could double, triple or increase the amount of the NQDC benefit by any other factor, and Mike Mutiny would have no problem under 409A.

Although the 409A rules are extremely lengthy and detailed, publicly held corporations and their high-paid executives will hire experts to help them safely navigate the waters of 409A. As a result, 409A will not curb the piratical practices of top executives.

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159 IRC § 162(m) merely requires that an amount be based on performance for the amount to be exempt from the $1 million cap. There is no requirement that the company base the amount on a significant improvement in performance (or for that matter, on any improvement in performance). *See* IRC § 162(m)(4)(C).

160 In addition, at least with respect to performance-based compensation such as bonuses, top executives can always avoid the 409A rules (which apply to *deferred* compensation) by not deferring the compensation. Instead, the top executives can receive their compensation currently in cash. For executives subject to the $1 million cap, NQDC will continue to be a very popular method for receiving additional *fixed* compensation because NQDC allows the executive to receive the money after termination of employment when the $1 million cap no longer applies. The $1 million cap does not apply after the executive retires (or otherwise terminates employment) because the executive at that time is no longer the CEO or one of the other four highest ranking corporate officers. *See* IRS Priv. Ltr. Rul. 200547006 (IRC §162(m) does not apply to compensation paid to a CEO in the year of the CEO’s resignation); Anne E. Moran, *Reasonable Compensation, 390-3rd* Tax Mgm’t. (BNA), at A-47 (“The IRS interpreted the preamble to the former § 162(m) proposed regulations to provide that an individual whose compensation must be reported under the SEC’s disclosure rules in any year also must be employed as an officer on the *last day* of that taxable year to be treated as a covered employee.”) (emphasis added).
VII. THE COLLATERAL DAMAGE 409A INFlicts ON SMALL BUSINESSES, CHARITIES, AND THEIR EMPLOYEES

409A applies to all employers and employees. The IRS has even issued a press release emphasizing that schools must amend their compensation practices.\textsuperscript{161} 409A regulates almost all arrangements in which compensation is deferred,\textsuperscript{162} including mundane compensation practices typically used by employers, including:

- Paid vacations, when the employee can carry over time to next year,
- Paid sick leave, when the employee can carry over time to next year,
- Arrangements in which employees who only work during part of a year, such as constructions workers and teachers, can elect to be paid over 12 months (called “annualization agreements”),
- Legal settlements,


\textsuperscript{162} Treas. Reg. § 1.409A-1(b)(1) (2007) (“Except as otherwise provided . . . a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year.”). Some of the more important deferred compensation arrangements that 409A does not apply to include:

- Qualified pension and profit-sharing plans. IRC § 409A(d)(1)(A).
- Eligible deferred compensation plans described in IRC § 457(b) established by tax-exempt organizations (generally not more than $15,000 per year can be contributed to these plans for each employee). IRC § 409A(d)(2)(B); IRC § 457(e)(15)(A) (the limit was $15,000 for 2006 and a cost-of-living adjustment applies).
- Bona fide vacation and sick leave plans. IRC § 409A(d)(1)(B).
- Nonqualified stock options (if the market price of the stock on the date of issue does not exceed the exercise price). \textit{Id}. § 1.409A-1(b)(5)(i)(A) (2007).
- Any arrangement (such as a bonus plan) in which the employer pays the compensation within 2-1/2 months of the end of the taxable year in which the compensation is earned. \textit{Id}. § 1.409A-1(b)(4) (2007); 72 Fed. Reg. at 19236 (called a “short-term deferral”).
• Noncompete agreements, and
• Reimbursement of business expense arrangements.

This Part analyzes how 409A will impact each of these compensation arrangements.

A. Vacation and Sick Leave.

The 409A rules on vacation and sick leave may impact the greatest number of employers and employees. 409A generally applies to “any plan that provides for the deferral of compensation,”\footnote{IRC § 409A(d)(1).} and excludes “bona fide vacation leave [or] sick leave . . . plan[s].”\footnote{Id. § 409A(d)(1) (emphasis added).} If the employer allows workers to earn paid vacation or sick leave in one year and use part of it in a future year, or allows workers to cash-out accrued vacation or sick leave at termination of employment, the arrangement has a deferral element.\footnote{Few people in the real world would think of a vacation carry-over arrangement as deferred compensation. Nevertheless, as a hyper-technical theoretical matter, there is a deferral involved.}

A key issue is whether a vacation or sick leave arrangement is “bona fide,” and therefore excluded by IRC § 409A(d)(1). Despite the importance

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\footnote{EXAMPLE #8. Pirates Cove Inc. (the “Company”) hires Gary Gangplank as a middle-manager effective January 1, 2009. The Company agrees to pay him $1,000 per week, and provides three weeks paid vacation per year. Any employee can carry over up to six weeks paid vacation into future years, and upon termination of employment, the Company will pay the employee cash (reduced by customary withholding) for his or her accrued vacation (based on his or her rate of pay at the time of termination). Gary Gangplank takes no vacation time in 2009 or 2010, and he quits on January 1, 2011. One could argue that Gary Gangplank’s real compensation each year was $55,000, and that Gary Gangplank elected to defer $3,000 of his 2009 compensation (the three weeks of paid vacation), and $3,000 of his 2010 compensation (the three weeks of paid vacation in 2010) into 2011. Thus, under 409A, the vacation program would be an elective NQDC program, and if this is not a bona fide vacation plan, a 409A violation occurred because Gary Gangplank failed to make a timely election to defer.}
of this issue, the IRS regulations are silent, and the preamble fails to provide guidance. The IRS acknowledges the difficulty of these issues, stating “[b]ecause the definitions of [bona fide vacation or sick leave] may raise issues and require coordination with the provisions of [IRC] Section 451, Section 125, and, with respect to [tax-exempt employers and employees] Section 457, the final regulations do not address these issues.”

Until the IRS provides guidance, tax-exempt employers can rely on authorities defining “vacation plan” or “sick leave plan” under IRC § 457(f). But the final regulations provide no guidance for taxpaying employers and their employees. The following examples demonstrate some of the potential problems.

**EXAMPLE #9.** Sherri Shipwreck works for Pirates Cove Inc. and is entitled to three weeks paid vacation each year. Every employee can accrue up to a maximum of six weeks of paid vacation, and can use those weeks in future years. Sherri Shipwreck has no accrued vacation as of January 1, 2009. Sherri Shipwreck takes only two weeks of vacation in 2009, takes three weeks in 2010, takes three weeks in 2011, and then takes four weeks in 2012 (using her one “carry-over” week from 2009 in the last week of 2012). Sherri does not “elect” to take that carry-over week until December 1, 2012, when she notifies her supervisor.

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166 See 72 Fed. Reg. at 19234.
167 Id.
168 Id. (referring to IRS Notice 2005-1, Q&A-6). The IRS considered a tax-exempt organization’s sick leave policy and vacation plan under IRC § 457(e)(11) in IRS Priv. Ltr. Rul. 200450010 (Dec. 10, 2004). Unfortunately, any guidance under IRC § 457(e)(11) may only be considered by tax-exempt employers. 72 Fed. Reg. at 19234.
If this vacation plan is not “bona fide,” a 409A violation occurs each year because Sherri did not specify the time when she would use the one week of carry-over vacation before the beginning of each year. \(^{169}\) As a result, Sherri Shipwreck will be subject to three different taxes under IRC § 409A (the “Terrible Triple Tax”) each year. First, she will be taxed on the value of the vacation (which she does not take each year). \(^{170}\) Second, she will owe an extra 20% tax. \(^{171}\) Third, she will owe an extra tax equal to the interest that would have accrued if the value of the deferred vacation pay had triggered a tax underpayment for each year. \(^{172}\)

**EXAMPLE #10.** Same as Example #9, but Sherri Shipwreck (and all other full-time employees of Pirates Cove Inc.) can carry forward a maximum of 12 weeks of paid vacation. If the employee fails to take all of his or her accrued vacation before termination of employment, Pirates Cove Inc. will pay the employee for the accrued vacation time (based on his or her compensation rate at the time of termination). Sherri Shipwreck terminates employment at age 65 with 12 accrued weeks of vacation. Pirates Cove Inc. pays Sherri Shipwreck cash (less customary withholding) for the accrued vacation time. If 409A applies to this arrangement (because it is not a “bona fide” vacation plan), there is a 409A violation every time

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\(^{169}\) For example, a 409A plan failure occurs in 2009 because Sherri deferred compensation in 2009, but failed to make an irrevocable election to defer before 2009. Treas. Reg. § 1.409A-2(a)(3) (2007). Additional 409A violations occur in 2010 and 2011 because Sherri is entitled to compensation which she elects not to receive – she has four weeks paid vacation and she defers one week each year – and she fails to file an irrevocable election to defer before the beginning of the year. *Id.* Whether Sherri Shipwreck has violated 409A three times (in three years), or one time (in only one year), may depend on how the carry-over mechanism applies. If Sherri is deemed to carry over the same one week of paid vacation into 2010, 2011, and 2112, then presumably the Triple Tax should only apply once, because the same item of compensation can only be included in taxable income once. *See* IRC § 409A(a)(1)(A)(i). However, if the carry-over week from 2009 is deemed to be the first week of vacation Sherri uses in 2010, and then Sherri is deemed to carry over a week of the 2010 vacation into 2011, and so forth, Sherri would violate 409A every year, and the IRS could impose the Triple Tax every year. The exact application of the Terrible Triple Tax when a similar practice results in a 409A violation in multiple years hopefully will be addressed in future regulations. *See* 72 Fed. Reg. 19322 (April 7, 2007) (“calculation of income inclusion [reserved]”) (indicating that the IRS intends to issue regulations at Treas. Reg. § 1.409A-4 regarding the application of the ‘Triple Tax’).

\(^{170}\) IRC § 409A(a)(1)(A)(i).

\(^{171}\) *Id.* § 409A(a)(1)(B)(i)(II). This “additional tax” is 20% of the amount included under IRC § 409A(a)(1)(A)(i).

\(^{172}\) *Id.* § 409A(a)(1)(B)(i)(I); *see supra* note 169 (regarding whether a 409A violation occurs in this situation once or every year).
Sherri Shipwreck accrues a vacation week and fails to make an irrevocable election to defer before the beginning of the year.\textsuperscript{173}

These examples illustrate some of the many potential issues that employers and employees must consider in analyzing and restructuring vacation and sick leave plans in response to 409A. Other potential issues when an employee can carry over vacation or sick leave include:

- What are the standards for a \textit{bona fide} sick leave program?

- What if the company has no sick leave policy, and expects the employees to use vacation time when they are sick?

- Can the amount of sick leave vary based on occupation and still be \textit{bona fide}? For example, can a mining company grant more sick leave to the miners than to the office employees?

- Can the amount of vacation or sick leave vary based on an employee’s years of service, or age, and still be \textit{bona fide}? For example, can employees with less than three years of service receive only two weeks of paid vacation, while those with three or more years of service receive three weeks of paid vacation? Is that a \textit{bona fide} vacation program, or will the IRS consider this a scheme to transfer more compensation to more senior employees? What if all top executives automatically are entitled to four weeks of paid vacation each year?

- Should the company’s holidays be considered in evaluating whether the vacation policy is “\textit{bona fide}”? For example, can a company that observes fewer holidays allow its employees to carry over more paid vacation?

Enron’s payment of outrageous compensation to its top executives inspired 409A,\textsuperscript{174} but every taxpaying employer that allows employees to


\textsuperscript{174}
carry over unused vacation or sick leave must analyze its vacation and sick leave arrangements under 409A.

B. Teachers, Construction Workers, and Other Part-Year Employees.

Another key 409A rule that may impact many taxpayers is the IRS approach to employees who work part of the year and elect to annualize their compensation. These rules may impact

- teachers,
- construction workers,\(^{175}\)
- ski-resort employees,\(^{176}\)
- fishermen,\(^{177}\) and
- other seasonal employees.

The IRS finds NQDC subject to 409A when teachers performing services during a school year running from September of one year through June of the next year . . . are provided an election to receive [their] compensation on an annualized basis over 12 months instead of during only the school year . . . . [B]ecause the teacher is [deferring] some of the compensation that would be paid in September through


\(^{176}\) *See* Ashley Kosciolek, *With a surprise fall freeze, time to break out the skis*, Allentown Morning Call, Nov. 10, 2007, at B1 (discussing 1500 “seasonal workers” hired at local ski resorts), *available at* 2007 WLNR 22281257.

December of that year to a period in the subsequent year [409A applies].

The IRS notes that schools “often” provide this option to teachers, and a brief example demonstrates the reason.

**EXAMPLE #11.** The teachers at Happy Valley High School earn $36,000 each year, and teach from September 1 through May 31. The school closes for three months each year from June 1 through August 31. If a teacher cannot annualize his or her compensation, the teacher will receive gross compensation of $4,000 per month for the 9 months from September through May, and will receive *nothing* from June through August. Without an election to annualize, a Happy Valley High teacher will have to be extremely careful to save from September through May, or he or she may starve from June through August.

Even though the IRS classifies these arrangements as “deferred compensation plans” subject to 409A, initially one might conclude that there will be no trouble complying with 409A because the school will always pay the amounts during the summer break. As a result, there will be no acceleration under IRC § 409A(a)(3); there will be no subsequent deferral under IRC § 409(a)(4)(C); and the amount will be paid on a fixed schedule in compliance with IRC § 409A(a)(2)(A)(iv). However, as the IRS points out, the trap for the unwary is that the *election to annualize* must be made

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179 Id. at 19255.
“before the period of service begins,” or a 409A violation automatically occurs.

EXAMPLE #12. Same as Example #11, and the Happy Valley High School teachers can elect to annualize their compensation. Sam Slow, the office administrator, does not put the election forms in the teachers’ mailboxes until September 2, 2010, which is the second day of classes. Every teacher who elects to annualize compensation will have made a late election (because the “period of service” has begun). As discussed in Example #11, for the period from September to December 2010, each teacher is deferring $4,000 of compensation until the summer of 2011. Because each teacher made a late election, each teacher has violated 409A and is subject to the Triple Tax. The extra amount included in income under IRC § 409A(a)(1) in 2010 will be $4,000, and, in addition, each teacher will be liable for a 20% additional tax of $800 under IRC § 409A(a)(1)(B)(i)(II).

The same problem can arise for fishermen who only work when the fish are biting; construction workers who do not work during the harshest winter months; ski-resort employees who head for the beach when the powder disappears; and other part-year employees. Thus, although Enron’s

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180 Id.
181 Id.
182 If a teacher elects to annualize, then for the period from September 1, 2010 through December 31, 2010, the school will pay the teacher only $3,000 per month, instead of $4,000 per month. In effect, the teacher is deferring $1,000 per month, which will be paid in the summer of 2011. As a result, over the 4-month period in 2010 (from September 1, 2010 through December 31, 2010), the teacher defers $4,000. If there is a 409A violation, the $4,000 is taxed in 2010 under IRC § 409A(a)(1)(A)(i) even though the teacher will not actually receive that $4,000 until the summer of 2011. Also, because the amount is taxed under IRC § 409A(a)(1)(A), the teacher is subject to an extra tax equal to 20% of the amount included in gross income. IRC § 409A(a)(1)(B)(i)(II).
payment of outrageous compensation inspired 409A, one of 409A’s biggest impacts may be for employees who work only part of the year.

C. Legal Settlements, Including Having an Employee Sign a Waiver on Termination of Employment.

409A can apply whenever an employee entitled to NQDC terminates employment, and the employee signs a waiver of claims in exchange for a payment. The regulations provide that agreements paying “settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers compensation statutes . . . or for reimbursements or payments of reasonable attorneys fees . . .” do not provide for the deferral of compensation, and therefore are not subject to 409A. The IRS will determine whether the

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184 Schools and other employers with part-year employees could structure the election procedure to reduce the risk of a 409A violation. These employers could provide that a returning employee’s “annualization” election for the prior year may only be changed before the beginning of a subsequent service period. Also, the employer’s plan could provide that if the election is not changed before the beginning of the subsequent service period, the election to annualize is irrevocable during the year. See Treas. Reg. § 1.409A-2(a)(2) (2007); see also I.R.S. News Release IR 2007-142, Aug. 7, 2007, Frequently Asked Questions: Section 409A and Deferred Compensation. However, this only eliminates the risk for returning employees. The risk would persist for new employees. In a News Release, the IRS also suggests that a school could adopt a rule that if a teacher fails to file an annualization election before the beginning of the school year, the election is invalid, and the school will only pay the teacher in the months the teacher works. Id. As indicated in Example #11, if a school follows this IRS suggestion, its tardy teachers who do not save during the school year may starve in the summer (or at least spend the summer feasting on macaroni-and-cheese or peanut-butter-and-jelly-sandwiches).
employer’s payment is for a *bona fide legal claim* “based on the facts and circumstances.”\textsuperscript{187} The preamble to the final regulations states that

> [t]he exception [for legal settlement payments] covers only rights arising from the bona fide claim, and is not intended to allow such settlements or awards to act as substitutes for, or to allow for the restructuring of, preexisting deferred compensation subject to section 409A . . . . [T]he payment of an amount upon the execution of a waiver of any or all such claims does not necessarily indicate that the amounts are paid as an award or settlement of an actual bona fide claim.\textsuperscript{188}

The IRS approach will create uncertainty:

- Was the employee’s claim *bona fide*?
- What if the parties settled before both parties completed discovery?
- What if the parties settled without performing significant discovery?
- What if the key documents were in the employer’s possession and are no longer available at the time of the employee’s tax audit under 409A?
- What if the employer destroyed the relevant documents?
- Even if the employee’s claim is bona fide, how can the parties be sure that the *amount* of the settlement payment will be deemed reasonable by the IRS? Should the employee hire a second attorney (or a third) to evaluate

\textsuperscript{187} Id.
the claim and opine on whether the settlement payment is reasonable?

D. *Noncompete Agreements.*

In a stunning development, the preamble to the regulations asserts that payments under a noncompete agreement are NQDC.\(^{189}\)

Because . . . a [noncompete] payment would occur in connection with the performance or nonperformance of services, . . . a legally binding right obtained in one year to a payment in a subsequent year in connection with a noncompetition agreement generally would constitute deferred compensation.\(^{190}\)

In most cases, a noncompete agreement is *not* used as a device for the company to pay extra compensation to a departing employee. Usually the company would prefer *not* to pay extra money to an ex-employee. Typically the company enters into a noncompete agreement to prevent the employee

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\(^{189}\) In a noncompete, the employer agrees to make periodic payments to the ex-employee over a limited period of time (frequently two to three years) in exchange for the ex-employee’s agreement to refrain from contacting customers, soliciting employees, using proprietary information, or otherwise competing against the ex-employer within an established geographic area. A leading treatise on the subject states:

Employees often have access to the proprietary information, trade secrets, and other confidential data of the employer. Certain employees frequently have key relationships with customers and obtain specialized training or technical knowledge, expertise, or skills on the job, often at substantial expense – in terms of both money and time – to the employer. Post-employment restrictions seek to protect employers’ interests in such assets and investments by preventing former employees from entering into competitive employment and otherwise eroding the former employer’s market share. Such restrictions safeguard interests not protected by trade secret, patent, and copyright statutes, and augment those protections by supplying contractual remedies to which an employer might not otherwise be entitled.

Brian M. Malsberger, *Covenants Not to Compete: A State-by-State Survey*, ix (2002) (published by the Section of Labor and Employment Law of the American Bar Association). Presumably the IRS’s rationale for treating noncompete payments as NQDC is that the employee would not receive the payments if the employee had never rendered services. Nevertheless, the IRS approach is dubious because the payer makes noncompete payments in exchange for the former employee’s agreement to *refrain* from providing services.

\(^{190}\) 72 Fed. Reg. at 19236 (emphasis added).
from going to work for the competition and soliciting the company’s clients or employees.\footnote{191} Also, when an unrelated party purchases the stock of a corporation, often the purchaser will cause the acquired corporation to enter into noncompete agreements with its prior owners, executives, and salespersons. Because the new owners have no desire to provide extra compensation to the prior owners, executives or salespersons for services previously rendered, but instead are merely trying to protect the corporation’s goodwill, the parties and their attorneys may not even think of 409A when structuring the noncompete arrangements.

EXAMPLE #13. Jewel Thief is the top salesperson at Smugglers Cove Inc. A competitor, Buying Contraband Inc. purchases all the stock of Smugglers Cove Inc. The new owners decide to terminate Jewel Thief’s employment. The new owners have no desire to pay Jewel Thief extra compensation, but they agree to pay her $50,000 per year for three years, in exchange for her agreement that she will not steal the corporation’s customers or employees.

Numerous problems ensue if 409A applies to a noncompete agreement.

- If the noncompete agreement is with a current employee, and provides that payments begin when the employee switches from full-time to part-time employment, there may be a 409A violation because the agreement provides for payments before a “separation from service.”\footnote{192}
• If there is an acceleration, or subsequent deferral, of the payments under a noncompete, a 409A violation could occur.\textsuperscript{193}

• If a payment under the noncompete is accelerated on a change of ownership or control, or a sale of substantially all the corporation’s assets, and the definition of those events in the noncompete agreement does not match the definition in Treas. Reg. § 1.409A-3(i)(5), a 409A violation occurs.

E. Reimbursement of Business Expenses.

A company’s agreement to reimburse an employee in a future year for business expenses, such as

- car expenses,
- outplacement services,
- a loss on a sale of a residence,
- moving expenses,

a switch to part-time employment is a “separation from services” depends on the particular facts and circumstances. Whether a termination of employment has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services . . . (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed . . . over the immediately preceding 36-month period . . . . Treas. Reg. § 1.409A-1(h)(1)(ii) (2007). If the employee’s level of services is above 20% of her previous level of service, there is a presumption that no “separation from service” occurred. See id. § 1.409A-1(h)(1)(ii) (2007). The NQDC agreement could provide for a percentage above 20%, but not in excess of 50%, that would determine whether the employee separated from service for 409A purposes. See id. § 1.409A-1(h)(1)(ii) (2007).

\textsuperscript{193} Generally the acceleration of a NQDC payment violates 409A, IRC § 409A(a)(3), but the final regulations contain exceptions, including situations when the employee’s total NQDC benefit is below the IRC § 402(g)(1)(B) amount ($15,500 in 2008). See Treas. Reg. § 1.409A-3(j)(4) (2007); I.R.S. News Release IR 2007-171, Limits on benefits and contributions – cost-of-living adjustments, Oct. 18, 2007 (announcing that the amount for 2008 is $15,500). Generally a subsequent deferral will violate 409A unless the parties agree to the subsequent deferral at least one year before the employer otherwise would pay the deferred amount, and the parties extend the date of payment for at least five years. IRC § 409A(a)(4)(C); Treas. Reg. § 1.409A-2(b)(1) (2007).
• airplane travel, or

• country club dues,

is a NQDC arrangement subject to 409A unless a series of requirements are satisfied. The general requirements are:

• the employee must pay the expense (or incur the loss) within two years of a separation from service;

• the employer must reimburse the employee for the amount within three years of the separation from service;\(^{194}\) and

• the agreement to reimburse must be on a *fixed schedule*.\(^{195}\)

A reimbursement agreement must meet four conditions to be on a *fixed schedule*:

• “The plan provides an objective, determinable, non-discriminating definition of the expenses eligible for reimbursement . . . .”

• The employer will reimburse expenses for “an objectively and specifically prescribed period . . . .”

• The right to reimbursement cannot be exchanged for another benefit.

• “The . . . amount of expenses eligible for reimbursement . . . during [an employee's] taxable year *may not affect the expenses eligible for reimbursement . . . in any other taxable year.*”\(^{196}\)

The last requirement is the one most likely to trap unsuspecting taxpayers. An example in the regulations provides that an agreement to


reimburse $30,000 of expenses each year for three years satisfies 409A, but an agreement to reimburse a total of $90,000 of expenses over a three-year period violates 409A and triggers the Terrible Triple Tax.

**EXAMPLE #14.** Mark Matey is a superstar engineer at Land-Lover Inc. Land-Lover Inc. established a NQDC plan for Mark Matey several years ago, but in 2010 the company adds a new provision that for the first five years after a “separation from service” (under IRC § 409A(a)(2)(A)(i)), Land-Lover Inc. will reimburse Mark Matey for computers, software and any other technological products that Mark Matey desires, up to a cumulative total of $15,000 retail over five years. Because the arrangement fails to satisfy the last requirement listed above, a 409A violation occurs, and Mark Matey will be required to pay the Terrible Triple Tax.

**F. Anti-Abuse Rule – You Can Never Be Sure 409A Does Not Apply.**

In case any arrangement otherwise would avoid the definition of NQDC under 409A, or would qualify for an exception, the preamble to the regulations states “[i]f a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the [IRS] may treat the plan as a [NQDC] plan for purposes of Section 409A.” A vexing problem in applying this anti-abuse rule will be determining the “purposes of Section 409A.” The regulations

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197 Id. § 1.409A-3(i)(1)(vi)(Ex. 7) (2007).
198 Id. § 1.409A-3(i)(1)(vi)(Ex. 8) (2007) (example involving country club dues). A violation also occurs if the company agrees to provide “in-kind” benefits in a similar situation. Id. §1.409A-3(i)(1)(iv)(A) (2007).
200 The regulations provide relief from the final requirement if the employer is reimbursing medical expenses (described in IRC § 105(b)). Id. § 1.409A-3(i)(1)(iv)(B) (2007).
201 72 Fed. Reg. at 19235 (emphasis added).
fail to provide a list of these “purposes,” and the legislative history is sparse.\textsuperscript{202} As a result, the regulations set the stage for disputes over the application of the anti-abuse rule and the purposes of 409A.

VIII. CONCLUSION.

Current laws allow top executives to plunder publicly held corporations with impunity.\textsuperscript{203} In 1976, CEOs made 36 times more than the average worker; today CEOs make 369 times more than the average worker.\textsuperscript{204} The government’s latest attempt to restrict CEO pillaging with income tax rules will not limit the looting. IRC Section 409A imposes no constraints on the amount of CEO compensation, and imposes mere timing requirements on NQDC arrangements, which represent a trivial portion of total CEO compensation.\textsuperscript{205} For the trivial portion of CEO compensation that will be subject to 409A, high-priced experts will be able to navigate through 409A’s complex minefield and allow CEOs at publicly held corporations to avoid the confiscatory taxes of 409A.

\textsuperscript{202} The “Reasons for Change” section of the legislative history states, Executives often use arrangements that allow deferral of income, but also provide security of future payments and control over amounts deferred. The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. H.R. Rep. No. 108-548 pt.1, \textit{reprinted in} [2007] 7 Stand. Fed. Tax Rptr. (CCH) ¶18,952, at page 36,143. The legislative history provides only two examples – (i) the “haircut” provision which allows the participant to receive NQDC benefits earlier than scheduled (if the employee forfeits a percentage of the benefit, such as 10%), and (ii) the investment of deferred amounts into a foreign trust. \textit{Id.; see also supra} notes 133-43 and accompanying text (discussing “haircut” provisions).

\textsuperscript{203} See \textit{supra} Part III.

\textsuperscript{204} Smith, \textit{supra} note 24, at B13.

\textsuperscript{205} See Drennan, \textit{supra} note 132 (even at Enron, NQDC represented less than 5% of the top executives’ compensation).
Even worse, 409A imposes outrageous administrative costs on small businesses and charities, which are forced to comply with the 91-page preamble and final regulations package, the two sets of technical corrections,\textsuperscript{206} and the IRS’s seven notices.\textsuperscript{207} If a small business or charity fails to comply, their employees can be liable for the Terrible Triple Tax, which includes an automatic 20\% extra tax on the total amount of compensation deferred in the current year and in all prior years.\textsuperscript{208} Section 409A is a disaster and should be repealed retroactively.\textsuperscript{209}

Nevertheless, lawmakers should still consider amendments to income tax laws as a potential weapon against CEOs’ piratical practices that flourish in part because of tax loopholes. For example, plundering CEOs use non-indexed stock options to add billions to their buccaneer booty every year.\textsuperscript{210} These stock options enjoy two huge income tax benefits that should be re-evaluated.

\textsuperscript{207} See supra note 14.
\textsuperscript{208} See supra notes 170-72 and accompanying text.
\textsuperscript{209} Congress can amend federal tax laws retroactively if the change does not impose excessive hardships. Welch v. Henry, 305 U.S. 134, 147 (1938) (“In each case it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation [under the due process clause].”).
\textsuperscript{210} “There is no question in my mind that mediocre CEOs are getting incredibly overpaid. And the way it’s being done is through stock options.” Bebchuk & Fried, supra note 45, at 143 (quoting Warren Buffett); see supra note 46.
• No income tax is imposed until the employee actually exercises the stock option.\textsuperscript{211} This provides tax-deferred wealth even though the executive has complete flexibility to obtain the cash at any time.\textsuperscript{212}

• Stock options are exempt from the $1 million of cap of IRC § 162(m) which limits a corporation’s tax deduction for fixed compensation paid.\textsuperscript{213} As a practical matter, this allows a corporation to claim an unlimited tax deduction for stock option compensation.\textsuperscript{214} IRC § 162(m) treats stock options as “performance-based compensation,”

\textsuperscript{211} Treas. Reg. § 1.83-7(a) (2002); Mancoff & Weiner, \textit{supra} note 48, at § 4.05, page 4-13 (2001). The employee is not subject to income tax until the option is exercised, even though taxpayers can estimate the fair market value of unexercised stock options under the Black-Scholes method for gift tax purposes. Rev. Proc. 98-34, 1998-1 C.B. 983, § 4.01 (“Taxpayers may determine the value of Compensatory Stock Options for transfer tax purposes by using a generally recognized option pricing model (for example, the Black-Scholes model or an accepted version of the binomial model) that takes into account . . . the following factors . . . .”).

\textsuperscript{212} Technically, nonqualified stock options would have to be exercised in accordance with any rules set out in the plan document, and the executive would need to pay the exercise price. However, these requirements pose no practical problems because the company designs the plan, and the company can advance the executive the money to exercise the option. Taxpayers exercising \textit{qualified} stock options enjoy an even greater tax benefit – the gain is not taxed until the executive actually sells the stock. Mancoff & Weiner, \textit{supra} note 48, at § 3.03, page 3-8. In exchange for this added tax benefit, the executive must refrain from selling the stock for at least two years from the date he or she receives the option, and at least one year from the date he or she exercises the option and receives the shares. IRC §422(a)(1). Nevertheless, the amount of qualified stock options available is severely restricted. IRC §422(b)(7) (the fair market value of stock subject to a qualified option for the first time in any year cannot exceed $100,000). As a result, the great majority of stock option wealth transferred to highly-paid CEOs is from nonqualified stock options.

\textsuperscript{213} IRC § 162(m)(4)(C) (exempting “performance based compensation” from the $1 million restriction); Mancoff & Weiner, \textit{supra} note 48, at § 4:23, page 4-32 (“[C]ompensation realized with respect to stock options will qualify as performance based compensation, without the existence of a predetermined objective goal . . . .”); Moran, \textit{supra} note 160, at A-48 (“Stock options . . . generally are performance based compensation if the requirements for outside director and shareholder approval are met . . . because the amount of compensation attributable to the options . . . is based solely on an increase in the price of the corporation’s stock.”).

\textsuperscript{214} Technically, the total amount of compensation that can be deducted must be reasonable under IRC § 162(a)(1). However, as a practical matter, the IRS does not apply the “reasonableness” test to publicly held corporations. As one commentator states,

\begin{quote}
Virtually all challenges by the IRS to the deductibility of compensation have occurred in the context of salary arrangements between related parties, involving dealings between corporations and shareholders or relatives of shareholders, or dealings between partners or proprietors and their relatives . . . .
\end{quote}

. . . . This suggests that any amount of compensation paid by a publicly held corporation should be \textit{per se} reasonable. In this situation, the operation of the normal system of commercial checks and balances arguably is adequate to ensure a proper result so that review by the IRS generally is unnecessary.

even though a CEO who performs miserably may receive enormous wealth from stock options.\footnote{\"Most so-called pay for performance plans are really \textquote{pay for pulse} plans.\" Nocera, \textit{supra} note 31, at B12. IRC § 162(m) does not apply to stock options. \textit{See supra} notes 159-60, 213. Part II.A. discusses the ability of a CEO to profit from stock options despite his or her poor performance. S. 2116, The Ending Corporate Tax Favors for Stock Options Act, § 3 (introduced by Senator Carl Levin, Michigan) would make executive stock option compensation deductions subject to the $1 million cap of IRC § 162(m).}

The CEO pirates won the battle of 409A, but the government should not hoist the white flag of surrender.