THE PIRATES WILL PARTY ON! THE NONQUALIFIED DEFERRED COMPENSATION RULES WILL NOT PREVENT CEOS FROM ACTING LIKE PLUNDERING PIRATES AND SHOULD BE SCUTTLED

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"I laughed so hard I almost fell overboard."[1]

INTRODUCTION

CEOs and their sidekicks resemble swashbuckling pirates emptying the coffers of vulnerable prey.[2] Some argue that CEOs, like professional athletes, must be worth their compensation or corporations would not pay it.[3] However, structural deficiencies at publicly held corporations impede natural market forces. A Delaware Chancery Court judge stated, "executive compensation . . . seems . . . to have become *spectacularly 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]

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1. Talklikeapirate.com, Get "Pirattitude" and Other Books from the Pirate Guys!, http://www.talklikeapirate.com/book.html (last visited Nov. 10, 2008) (quoting Jamaica Rose). The quote would be appropriate for a corporate CEO gloating over his or her excessive compensation, but a book reviewer said it. *Id.*

2. *See* Dan Whitcomb, *Lay Turns to God and Family After Guilty Verdict*, REUTERS NEWS, May 25, 2006, *available at* http://propagandapress.org/2006/05/25/corporate-pirate-ken-lay-finds-god-upon-conviction ("Lay, the son of a preacher . . . was convicted on Thursday along with former Enron CEO Jeffrey Skilling of concealing the energy' [sic] giant's crumbling finances as it spiraled toward bankruptcy in 2001.").

3. *See* Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 7 (1993) (describing arguments that CEO compensation is reasonable).

4. Rich Ferlauto, *Commentary on Leo Strine's "Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance,"* 33 J. CORP. L. 41, 42 (2007) (quoting William B. Chandler III, Chancellor, Del. Court of Chancery, When Boards Make (or Allow) Bad Decisions—Anatomy of a Board Liability Case, Inaugural Address at the UCLA Law Center for the Study of Mergers and Acquisitions (Feb. 6, 2006)) (emphasis added).

5. *See* Holly Sklar, *CEO Pay Still Outrageous*, PEOPLE'S WKLY. WORLD, July 3, 2003,

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 $1 *billion* in the year before Enron went bankrupt.[7] 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] and their jobs.[9]

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%[10] of the top executives' compensation.[11] 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% of the executives' compensation.[12] 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 *timing* rules on NQDC.[13] And shiver me timbers, 409A applies to *all* employers and employees, rather than just the top executives at publicly held corporations![14] The government continued on its rudderless course as

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http://www.pww.org/article/articleprint/3710 (reporting on a study by Towers Perrin comparing CEO compensation between countries).

6. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 1 (Comm. Print 2003) [hereinafter ENRON COMPENSATION REPORT], *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html. Senators Max Baucus and Charles Grassley of the Senate Committee on Finance requested the study. *Id*.

7. *See id*. at 547 (indicating that in 2000, Enron paid its top 200 executives $1.424 billion in total compensation, which included $1.063 billion in stock-option compensation). Enron declared bankruptcy on December 2, 2001. *Timeline of Enron's Ownership of PGE*, THE OREGONIAN, Apr. 2, 2006, at D1, *available at* 2006 WLNR 5695275.

8. ENRON COMPENSATION REPORT, *supra* note 6, at 37.

9. *See* Rick Bragg, *Enron's Collapse: Workers Feel Pain of Layoffs and Added Sting of Betrayal*, N.Y. TIMES, Jan. 20, 2002, at A1, *available at* 2002 WLNR 4054886 (reporting on the sentiment of the four thousand Enron employees who had been laid off).

10. ENRON COMPENSATION REPORT, *supra* note 6, at 547.

11. *Id.* at 41. The Joint Tax Committee stated: "In implementing its stock-based compensation programs, Enron appeared generally to follow IRS published guidance. Thus, no recommendations are made with respect to such programs." *Id.*

12. 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, 428 (2006).

13. *See* Legal Update, Funkhouser Vegosen Liebman & Dunn Ltd., Section 409A: New Rules for Deferred Compensation (Dec. 2007), http://www.fvldlaw.com/newsletters/2007-12.htm ("Section 409A regulates the timing, not the amount, of deferred compensation payments.").

14. Only two 409A rules apply exclusively to publicly held corporations, and they are trivial.

the IRS generated regulations,[15] notices,[16] and press releases[17] that will have no practical impact on the piratical practices of top executives.

Rather than making the pirates walk the plank, 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;[18] sick-leave policies that allow an employee to carry over unused sick days to the next year;[19] settlement agreements with employees who are fired;[20] noncompete agreements with former employees;[21] annualization agreements for school teachers, construction

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First, I.R.C. § 409A(a)(2)(B)(i) provides that if a publicly held corporation will make a NQDC payment to a key employee upon separation from service, the first payment must be delayed at least six months. I.R.C. § 409A(a)(2)(B)(i) (Supp. V 2005). 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 I.R.C. § 162(m). Treas. Reg. § 1.409A-2(b)(7) (2007). Under I.R.C. § 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. I.R.C. § 162(m)(1)(3) (Supp. 2007). This opportunity to redefer is actually an extra benefit to top executives because it allows them additional flexibility in timing NQDC payments. Under 409A, normally to extend the payment of NQDC benefits further, 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. I.R.C. § 409A(a)(4)(C) (Supp. V 2005).

15. Treas. Reg. §§ 1.409A-1 (2007) to 1.409A-6 (as amended in 2008).

16. *See, e.g.*, I.R.S. Notice 2005-1, 2005-1 C.B. 274 (providing "the first part of what is expected to be a series of guidance [notices] . . . to the application of § 409A"); I.R.S. Notice 2005-94, 2005-2 C.B. 1208 (suspending reporting and withholding requirements under § 409A for calendar year 2005); I.R.S. Notice 2006-4, 2006-1 C.B. 307 (excluding the exercise of certain stock options from the requirements of § 409A); I.R.S. Notice 2006-33, 2006-1 C.B. 754 (providing "transition relief with respect to the application of [§] 409A(b)"); I.R.S. Notice 2006-64, 2006-2 C.B. 88 (providing exceptions to § 409A's ban on payment acceleration for subject plans); I.R.S. Notice 2006-79, 2006-2 C.B. 763 (providing additional "transition relief under [§] 409A"); I.R.S. Notice 2006-100, 2006-2 C.B. 1109 (providing guidance on "reporting and wage withholding requirements . . . under [§] 409A"); I.R.S. Notice 2007-34, 2007-17 I.R.B. 996 (guiding the application of § 409A to "split-dollar life insurance arrangements"); I.R.S. Notice 2007-62, 2007-32 I.R.B. 331 (describing anticipated guidance for the application of § 409A and soliciting feedback on the same); I.R.S. Notice 2007-100, 2007-52 I.R.B. 1243 (providing further "transition relief and guidance on the correction of certain failures . . . to comply with [§] 409[A]"); I.R.S. Notice 2008-62, 2008-29 I.R.B. 130 (describing anticipated regulation proposals to govern "recurring part-year compensation").

17. *See, e.g.*, I.R.S. News Release IR-2007-142 (Aug. 7, 2007) ("[T]he [IRS] today reassured teachers and other school employees that new deferred-compensation rules will not affect the way their pay is taxed during the upcoming school year."); I.R.S. News Release IR-2007-157 (Sept. 10, 2007) ("[T]he Internal Revenue Service . . . announced today that taxpayers will have until Dec. 31, 2008, to bring documents into compliance with the final nonqualified deferred compensation regulations under section 409A of the Internal Revenue Code.").

18. I.R.C. § 404(a)(5) (2000).

19. I.R.C. § 409A(d)(1)(B) (Supp. 2007).

20. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,249 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1).

21. *Id*. at 19,236.

workers, fishermen, and other part-time employees;[22] and agreements to reimburse business expenses.[23] Two examples vividly demonstrate the failure of 409A:

> *Example #1*. During the calendar year, Jolly Roger,[24] the CEO of a large publicly held corporation, defers $30 million to his NQDC plan,[25] 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.
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> *Example #2*. Sam Small is a construction worker who works from March 15 to December 31 each year. He cannot work during the first part of the year because of the harsh weather. Sam signs an annualization agreement with his employer to spread his compensation over twelve months.[26] Under the arrangement, Sam defers $18,000 of his compensation from one year to the next. Sam signs the annualization agreement on his *second* day back to work (March 16). Because Sam failed to sign and turn in the form on or before the *first* day of work, under 409A, Sam automatically must pay an extra $3,600 of income tax![27] Neither the regulations nor the IRS pronouncements[28] on this topic indicate that Sam can avoid the extra tax.

Acclaimed sociologist Robert Merton, in his influential work on the law of "unanticipated consequences," observed that actions often have unintended consequences—including collateral damage—particularly when

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22. *Id*. at 19,254–55. The IRS adopted a special administrative procedure that will allow annualization agreements to avoid 409A if the amount deferred does not exceed $15,500. I.R.S. Notice 2008-62, 2008-29 I.R.B. 130 (stating that the IRS plans to adopt proposed regulations to implement this administrative procedure).

23. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. at 19,248.

24. The term "Jolly Roger" was used to refer to a pirate's distinctive black flag. 22 THE ENCYCLOPEDIA AMERICANA 135 (international ed., Grolier 1994) (1829).

25. As a historical note, Enron CEO Ken Lay deferred $32 million into his NQDC plan in 2000, which was the year before Enron went bankrupt. ENRON COMPENSATION REPORT, *supra* note 6, at 604 n.1817. *See also Timeline of Enron's Ownership of PGE, supra* note 7, at D1 (indicating that Enron went bankrupt in 2001).

26. *See infra* Part VI.B (explaining the annualization agreement).

27. Because the amount is taxed under I.R.C. § 409A(a)(1)(A), the construction worker would be subject to an extra tax equal to 20% of the amount included in gross income. I.R.C. § 409A(a)(1)(B)(i)(II) (Supp. V 2005).

28. *See generally* I.R.S. News Release IR-2007-142 (Aug. 7, 2007) (failing to include information regarding penalties for the late annualization agreement filings). *See also* I.R.S. Notice 2008-62, 2008-29 I.R.B. 130 (providing relief if the amount deferred is $15,500 or less).

the actor makes errors.[29] In this case, the government failed to keep its eyes 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.

I. CEOS' PIRATICAL PRACTICES

Enron's collapse in 2001 created great interest in savvy CEO pirates who raid corporate treasuries.[30] The government has enacted a few laws in an attempt to limit the looting,[31] but studies demonstrate that the pirates

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29. Robert K. Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOC. REV. 894, 894, 901 (1936).

30. *See* Frank P. VanderPloeg, *Legal Standards for Adoption of Executive Compensation Programs and Contracts*, 775 PLI/Tax 891, 893 (2007) ("Executive compensation has come under particular public and governmental 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 . . . ."). *See also* Jack Z. Smith, *The Platinum Helicopters*, FORT WORTH STAR-TELEGRAM, Jan. 19, 2007, at B13, *available at* 2007 WLNR 1065215 ("Enron was . . . the undisputed champ at high-level corporate chicanery.").

31. *See* 15 U.S.C. § 78m(k) (Supp. 2004) (prohibiting loans to top executives through the Sarbanes-Oxley Act of 2002 because many corporations made below-market interest loans to top executives or completely forgave loans made to top executives); Jayne W. Barnard, *Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act*, 31 OHIO N.U. L. REV. 325, 326–34 (2005) (discussing the Sarbanes-Oxley Act and its implications on excessive executive compensation). Also, the SEC adopted disclosure rules to clarify the reporting of executive compensation. *See* Executive Compensation and Related Person Disclosure, Securities Act Release No. 8,732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158, 53,158, 53,190 (Sept. 8, 2006) (to be codified at 17 C.F.R. pt. 228–29, 232, 239, 240, 245, 249, 274) ("The [Securities Exchange Act of 1934] amendments are intended to make proxy and information statements, reports and registration statements easier to understand."); Executive Compensation Disclosure, Securities Act Release No. 8,765, Exchange Act Release No. 55,009, 71 Fed. Reg. 78,338 (Dec. 29, 2006) (to be codified at 17 C.F.R. pt. 228–29) (explaining the Securities and Exchange Commission's amendments to the disclosure requirements for executive and director compensation). *See also* Christopher Cox, Chairman of the U.S. Sec. & Exch. Comm'n, Remarks at Northwestern University School of Law (Jan. 22, 2007) (explaining that new SEC rules on disclosure of executive compensation make the information more accessible to the common shareholder); Linda E. Rappaport & Amy B. Gitlitz, *2007 Proxy Season: Executive Compensation Roundup*, 1618 PLI/Corp 321, 323 (2007) ("The final rules represent a major overhaul of compensation disclosure in proxy statements and other public filings and are intended to provide shareholders with a more accurate, complete and accessible explanation of the compensation paid to executive officers."). In addition, the Financial Accounting Standards Board developed new standards of accounting for stock options to close a loophole that encouraged companies to issue excessive stock options. *See Executive Stock Options: Should the IRS and Stockholders Be Given Different Information?: Hearing Before the Permanent Subcomm. on Investigations,* 110th Cong. 10 (2007) (statement of Jeffrey P. Mahoney, General Counsel, Council on Institutional Investors) ("Through this strange but very tempting little loophole, truckloads of

continue to raze, ravage, plunder, pilfer, seize, and assail.[32]

Even a majority of institutional investors believe that "CEO compensation . . . [is] excessive."[33] These excesses are visible on an international scale. 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."[34] Furthermore, the amount of compensation continues to increase. 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*."[35]

Another study found that CEO income grew 30% in 2004 after growing "15% in 2003 and 9.5% in 2002," while "working stiffs s[aw] their income go up by 2% or 3% a year."[36] "[T]he compensation of the five highest-paid executives at public companies climbed to 9.8% of the companies' aggregate earnings in the 2001–03 period, from 5% of . . . aggregate earnings in the 1993–95 period."[37] If factory workers' average

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option grants were delivered to executives with no expense to the companies granting them. Because of this same loophole, hundreds of billions of dollars of shareholder value were transferred to executives with virtually no controls or limitations.").

32. *See* MAJORITY STAFF, U.S. HOUSE OF REP. COMM. ON OVERSIGHT AND GOV'T REFORM, 110TH CONG., EXECUTIVE PAY: CONFLICT OF INTEREST AMONG COMPENSATION CONSULTANTS 1 (Comm. Print 2007) [hereinafter COMPENSATION CONSULTANTS' CONFLICT OF INTEREST REPORT] ("In 2006, the average Fortune 250 CEO was paid over 600 times the average worker."); Smith, *supra* note 30, at B13 ("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."). *See also* LEO HINDERY, IT TAKES A CEO 79 (2005) ("[T]he spread between the pay of Cisco's CEO John Chambers and that of his average employee is 2,300:1."); Mark Fortier, *Former Telecom CEO Leo Hindery on CEO Responsibilities, Pay, and Ethics*, FRUGALMARKETING.COM, http://www.frugalmarketing.com/dtb/leo-hindery.shtml (last visited Nov. 10, 2008) ("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.") (quoting Leo Hindery) (emphasis added); Posting of Donna Jablonski to AFL-CIO Now Blog, *Outrageous CEO Pay Costs Workers, AFL-CIO Tells Congress*, http://blog.aflcio.org/2006/05/25/outrageous-ceo-pay-costs-workers-afl-cio-tells-congress/ (May 25, 2006) ("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 . . . ."); Sklar, *supra* note 5 ("Up through the 1970s, 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.").

33. Editorial, *Funds Still Too Eager to Appease Management*, INV. NEWS, June 11, 2007, at 8.

34. Sklar, *supra* note 5.

35. COMPENSATION CONSULTANTS' CONFLICT OF INTEREST REPORT, *supra* note 32, at 1 (emphasis added). "[T]he median compensation among chief executives of companies in the Standard & Poor's 500 index increased by 23.6% in 2006, compared with the 2005 level." *Funds Still Too Eager to Appease Management*, *supra* note 33, at 8.

36. Jim Pavia, *Excessive Exec Pay Symptomatic of Weak Boards*, INV. NEWS, Mar. 13, 2006, at 8. "[T]he heads of America's 500 biggest companies received an aggregate [54%] pay raise in 2004 . . . ." Fortier, *supra* note 32.

37. *Funds Still Too Eager to Appease Management*, *supra* note 33, at 8. *See also*

pay grew at the same rate as that of CEOs, “their 1999 earnings would have been $114,035, rather than $23,753.”[38] Applying the same principle, “[the minimum wage] would now be $24.13 per hour, instead of $5.15.”[39] Further comparison shows that “[in the 1950’s] your typical CEO made about twice as much as your typical president of the United States,” but “[t]oday, your average CEO makes more than *sixty-two times* as much as your average U.S. president.”[40] Of major institutional investors surveyed, 75% agreed that CEO compensation at large companies was “excessive.”[41]

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.[42] The resulting corporate bankruptcies mean unemployment and evaporated retirement plans for rank-and-file employees.[43]

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.”[44] 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.[45]

COMPENSATION CONSULTANTS’ CONFLICT OF INTEREST REPORT, *supra* note 32, at 1 (“By 2003, the share of corporate earnings paid to top executives had doubled to 10%.”); Joseph Nocera, *Disclosure Won’t Tame C.E.O. Pay*, N.Y. TIMES, Jan. 14, 2006, at C1, *available at* 2006 WLNR 770657 (“[T]he total compensation of the five best-paid officers of all publicly held companies amounted to [10%] of corporate earnings.”).

38. HINDERY, *supra* note 32, at 72.

39. *Id*. *See also* COMPENSATION CONSULTANTS’ CONFLICT OF INTEREST REPORT, *supra* note 32, at 1 (“While CEO pay has soared, employees at the bottom of the pay scale have seen their real wages decline. In real terms, the value of the new federal minimum wage, $5.85 per hour, is 13% below its value a decade ago.”).

40. HINDERY, *supra* note 32, at 71–72.

41. *Funds Still Too Eager to Appease Management*, *supra* note 33, at 8.

42. Brian P. Cove, *Study Links Excessive CEO Compensation with Higher Credit Risk*, SECURED LENDER, Nov. 1, 2005, at 12.

43. 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. *See also* Leslie Cauley, *Rigas Tells His Side of the Adelphia Story*, USA TODAY, Aug. 6, 2007, at 1B, *available at* 2007 WLNR 15045400 (stating that 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. Editorial, *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.

44. Cove, *supra* note 42, at 12 (referring to comments from Moody’s Investor Service linking excessive CEO pay to possible weak oversight by the board of directors).

45. *See* William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CAL. L. REV. 1557, 1558 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004)) (“[M]anagers

> *Example #3*. Bob Bluebeard ("Bluebeard") is CEO of Scurvy Dog, Inc. Scurvy Dog pays Bluebeard $1 million in fixed salary[46] 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.[47] As a result, Bluebeard has powerful incentives to greatly inflate the year-end stock price and earnings,[48] but his incentive to promote long-term stability is comparatively weak. If Bluebeard's get-rich-quick schemes for Scurvy Dog fail and he 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.[49]

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."[50] "Wretched excess" is "socially corrosive."[51] Professors Bebchuk, Fried, and others have examined the negative impacts of excessive executive compensation in depth.[52]

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possess and effectively wield power, ensuring that so-called incentive pay comes on easy terms . . . . [T]he victims of the imbalanced arrangement are the shareholders . . . .").

46. I.R.C. § 162(m)(1) (2000). A corporation can only deduct the first $1 million of fixed compensation it pays to its CEO each year. *Id.*

47. 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, *Executive Pay: My Big Fat C.E.O. Paycheck*, N.Y. TIMES, Apr. 3, 2005, at 31, *available at* 2005 WLNR 5181447. In these situations, "rich severance" provides a "soft landing . . . in case they fail." *Id.*

48. Stock options "prompted some managers to time decisions to pump up the stock just when their options vested." *Id.*

49. *See* John M. Connor & Robert H. Lande, *How High Do Cartels Raise Prices? Implications for Optimal Cartel Fines*, 80 TUL. L. REV. 513, 520 n.37 (2005) ("[T]he reward structures of executive compensation contracts typically give short-term personal enrichment a greater weight in executive decisions than the long-run interests of stockholders.").

50. Pavia, *supra* note 36, at 8.

51. HINDERY, *supra* note 32, at 78 (calling bonuses and incentive packages "wretched excess"); Nocera, *supra* note 37, at C1 (calling uncontrolled executive pay "socially corrosive").

52. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 8 (2004) ("[P]aying executives hundreds of times what other employees get is inherently unfair and unacceptable. . . . [But w]e would accept compensation at current or even higher levels as long as such compensation, through its incentive effects, actually serves

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. Conversely, 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 Buffett, "[t]here is no question . . . that mediocre [executives] are getting incredibly overpaid. And the way it's being done is through stock options."[53] Stock options may allow a CEO to make out like a bandit even when the company's performance is miserable compared the industry, or even the stock market in general.[54]

> *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. 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 price would be $150. Under

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shareholders."); Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J.L. BUS. & FIN. 31, 43–44 (1997) ("[T]he effect on morals and morale . . . is the problem."); Susan Lorde Martin, *The Executive Compensation Problem*, 98 DICK. L. REV. 237, 237 (1994) ("Americans think excessive executive pay is the main reason for the loss of American jobs in the last decade.").

53. Shawn Tully, *Raising the Bar*, FORTUNE, June 8, 1998, at 272, *reprinted in* BEBCHUK & FRIED, *supra* note 52, at 143. *See* Scott DeCarlo, *Big Paychecks*, FORBES, May 21, 2007, at 112 ("The 500 chief executives [Forbes] track[ed] got a collective 38% pay raise [in 2006], to $7.5 billion. . . . Exercised stock options again account for the main component of pay, 48%."); HINDERY, *supra* note 32, at 72–73 ("CEO pay has been skewed upward enormously by the huge increase in the frequency, scale, and value of options awards.").

54. 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%] of share price movement reflects corporate performance; the remaining [70%] 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 52, at 139 (footnote omitted).

> Davy's leadership, the stock price for Skull-and-Cross-Bones, Inc. has only increased to $120. Nevertheless, in year nine, Davy exercises the options, sells the stock he acquires, and reaps a $20 million bonanza.[55]

The amounts plundered with stock-option schemes are staggering. UnitedHealth Group's CEO William McGuire should feel satiated. He has over $1.5 *billion* in unexercised stock options.[56] McGuire actually cashed in over $136 million of stock option gains in 2006,[57] and over $114 million in 2004.[58] 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.[59] Occidental Petroleum CEO Ray Irani hit a gusher when he received $270 million from exercising stock options in 2006.[60]

The plundering does not stop there. IAC/Interactive CEO Barry Diller connected with $295 million from stock options.[61] Fidelity National Financial's CEO William P. Foley should have felt secure in 2006. Most of his $180 million in compensation was from exercised stock options.[62] 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.[63] Coach CEO Lew Frankfort received something better than a bucket of Gatorade over his head in 2004—new stock options worth approximately $130 million.[64]

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55. Davy will pay income tax on the gain when he exercises the stock options. Treas. Reg. § 1.83-7(a) (as amended in 2004). *See also* NEAL A. MANCOFF & DAVID M. WEINER, NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS 4-17 (2008) ("Section 83 will not require the employee to recognize income until stock is acquired upon exercise of the option . . . .").

56. Bruce Meyerson, *Options Inquiries Raise Fears of Deeper Troubles*, FORT WORTH STAR-TELEGRAM, May 21, 2006, at F7, *available at* 2006 WLNR 8729181 (discussing the value of his unexercised options in 2005). Federal prosecutors opened a criminal investigation into UnitedHealth Group's stock option program, and the IRS also launched an investigation. *Id.* After an internal review, McGuire surrendered $320 million in stock options. NAT'L L. J., *Ex-United Health CEO Settles Backdating Claims*, Dec. 10, 2007, at 16 col. 3.

57. Meyerson, *supra* note 56, at F7.

58. James E. Twining, Editorial, *UnitedHealth's 'Good Business' Looks Greedy*, PROVIDENCE J. BULL. (R.I.), Feb. 6, 2006, at A13, *available at* 2006 WLNR 2141152.

59. Susan Chandler, *'Golden Hellos' Still Glitter: Recent Hiring and Exit Packages for Top Executives Show that Boards Seem to Have Little Fear of Shareholder Revolt*, CHI. TRIB., July 19, 2005, at C1, *available at* 2005 WLNR 23509081.

60. Scott DeCarlo, *Big Paychecks*, FORBES, May 3, 2007, at 112; Greg Farrell & Barbara Hansen, *A Peek at the Perks of the Corner Office*, USA TODAY, Apr. 16, 2007, at 1B, *available at* 2007 WLNR 7180591.

61. Geraldine Fabrikant, *Diller, a Late Entry, Takes the Prize for Highest Paid*, N.Y. TIMES, Oct. 26, 2006, at C1, *available at* 2006 WLNR 18551812.

62. DeCarlo, *supra* note 60.

63. *Id.*

64. Too Much: Executive Pay Scoreboard, *The Too Much Executive Pay Scorecard*,

Similarly, in 2006 "Bank of America CEO Kenneth Lewis bolstered his take-home pay of $23 million by exercising $77 million worth of stock options."[65] Wells Fargo CEO Richard Kovacevich stashed $62 million in his personal wagon train from the exercise of stock options in 2006.[66] Advance Auto Parts CEO Michael Coppola can buy a new car instead of repairing an old clunker. He drove away with $42 million in stock option profits in 2004.[67]

B. 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 *billion* retirement package when he steps down."[68]
- Exxon Oil executive Lee Raymond slipped away with an "outrageous" $400 million retirement package that included stock options.[69]
- 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 six years.[70] During his reign, Home Depot's stock price dropped 7.9%.[71]
- "The contract of L. Dennis Kozlowski at Tyco International called for an immediate payout of about $135 million if he was dismissed, and a retainer of $3.4 million annually for the rest of his life."[72]
- Disney's Michael Ovitz danced away with a severance package of

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http://www.toomuchonline.org/articlenew2005/ExecPay2004.html [hereinafter Too Much] (last visited Nov. 10, 2008).

65. Farrell & Hansen, *supra* note 60, at 2B.

66. Vinnee Tong, *High Energy Prices Prove Positive for Oil CEOs,* OKLAHOMAN, June 14, 2007, at 6B, *available at* 2007 WLNR 11222930.

67. Too Much, *supra* note 64.

68. Michael Brush, *CEOs Who Take the Millions and Run*, Nov. 22, 2006, http://articles.moneycentral.msn.com/Investing/CompanyFocus/ForeSelectCEOsRetirementAndABigRaise.aspx (emphasis added).

69. Larry Elder, *It's the Debate on Profits That's Obscene*, DAILY BREEZE, May 14, 2006, at A17, *available at* 2006 WLNR 8324875.

70. Smith, *supra* note 30, at B13 ("[H]e waltzed away with a mind-boggling goodbye gift worth more than $30 million for each year he worked there.").

71. *Id*.

72. Deutsch, *supra* note 47, at 31. Kozlowski ultimately resigned and released Tyco from the terms of the agreement. *Id*.

$130 million after his 14-month term as president.[73] 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.[74]
- American Express's Kenneth Chenault should be able to pay his credit card bills if he becomes unemployed. "If the company is acquired[,] [h]e walks away with $109 million."[75]
- 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.[76]
- Pfizer's CEO Henry McKinnel should not need anti-depressants if he becomes unemployed. He "can choose an annual pension of $6.5 million or an $83 million lump-sum" when he leaves.[77]
- Hewlett-Packard reportedly paid CEO Carly Fiorina $42 million in severance pay, even though HP's market value declined by one-third during her term.[78] The arrangement has been described as a "pay for failure" contract.[79]
- 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*.[80]
- 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."[81]

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73. David Lieberman, *Disney Wins Ruling in Lawsuit Over Ovitz Pay*, USA TODAY, Aug. 10, 2005, at 1B, *available at* 2005 WLNR 12561063.

74. Greg Farrell, *Morgan Stanley Sued Over Payments to Former Execs*, USA TODAY, July 20, 2005, at 6B; Charles Gasparino & Nicole L. Joseph, *Good News: You're Fired*, NEWSWEEK, July 25, 2005, at 48, *available at* 2005 WLNR 11310852.

75. Farrell & Hansen, *supra* note 60, at 1B.

76. Deutsch, *supra* note 47, at 31. *See also* Nocera, *supra* note 37, at C1 (estimating Kilts' golden parachute to be $175 million including stock options).

77. Jablonski, *supra* note 32.

78. *See* Pavia, *supra* note 36, at 8 ("I guess there's nothing better than collecting for a job not well done."). *But see* Gary Strauss, *$21 Million Severance Package Eases Exit; Still, That's Less Than Mangy Outgoing CEOs*, USA TODAY, Feb. 10, 2005, at 2B, *available at* 2005 WLNR 1851434 (reporting that Hewlett-Packard paid Fiorina $21 million).

79. Deutsch, *supra* note 47, at 1.

80. Gasparino & Joseph, *supra* note 74, at 48 ("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.").

81. MarketWatch, *Prince Exit Deal: $29.5 Million Plus Incentive Award*, THOMPSON FIN.

- Fannie Mae paid CEO Franklin Raines $26 million when he left, even though the company lost almost $9 *billion* during his term.[82]
- May Department Stores CEO Gene Kahn left with more loot than most shoplifters. He raced out the door with a $9 million severance package, although the company's profits fell 50% in four years while he was in charge.[83] Apparently, no alarm went off, and no security guards chased him.
- Nike paid CEO William Perez $5.5 million in severance when he resigned after a little over a year on the job.[84]

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."[85]

- Citigroup Inc. of New York "stuffed [Chairman Stanford I. Weill's] pockets with $21.5 million in pay [in 2005]."[86] In addition, the company paid his income taxes (likely costing the company approximately $17.5 million),[87] the cost of his personal use of a

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NEWS, Nov. 9, 2007.

82. Editorial, *Fannie Mae's Golden Eggs*, N.Y. POST, Jan. 2, 2005, at 24, *available at* 2005 WLNR 23210364.

83. H.D. Maynard, Letter to the Editor, *Failure Shouldn't Pay*, ST. LOUIS POST DISPATCH, July 22, 2005, at B8, *available at* 2005 WLNR 24295042.

84. Michael Brush, MSN MONEY, *Most Outrageous CEO Perks of 2006—So Far*, Aug. 16, 2006, http://articles.moneycentral.msn.com/Investing/CompanyFocus/MostOutrageousCEOPerksOf2006SoFar.aspx.

85. Farrell & Hansen, *supra* note 60, at 2B (citing statistics compiled by The Corporate Library, a corporate governance monitoring group).

86. Pavia, *supra* note 36, at 8.

87. 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 one minus the tax rate. 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS 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 from it. They're receiving a benefit.'" Farrell & Hansen, *supra* note 60, at 2B (quoting Paul Hodgson of The Corporate Library, a shareholder watchdog group). "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, '[o]nly the little people pay taxes.' It's the ultimate in pigginess . . . . It adds insult to injury, and then adds a little more injury." Greg Farrell, *Most Galling of All Perks Could Be Gross-ups: Some CEOs Get Extra Dough to Pay Tax Bills on Freebies*, USA TODAY, Apr. 16,

private jet (worth $524,000), and the fees for his personal financial advice ($85,714).[88]

- Tyco allowed its CEO Dennis Kozlowski to use a $17 million Manhattan apartment.[89] The company also provided a $15,000 dog-shaped umbrella stand, and a $6,000 shower curtain.[90] In addition, Tyco paid for a $2 million birthday party for Kozlowski's spouse on the Italian island of Sardinia.[91] Jimmy Buffet was flown in to sing "Happy Birthday."[92] Under Kozlowski's reign, Tyco shareholders lost $80 billion in value on their stock.[93]
- 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 he can live in California and commute to work in New York.[94]
- General Electric's former CEO Jack Welch enjoys 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.[95]
- In 2006, Occidental Petroleum's CEO Ray Irani struck it rich, taking home $415 million, not including "$562,589 worth of security services . . . [and] $556,470 for tax preparation and financial-planning services . . . ."[96]
- 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."[97]

2007, at 2B, *available at* 2007 WLNR 7180588 (quoting Nell Minow, editor at The Corporate Library, a shareholder watchdog group).

88. Pavia, *supra* note 36, at 8.

89. Andrew Ross Sorkin, *Tyco Details Lavish Lives of Executives,* N.Y.TIMES, Sept. 18, 2002, at C1, *available at* 2002 WLNR 3554731.

90. *Id.*

91. A.J. Carter, *Lessons of the Boys of October*, NEWSDAY, Oct. 3, 2003, at A46, *available at* 2003 WLNR 885806.

92. *Id*.

93. Ellen Frank, *The Great Stock Illusion*, DOLLARS & SENSE, Nov. 1, 2002, at 14, *available at* 2002 WLNR 5525832.

94. Brush, *supra* note 84.

95. John J. Sweeney, *The Foxes Are Still Guarding the Henhouse*, L.A. TIMES, Sept. 19, 2003, at B13; Nocera, *supra* note 37, at C1, *available at* 2003 WLNR 15189759.

96. Farrell & Hansen, *supra* note 60, at 1B.

97. Portfolio.com, The Most Outrageous C.E.O. Perks, June 20, 2007, http://www.portfolio.com/slideshows/2007/06/Executive-perks (last visited Nov. 10, 2008).

- 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."[98]
- Nike paid $579,649 to remodel an outgoing chief executive's home.[99]

II. 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. In publicly held corporations, the board of directors is responsible for reviewing the top executives' compensation. Each director has "various economic incentives to support, or at least go along with, arrangements favorable to the company's top executives."[100] Top executives can direct business, either now or in the future, to the enterprise with which the director regularly works.[101] They also influence directors' compensation, which can be substantial.[102] Perhaps as important, CEOs wield considerable control over who is re-elected to the board.[103] "There is no such thing as an independent director if [CEO's] are picking them."[104] Executives may even

98. Farrell & Hansen, *supra* note 60, at 1B.

99. Brush, *supra* note 84.

100. BEBCHUK & FRIED, *supra* note 52, at 4. "Boards of large public companies delegate to compensation committees the task of working out the critical details of executive compensation arrangements." *Id.* at 24.

101. As an example, "Verizon's 2001 board [of directors] included an executive director of Boston Consulting Group, which received $3.5 million from Verizon for services [rendered] in 2000; the CEO of a railroad that was paid $650,000 by Verizon for services and products; and two attorneys from law firms that provided Verizon with legal services." *Id*. at 27–28.

102. *See id*. at 30. ("[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."). Estimates regarding director compensation vary. "Pearl Meyer [& Partners'] 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 47, 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 average $136,360." Robert C. Pozen, *If Private Equity Sized Up Your Business*, HARV. BUS. REV., Nov. 1, 2007, at 78, 86, *available at* 2007 WLNR 25827141. In 2002, directors at the Fortune 1000 companies spent an average of 190 hours on board service, resulting in compensation of approximately $611 per hour. *See* BEBCHUK & FRIED, *supra* note 52, at 25, 37 (documenting that in 2002 the average director at a Fortune 1000 company was paid $116,000 and worked 190 hours).

103. *See* BEBCHUK & FRIED, *supra* note 52, at 26. "Boards [likely will not] . . . nominate a director clearly opposed by the CEO. At a minimum, CEOs have had considerable power to block nominations. Thus, sparring with the CEO over executive compensation could have only hurt a director's chances of being renominated . . . ." *Id.*

104. Nocera, *supra* note 37, at C1 (quoting Nell Minow, editor at The Corporate Library, a shareholder watchdog group).

direct a company's charitable contributions to institutions that a director supports.[105] These economic conflicts of interest may prevent the board from exercising its oversight responsibilities effectively.

Social and psychological factors may also affect the reasonableness of CEO compensation. For example, "collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friendship and loyalty" can prevent a director from challenging top-executive compensation.[106] "[L]imitations on time and resources have made it difficult for even well-intentioned directors to do their pay-setting job properly."[107] Moreover, many directors, as current or retired highly paid executives, may experience cognitive dissonance on compensation decisions. "Individuals are known 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."[108]

Additionally, influences outside a corporation may significantly impact executive compensation. Publicly held corporations frequently 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.[109] "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 assess."[110] Such incentives may prevent these consultants from accurately depicting the reasonableness of CEO compensation.

As a result, "[e]xecutives and boards often form cozy cabals that shortchange shareholders because they allow executives to put their own interests first."[111] 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

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105. *See, e.g.*, BEBCHUK & FRIED, *supra* note 52, at 28 (observing that Oracle made contributions to Stanford while three Stanford professors were on the Oracle board of directors).

106. *Id*. at 4.

107. *Id*.

108. *Id.* at 33. A 2002 study reported that 41% of directors on compensation committees are active executives (approximately 50% are active CEOs) and 26% of members are retired, and most of them are former executives. STACEY BURKE, GLENN DAVIS, CHRIS LOAYZA, CONOR MURPHY & SERGIO SCHUCHNER, BOARD STRUCTURE/BOARD PAY 2002 at 47 (2002).

109. COMPENSATION CONSULTANTS' CONFLICT OF INTEREST REPORT, *supra* note 32, at 4.

110. *Id.* at i. "In 2006, 113 of [the 179 corporations reporting] . . . paid the same consultant to provide other services for the company in 2006." *Id.* at 4. If the consultant received $10,000 or less for other services, that was not considered a conflict of interest. *Id.* at 4 n.16.

111. Michael Brush, *The Worst CEO Perks*, MSN MONEY, Apr. 25, 2007, http://articles.moneycentral.msn.com/Investing/CompanyFocus/CEOPerksLifeGetsBetterAtTheTop.aspx?page=all.

with adverse interests, analogous arguments are not applicable to executive compensation in publicly held corporations.[112]

III. 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 government—always have effects that are unanticipated or unintended."[113] A four-step method of analysis applying Merton's concepts can assist in evaluating a law or other action, such as 409A.

First, one must identify the purpose or goal of the action being analyzed.[114] After unintended consequences arise, there is a risk people will engage in ex post facto rationalizations rather than acknowledging the intended purpose or goal.[115] "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.'"[116]

Second, after identifying the purpose or goal, one considers both the intended and the unintended consequences.[117]

Third, the unintended consequences are assigned among three categories.[118] These categories are beneficial consequences, unrelated consequences, and perverse consequences.[119] Beneficial consequences are

112. 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 (in this case, the shareholders). *See* T.P. Gallanis, *The Trustee's Duty to Inform*, 85 N.C. L. REV. 1595, 1616 (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 losses that result from this misalignment of incentives are known in the law and economics literature as agency costs.").

113. Rob Norton, *Unintended Consequences*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS 505, 505 (David R. Henderson ed., 2008). *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. Merton, *supra* note 29, at 897.

114. *See* Merton, *supra* note 29, at 897 (discussing methodological pitfalls that might interfere with an attempt to discern the actual purposes of a given action).

115. *Id*.

116. *Id*.

117. *See id.* at 898 (identifying obstacles to the correct anticipation of an action's consequences).

118. *See* ROBERT K. MERTON, SOCIAL THEORY AND SOCIAL STRUCTURE 105 (1968 enlarged ed.) [hereinafter SOCIAL THEORY AND SOCIAL STRUCTURE] (identifying the three categories of unanticipated consequences).

119. *Id*.

unintended consequences that help achieve the purpose.[120] Unrelated consequences, including collateral damage, have no bearing on the achievement of the purpose.[121] For example, a law intended to curb an abusive activity impacts individuals or entities not engaged in the abusive activity.[122] Finally, perverse consequences are unintended consequences that not only fail to advance the goal, but actually exacerbate the problem.[123] 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[.]"[124] The law actually increased executive salaries because "it made $1 million the new salary floor."[125]

Fourth, according to Professor Merton, rather than always attributing unintended consequences "to the inscrutable will of God or Providence or Fate,"[126] we can trace unintended consequences to one of the following five factors: ignorance,[127] error,[128] the "imperious immediacy of interest,"[129] basic values,[130] and self-defeating prophecy.[131] The "imperious immediacy of interest" refers to situations when the actor is so concerned with the short-term consequences that potential long-term consequences are ignored or disregarded.[132] Basic values drive unintended consequences when actions

120. *Id*.

121. *Id*.

122. The following illustrates collateral damage:

> *Example #5*. Quotas on Steel Imports. "[T]he U.S. government has imposed quotas on imports of steel in order to protect steel companies and steelworkers from lower-priced competition. The quotas do 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 do. So a policy that protects one industry from foreign competition makes it harder for another industry to compete with imports."

Norton, *supra* note 113, at 506.

123. *See* SOCIAL THEORY AND SOCIAL STRUCTURE, *supra* note 118, at 105 (describing unintended consequences that are dysfunctional in their system).

124. Nocera, *supra* note 37, at C1.

125. *Id*. "In the hall of fame of unintended consequences . . . [the 1993 law] has to rank right near the top." *Id.* (quotation marks omitted) (quoting Nell Minow, editor at The Corporate Library, a shareholder watchdog group).

126. Merton, *supra* note 29, at 894.

127. *See id.* at 900 (noting that because of the "exigencies of practical life," people frequently must act on "opinion and estimate").

128. *See id.* at 901 (explaining the pervasive opportunities for error). Merton explains: Error 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. *Id.*

129. *Id.*

130. *Id.* at 903.

131. *See id.* ("Public predictions . . . are frequently not sustained precisely because the prediction has become a new element . . . tending to change the initial course of developments.").

132. *Id.* at 901.

are taken because of "certain fundamental values" without further consideration.[133] For example, "the Protestant ethic and the spirit of capitalism[] . . . paradoxically leads to its own decline through the accumulation of wealth and possessions[.]"[134] Finally, a prophecy may become self-defeating when fear of an anticipated consequence results in action that prevents the anticipated problem from developing.[135] As an example, fear of over-population and mass starvation inspired scientific breakthroughs in agricultural productivity that have diminished the risk of over-population.[136]

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. 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.[137] 409A will inflict needless costs on small businesses and charities, and will impose unfair taxes on their employees.

IV. 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 corporations.[138] The purpose was to curb CEO piracy and eliminate the resulting hardship on the victims—employees, shareholders, and society in general.[139] This Part discusses four key errors the government made along the voyage that resulted in the 409A shipwreck.

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133. *Id.* at 903.

134. *Id*.

135. *See id.* at 904 (describing how Marx's predictions concerning capitalism prompted the creation of labor organizations and collective bargaining, which in turn frustrated "the developments which Marx had predicted").

136. *See id.* at 904 (explaining how the predictions of social scientists often account for "social movements developing in utterly unanticipated directions").

137. *See* JOINT CHIEFS OF STAFF, DEPARTMENT OF DEFENSE DICTIONARY OF MILITARY AND ASSOCIATED TERMS 95 (as amended through 26 Aug. 2008) (defining collateral damage as "[u]nintentional or incidental injury or damage to persons or objects that would not be lawful military targets in the circumstances ruling at the time").

138. ENRON COMPENSATION REPORT, *supra* note 6, at 1.

139. *See supra* Part I (discussing CEOs' piratical practices).

A. Error #1—The Government Performed Empirical Research Only on Enron

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.[140] Enron declared bankruptcy on December 2, 2001,[141] and the government prosecuted Enron's top executives on various criminal charges.[142] These proceedings provided the Joint Tax Committee with substantial information. The Joint Tax Committee produced a 732-page report.[143]

It appears that the government did not gather data on other publicly held corporations in developing 409A. The legislative history refers only to the Enron Compensation Report, stating: "The staff of the Joint Committee on Taxation made recommendations similar to [409A] in the [Enron Compensation] report."[144] 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,[145] and the corporate culture at Enron was notorious.[146] The behavior at Enron was so remarkable that it inspired some particularly inventive people to create "Enron—The Musical!"[147] Although Enron was an interesting page in corporate

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140. ENRON COMPENSATION REPORT, *supra* note 6, at 5.

141. *Id.*; *Timeline of Enron's Ownership of PGE*, *supra* note 7, at D1.

142. Kurt Eichenwald, *Enron's Skilling is Indicted by U.S. in Fraud Inquiry*, N.Y. TIMES, Feb. 20, 2004, at A1, *available at* 2004 WLNR 5511853 (reporting that twenty former Enron executives were indicted, including Jeffery Skilling and Andrew Fastow).

143. The report discusses Enron's compensation practices and its strategies to save income taxes. *See* ENRON COMPENSATION REPORT, *supra* note 6, at 5–11.

144. H.R. REP. NO. 108-548, pt. 1, at 343 n.453 (2004). Also, both the legislative history and the Enron Compensation Report discuss a "haircut" feature in Enron's traditional NQDC plan. *Id.*

145. Eichenwald, *supra* note 142, at A1.

146. 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 pricey suits ravish the United States for extreme profit.

John E. Mitchell, *Real Life 'Pirates' Plunder America in this Documentary Tale*, N. ADAMS TRANSCRIPT (Mass.), June 9, 2005, at Entertainment.

147. Everett Evans, *Enron Scandal Gets Satirical Treatment; Musical Satire Makes Its World Premiere Tonight*, HOUSTON CHRON., Dec. 1, 2006, at 1, *available at* 2006 WLNR 20785001 ("Jeff Skilling, Andy Fastow and the rest of the Enron gang will have a new home very soon. No, not prison. The stage. Enron—The Musical makes its world premiere tonight . . . ."). *See also* Steven C. Day, *Songs of Enron: Sometimes Life Just Needs a Tune*, POPPOLITICS, Jan. 23, 2002, http://www.poppolitics.com/articles/print/2002/01/23/songs-of-enron. "The Enron mess has affected people in different ways. Some are sad, others blood-boiling mad and a few . . . apparently couldn't care

America's history book, Enron represents a better example of executives behaving badly than business as usual.[148]

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.[149] The government also could have studied survey reports prepared by consultants such as Clark Consultants, Buck Consultants or Watson Wyatt, who regularly assist publicly held corporations in establishing compensation arrangements.[150]

B. 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.[151] Stock options represented almost 75% of the total compensation Enron provided to these top executives.[152] Nevertheless, the Joint Tax Committee merely stated that Enron's stock-option plan appeared to comply with existing law, and made no

less. My response to the scandal, strangely enough, has been to break into song. In fact, I've written a two-act musical about it: *Songs of Enron*." *Id.* One commentator has even suggested creating "Enron: The Musical Comedy!" Alex Gibney, *Enron: The Musical*, http://www.landmarktheatres.com/mn/enron.html (last visited Nov. 9, 2008).

148. *See* ENRON COMPENSATION REPORT, *supra* note 6, at 4 (outlining corporate malfeasance by Enron's executives).

149. 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* Alert Letter from Frederic W. Cook & Co., Inc., SEC Proposes Extending Form S-8 Registration to Transferred Stock Options (Mar. 30, 1998), http://www.fwcook.com/980330.html (describing Form S-8 as a "simplified registration form . . . specifically for shares offered . . . to employees in a compensatory or incentive context," and noting that proxy statements are required to disclose "the gains realized from stock options exercised during the reporting year by named executive officers as well as gains on stock options held by those individuals as of year-end").

150. *See* CLARK CONSULTING, EXECUTIVE BENEFITS—A SURVEY OF CURRENT TRENDS: 2005 RESULTS at 5 (2005) (compiling data on executive benefits from approximately 20% of the Fortune 1000 companies); Buck Consultants, About: Buck Surveys, https://www.bucksurveys.com/ (follow "about" hyperlink on main navigation menu; then follow "Buck Surveys" hyperlink) (last visited Nov. 9, 2008) (describing the company's expertise in conducting surveys of employment compensation data); WatsonWyatt.com, Executive Compensation and Nonqualified Plans: What's Ahead? (Oct. 2002), http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=10500 (discussing data gleaned from a 2002 study of nonqualified deferred compensation plans).

151. ENRON COMPENSATION REPORT, *supra* note 6, at 547. Enron's top 200 executives received $1.063 billion from stock options in 2000. *Id.*

152. *Id.* In 2000, Enron paid its 200 highest-paid executives $1.424 billion, and $1.063 billion of that amount was from stock options. *Id.*

recommendation for change or study.[153] Thus, the Joint Tax Committee tacitly blessed a key tool that CEO pirates use to loot publicly held corporations.[154] 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 [that] 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.[155]

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 top-executive compensation was reasonable. "[I]n some cases, the studies appeared to be designed to justify whatever compensation arrangement management wanted to adopt."[156] In summarizing the procedures for reviewing compensation, the Joint Tax Committee stated, "Enron's top executives . . . essentially wrote their own compensation packages."[157] Nevertheless, the Committee made no recommendations for addressing the absence of arm's-length bargaining.[158]

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

Rather than address the key problems, the Joint Tax Committee went off on a tangent. The Committee chose to focus its recommendations on NQDC,[159] which was a particularly bizarre choice for three reasons.

First, NQDC represented less than 5% of top-executive compensation at Enron.[160] From 1998 through 2000, NQDC represented only 4.72% of total compensation for Enron's 200 highest-paid executives.[161] For that

153. *Id.* at 41.

154. *See supra* Part I.A (regarding the use of stock options by top executives).

155. ENRON COMPENSATION REPORT, *supra* note 6, at 19 (emphasis added).

156. *Id*. at 36. *See also* COMPENSATION CONSULTANTS' CONFLICT OF INTEREST REPORT, *supra* note 32, at i (discussing the Committee on Oversight and Government Reform's hearings on the problem of compensation consultants' conflicts of interest in December of 2007).

157. ENRON COMPENSATION REPORT, *supra* note 6, at 36.

158. *See id.* at 634 (failing to consider arm's-length bargaining in their findings).

159. *See* ENRON COMPENSATION REPORT, *supra* note 6, at 634 (focusing its recommendations on NQDC arrangements).

160. Drennan, *supra* note 12, at 428.

161. *Id.* at 434.

period, total compensation (including NQDC) was $2,019.5 million, and deferrals under the NQDC plans totaled $100 million.[162] 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.[163] Under the terms of the plan, Bilgewater would receive the deferred amounts (plus accrued interest) when he terminates employment.[164] In addition, the Enron NQDC plan included a "haircut" provision. 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.[165] A month before Enron declared bankruptcy (on December 2, 2001), Bill Bilgewater requests his entire $100,000 balance out of the Enron NQDC plan; Enron consents and pays Bilgewater $90,000.[166] 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 thousands of Enron's rank-and-file employees lost their jobs and Enron shareholders saw their retirement savings disappear.[167] The Joint Tax 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 event.[168]

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162. *Id.*

163. *See* ENRON COMPENSATION REPORT, *supra* note 6, at 606 (explaining that 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).

164. *Id.* at 608.

165. *Id*.

166. The Enron Compensation Report states that 181 of the 295 participants in Enron's NQDC plan requested accelerated distributions. *Id.* at 604, 622. The company approved 109 of those requests. *Id*. at 611, 624.

167. *See id.* at 20 (asserting that these eleventh-hour distributions prove that the executives had too much control over their NQDC benefits to justify the income-tax deferral). "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." *Id*.

168. *Id.* at 636.

Although the Enron eleventh-hour distributions sound egregious, the Joint Tax Committee ignored a bankruptcy statute that prevents executives from benefiting due to their "insider" status. Under bankruptcy laws, because Enron's top executives were "insiders," the Enron bankruptcy trustee can recover all the accelerated NQDC payments made within one year of the date Enron declared bankruptcy.[169] In fact, the Enron bankruptcy trustee recovered over 20% of the accelerated NQDC payments merely by mailing demand letters.[170] The balance can be recovered through litigation.[171]

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" normally restricts the use of NQDC.[172] However, the usual tension that flows from the basic income-tax rules governing NQDC was absent at Enron.[173]

Under the typical rules for NQDC, a corporation cannot claim an income-tax deduction for compensation until the amount is included in the employee's taxable income.[174] 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 a NQDC arrangement.[175]

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169. *See* 11 U.S.C. § 547(b)(4) (2000) (outlining the steps a trustee would take to avoid any transfers of interest). *See also* Drennan, *supra* note 12, at 425 ("[B]ecause bankruptcy laws enacted long before the Enron bankruptcy and subsequent enactment of Section 409A allow a bankruptcy trustee to recover NQDC payments made to a top executive within one year of the company's bankruptcy, the perceived abuse . . . did not exist.").

170. EmployeeCommittee.org, Deferred Compensation Update (July 23, 2004), http://www.employeecommittee.org/sr-deferredcomp.asp.

171. *See Current Issues in Executive Compensation*, 3 N.Y.U. J.L. & BUS. 519, 530 (2007) ("[Congress] failed to realize that $30 million or so . . . was recaptured in the Enron bankruptcy pursuant to existing law."); Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487, 520 (2002) ("[T]he bankruptcy courts should have no problems treating these withdrawals as voidable and using the proceeds for Enron creditors."). *See also* Drennan, *supra* note 12, at 442–43 (discussing *In re* Bank Bldg. & Equip. Corp. of Am., 158 B.R. 138, 140 (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).

172. *See* STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 654 (Comm. Print 1987) (discussing 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 concluding that this "usual tension" is absent if the employer is a tax-exempt entity).

173. ENRON COMPENSATION REPORT, *supra* note 6, at 634.

174. I.R.C. § 404(a)(5) (2000).

175. *See* I.R.C. § 162(a) (2000) (providing that the corporation can deduct the compensation

A cash-basis taxpayer,[176] however, would prefer to enter into a NQDC arrangement because an employee need not pay income tax on compensation until he or she receives the payment.[177] 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 a NQDC arrangement with the employer and defer the receipt of the payment until a future tax year.[178] The deferral will allow the employee's savings to grow tax-free.[179]

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.[180] As a practical matter, Enron was tax-exempt during the years involved, and the availability of an income-tax deduction was unimportant.[181] 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.

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payment if the amount is reasonable).

176. Generally, an individual is a cash-basis taxpayer. *See* I.R.C. § 446(a) (2000) ("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.").

177. 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) (as amended in 1999). S*ee* MICHAEL G. GOLDSTEIN, MICHAEL A. SWIRNOFF, & WILLIAM A. DRENNAN, TAXATION AND FUNDING OF NONQUALIFIED DEFERRED COMPENSATION: A COMPLETE GUIDE TO DESIGN AND IMPLEMENTATION, 44–62 (1998) (discussing the structuring of a NQDC plan prior to the enactment of I.R.C. § 409A such that that the employee would not be taxed on the compensation until he or she actually received the cash payment).

178. *See* Christopher Drew & David Cay Johnston, *Special Tax Breaks Enrich Savings of Many in the Ranks of Management*, N.Y. TIMES, Oct. 13, 1996, at A1 (explaining the prevalence of deferred-compensation schemes among highly paid executives). This assumes that the employee is confident that the corporation will make the payment at the agreed-upon time. If the employee believes that the corporation will declare bankruptcy before the deferred payment date, or within one year of the deferred payment date, the employee will not agree to defer the compensation. *Id.*

179. *See id*. (explaining how executives are able to shelter their money through NQDC plans).

180. ENRON COMPENSATION REPORT, *supra* note 6, at 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 . . . ."). I.R.C. § 172 allows a corporation to carry an operating loss forward into a future tax year (for up to twenty years) to reduce the tax that the corporation otherwise would pay in that future year. I.R.C. § 172(b) (2000 & Supp. 2007).

181. *See* ENRON COMPENSATION REPORT, *supra* note 6, at 5 (reporting that Enron paid no federal income tax from 1996 to 1999). 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. *Id.*

D. Error #4—The Government Applies 409A to Small Businesses and Charities

The report on Enron was the only empirical evidence Congress relied on in enacting 409A.[182] In the past, Congress specifically limited the application of certain income-tax rules on compensation to publicly held corporations.[183] Nevertheless, 409A applies to all employers and employees that defer compensation, including closely held corporations, subchapter S corporations, partnerships, and charities.[184]

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;[185] (ii) tax-exempt employers are subject to the detailed provisions of the "excess benefit" rules when structuring executive compensation arrangements;[186] (iii) closely held corporations and tax-exempt organizations may spend less time and effort in designing complex compensation programs, including NQDC;[187] and (iv) closely held corporations and tax-exempt organizations may not utilize highly sophisticated consultants, attorneys, and accountants to design compensation plans.[188]

Rather than relying exclusively on information about Enron, the government could have used *information reporting requirements* to gather

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182. *See* H.R. REP. NO. 108-548, pt. 1, at 343 n.453 (2004) (explaining the role of the Enron Compensation Report in the creation of 409A).

183. *See* I.R.C. § 162(m)(1) (2000) (dictating that the $1 million cap on tax deductions for fixed salary is applicable only to "publicly held corporation[s]"). *See also* I.R.C. § 280G(b)(5)(A)(ii)(I) (2000) (the "golden parachute" rules only apply if the stock of the corporation is "readily tradeable on an established securities market or otherwise").

184. *See* I.R.S. Notice 2007-62, 2007-32 I.R.B. 331 (noting 409A's impact on tax-exempt organizations). Only two rules in 409A apply exclusively to publicly held corporations, and they are trivial. *See supra* note 14 (describing the two rules).

185. *See* BEBCHUK & FRIED, *supra* note 52, at 82. The dynamics of a closely held corporation are different because the board of directors (which sets the compensation for the officers) typically owns a majority of the corporation's stock. As a result, every dollar paid to unrelated corporate officers reduces the return for the owner-directors. *See id.* ("CEO pay is negatively related to the share ownership of the board's compensation committee."). 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 overpaid. *Id.* at 34 ("[D]irectors commonly bear only a negligible fraction of the cost imposed by flawed compensation arrangements.").

186. *See generally* I.R.C. § 4958 (2000) (enumerating the taxes on excess benefit transactions).

187. *See* David A. Pratt, *Pension Simplification*, 35 J. MARSHALL L. REV. 565, 591 (2002) (discussing stringent rules governing NQDC and the associated difficulties posed to tax-exempt organizations in designing compensation programs).

188. *See* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 586 (2001) (stating that closely held corporations "rarely employ independent outside directors on compensation committees").

empirical data (on IRS Form W-2) about small businesses and charities.[189] The government could have used that information to evaluate whether new compensation laws for small businesses and charities were needed. Unfortunately, the government chose to apply 409A to small businesses and charities, and several unfortunate consequences are discussed in Part VI.

V. SECTION 409A WILL HAVE NO IMPACT ON SAVVY CEO PIRATES

Section 409A merely imposes timing rules. Basically, 409A prohibits the employee (or the employer) from changing the date on which the employer will pay a deferred amount.[190] It has no impact on the *amount* of compensation the employer can pay.[191]

> *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.[192] 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,

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189. The IRS could gather the following six types of valuable data with information reporting requirements: First, 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, SWIRNOFF, & DRENNAN, *supra* note 177, at 213–14 (discussing the reasons that these types of entities have little incentive to use NQDC arrangements for their owner-employees). Second, the income level of employees who typically defer a portion of their salary or bonus, and the amounts deferred. Third, the percentage of employees of tax-exempt entities who defer a portion of their salary or bonus, and the amounts deferred. Fourth, the percentage of NQDC arrangements that are account-balance plans, and the percentage that are defined benefit plans. Fifth, the percentage of NQDC arrangements that are subject to a substantial risk of forfeiture, and the amounts involved. Sixth, 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.

190. *See* I.R.C. § 409A(a)(3) (Supp. 2007) (prohibiting the acceleration of a payment "except as provided in regulations by the Secretary").

191. *See id.* § 409A(c) (stating that nothing in § 409A shall prevent including amounts of gross income "under any other provision of this chapter or any other rule of law").

192. I.R.C. § 162(m)(4)(C) (2000) only 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 id.* (requiring only that performance goals be "determined by a compensation committee . . . comprised solely of 2 or more outside directors," that material terms be disclosed to and approved by shareholders, and that the goals actually be met).

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 highly paid executives will hire experts to help them safely navigate the waters of 409A.[193] As a result, 409A will not curb the piratical practices of top executives.

VI. The Collateral Damage 409A Inflicts On Small Businesses, Charities, And Their Employees

Section 409A applies to *all* employers and employees. The IRS has even issued a press release emphasizing that schools may need to amend their compensation practices.[194] Section 409A regulates almost all arrangements in which compensation is deferred,[195] including mundane

193. 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 due compensation 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* I.R.S. Priv. Ltr. Rul. 200547006 (Nov. 25, 2005) (ruling that I.R.C. § 162(m) does not apply to compensation paid to a CEO in the year of the CEO's resignation); Anne E. Moran, *Reasonable Compensation*, *in* Tax Management Portfolios, at A-47 (The Bureau of Nat'l Affairs, Tax Mgmt. Inc. No. 390-4th, 2006) ("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).

194. I.R.S. News Release IR-2007-142 (Aug. 7, 2007). *But see* I.R.S. Notice 2008-62, 2008-29 I.R.B. 130 (July 1, 2008) (indicating that agreements to spread out compensation over twelve months will not violate 409A unless the amount deferred from one year to the next exceeds $15,500).

195. *See* 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 . . . the service provider has a legally binding right during a taxable year to compensation that . . . is or may be payable . . . in a later taxable year."). Some of the more important deferred compensation arrangements that 409A does not apply to include: (i) qualified pension and profit-sharing plans, I.R.C. § 409A(d)(1)(A) (Supp. 2007); (ii) eligible deferred compensation plans described in I.R.C. § 457(b) established by tax-exempt organizations (generally not more than $15,000 per year can be contributed to these plans for each employee), I.R.C. § 409A(d)(2)(B) (Supp. 2007); I.R.C. § 457(e)(15)(A)–(B) (Supp. 2007) (the limit was $15,000 for 2006, and a cost-of-living adjustment applies); (iii) bona fide vacation and sick-leave plans, I.R.C. § 409A(d)(1)(B) (Supp. 2007); (iv) qualified stock-option plans, I.R.C. § 422; H.R. Conf. Rep. No. 108-755, *reprinted in* 7 Stand. Fed. Tax Rep. (CCH) ¶ 18,952, at p. 36,163 (2007); Treas. Reg. § 1.409A-1(b)(5)(ii) (2007); (v) nonqualified stock options (if the market price of the stock on the date of issue does not exceed the exercise price), Treas. Reg. § 1.409A-1(b)(5)(i)(A) (2007); and (vi) any arrangement (such as a bonus plan) in which the employer pays the compensation within two and a half months of the end of the taxable year in which the compensation is earned, *id.* § 1.409A-1(b)(4); Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234,

compensation practices typically used by employers, including: (i) when the employee can carry over paid sick leave and vacation time to the next year; (ii) 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 ("annualization agreements"); (iii) legal settlements; (iv) noncompete agreements; and (v) reimbursement of business expense arrangements.[196] 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. Section 409A generally applies to "any plan that provides for the deferral of compensation,"[197] and excludes "*bona fide* vacation leave [or] sick leave . . . plan[s]."[198] 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.[199]

A key issue is whether a vacation or sick-leave arrangement is "bona fide," and therefore excluded by I.R.C. § 409A(d)(1). Despite the importance of this issue, the IRS regulations are silent, and the preamble fails to provide guidance.[200] The IRS acknowledges the difficulty of these issues, stating "[b]ecause the definitions of [bona fide vacation or sick leave] may raise

19,236 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1).

196. *See supra* note 195 (listing all arrangements in which compensation is deferred).

197. I.R.C. § 409A(d)(1) (Supp. 2007).

198. *Id.* § 409A(d)(1)(B) (emphasis added).

199. 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:

> *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. If this is not a *bona fide* vacation plan, a 409A violation occurred because Gary Gangplank failed to make a timely election to defer.

200. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. at 19,234.

issues and require coordination with the provisions of [I.R.C.] section 451, section 125, and, with respect to [tax-exempt employers and employees], section 457, the final regulations do not address these issues."[201]

Until the IRS provides guidance, *tax-exempt* employers can rely on authorities defining "vacation plan" or "sick leave plan" under I.R.C. § 457(f).[202] 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 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.
>
> 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.[203] As a result, Sherri Shipwreck will be

201. *Id*.

202. *Id*. (citing I.R.S. Notice 2005-1, 2005-1 C.B. 279). The IRS considered a *tax-exempt* organization's sick leave policy and vacation plan under I.R.C. § 457(e)(11) in I.R.S. Priv. Ltr. Rul. 200450010 (Dec. 10, 2004). Unfortunately, any guidance under I.R.C. § 457(e)(11) may only be considered by tax-exempt employers. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. at 19,234.

203. 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 that 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 2012, then presumably the "Terrible Triple Tax" should only apply once, because the same item of compensation can only be included in taxable income once. *See* I.R.C. § 409A(a)(1)(A)(i)(II) (Supp. 2007) ("[C]ompensation deferred . . . shall be includible in gross income for the taxable year . . . ."). 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 will hopefully be addressed in future regulations. *See* Treas. Reg. § 1.409A-4 (2007) (indicating by its title, "Calculation of income inclusion. [Reserved.]," that the IRS intends to issue regulations regarding the application of the Triple Tax).

> subject to three different taxes under I.R.C. § 409A (the "Terrible Triple Tax") each year. First, she will be taxed on the value of the vacation that she does not take each year.[204] Second, she will owe an extra 20% tax.[205] 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.[206]
>
> *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 Sherri Shipwreck accrues a vacation week and fails to make an irrevocable election to defer before the beginning of the year.[207]

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 questions that may arise when an employee can carry over vacation or sick leave include: What are the standards for a *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 *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 *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 *bona fide* vacation program, or will the IRS consider this a scheme to transfer more compensation to more-senior

204. I.R.C. § 409A(a)(1)(A)(i) (Supp. 2007).

205. *Id.* § 409A(a)(1)(B)(i)(II). This "additional tax" is 20% of the amount included under I.R.C. § 409A(a)(1)(A)(i).

206. *Id.* § 409A(a)(1)(B)(i)(I). *See supra* note 203 (exploring whether a 409A violation occurs in this situation only once or recurs every year).

207. Treas. Reg. § 1.409A-2(a)(3) (2007).

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 *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,[208] but every taxpaying employer that allows employees to 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 409A rule that may impact taxpayers is the IRS approach to employees who work part of the year and elect to *annualize* their compensation. These rules may impact a variety of seasonal employees, such as teachers, construction workers,[209] ski-resort employees,[210] and fishermen.[211] 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 . . . 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 December of that year to a period in the subsequent year [409A applies].[212]

The IRS notes that schools "often" provide this option to teachers,[213] and a brief example demonstrates the reason.

> *Example #11*. The teachers at Happy Valley High School teach from September 1 through May 31. The school closes for three months each year from June 1 through August 31. If a teacher

208. H.R. REP. NO. 108-548, pt. 1, at 343 n.453 (2004).

209. *See* Charles D. Chieppo, Op-Ed, *Easing the Burden of Unemployment Insurance*, BOSTON GLOBE, Jan. 18, 2008, at 15A, *available at* 2008 WLNR 1038479 (explaining that both construction companies and landscaping firms hire employees on a part year basis).

210. *See* Ashley Kosciolek, *With A Surprise Fall Freeze, Time to Break Out the Skis*, ALLENTOWN MORNING CALL (Penn.), Nov. 10, 2007, at B1, *available at* 2007 WLNR 22281257 (describing the influx of 1,500 "seasonal workers" to local ski resorts during the winter months).

211. Tony Pugh, *Health Insurance Costs Up 78 Percent in 6 Years*, SEATTLE TIMES, Sept. 12, 2007, at A1, *available at* 2007 WLNR 17853546.

212. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,254–55 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1).

213. *Id*. at 19,255.

> cannot annualize his or her compensation, the teacher will be paid each 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.

The IRS classifies these arrangements as "deferred compensation plans" subject to 409A.[214] Initially, one might conclude that the school will have no trouble complying with 409A because the teachers are paid the deferred amounts during the summer break. When teachers are paid in this manner, there is no acceleration under I.R.C. § 409A(a)(3); there is no subsequent deferral under I.R.C. § 409(a)(4)(C); and the amount will be paid on a fixed schedule in compliance with I.R.C. § 409A(a)(2)(A)(iv).[215] However, as the IRS points out, the trap for the unwary is that the *election to annualize* must be made "before the period of service begins,"[216] or a 409A violation automatically occurs.

> *Example #12*. Same as Example #11, except that 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).[217] As discussed in Example #11, for the period from September to December 2010, each teacher is deferring compensation until the summer of 2011. Because each teacher made a late election, each teacher has violated 409A.

Perhaps because of the potential harshness, on July 1, 2008, the IRS issued a notice that such annualization arrangements will not be treated as a 409A violation if the amount deferred from one year to the next does not exceed $15,500.[218]

The same issue 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

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214. *Id*.
215. *Id*.
216. *Id*.
217. *Id*.
218. *See* I.R.S. Notice 2008-62, 2008-29 I.R.B. 130 (July 1, 2008) (explaining that the exception is tied to the applicable dollar amount under I.R.C. § 402(g)(1)(B)).

disappears; and other part-year employees. Thus, although Enron's payment of outrageous compensation inspired 409A,[219] 409A can apply to employees who work only part of the year and defer more than $15,500.[220]

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

Section 409A can apply whenever an employee entitled to NQDC terminates employment, and the employee signs a waiver of claims in exchange for a payment.[221] 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 worker's 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.[222] The IRS will determine whether the employer's payment is for a *bona fide legal claim* "based on the facts and circumstances."[223] The preamble to the final regulations states:

> [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

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219. H.R. REP. NO. 108-548, pt. 1, at 343 n.453 (2004).

220. 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) (explaining the possible methods of complying with 409A in a situation where the employee does not have a timely "opportunity to elect the time or form of payment"). *See also* I.R.S. News Release IR 2007-142 (Aug. 7, 2007) (clarifying how teacher compensation will be treated under 409A). 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).

221. Shortly after the IRS issued the technical corrections to the 409A final regulations, a major provider of continuing legal education programs hosted a seminar focusing on this issue. Strafford Publications, Inc., Employee Severance Under Attack: The Courts' Latest Rulings: Crafting and Negotiating Enforceable Release and Pay Provisions, Including the Impact of the New 409A Regulations (Jan. 16, 2008), http://www.straffordpub.com/products/tlseaa/.

222. Treas. Reg. § 1.409A-1(b)(11) (2007) (emphasis added).

223. *Id.*

> 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.[224]

The IRS approach will create uncertainty. The IRS will have to determine whether an agreement is subject to 409A by parsing the details of both the agreement and the circumstances under which it was made. Auditors will have to judge the validity and nature of the employee's claim to decide whether it is *bona fide*. If a settlement is reached during litigation, evidence might be needed to evaluate the legitimacy of the waived claim. If the parties settle before they complete discovery or without performing significant discovery, they might not be in possession of evidence underlying the waived claim. The key documents could be in the employer's possession or no longer available at the time of the employee's tax audit under 409A. The employer could even destroy such documents. Perhaps worst of all, even if the employee's claim is *bona fide*, the parties will have no guarantee that the IRS will deem the *amount* of the settlement reasonable. Should the employee hire a second attorney (or a third) to evaluate the reasonableness of the claim?

D. Noncompete Agreements

In a stunning development, the IRS regulations assert that payments under a noncompete agreement are NQDC.[225] The preamble states:

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224. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,249 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1) (emphasis added). An exception should be available if the value of the NQDC is $15,500 (for 2008) or less. Treas. Reg. § 1.409A-3(j)(4)(v) (2007) permits the employer to accelerate the payment of NQDC amounts if the employee's total benefit is less than the I.R.C. § 402(g)(1)(B) limit. The limit for 2008 is $15,500. I.R.S. News Release IR-2007-171 (Oct. 18, 2007).

225. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. at 19,236. In a noncompete agreement, 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. Postemployment 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

> 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.[226]

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.

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 *not* prefer to pay extra money to an ex-employee. Typically, the company enters into a noncompete agreement to prevent the employee from going to work for competitors and soliciting the company's clients or employees.[227] Also, when an unrelated party purchases the stock of a corporation, the purchaser will often cause the acquired corporation to enter into noncompete agreements with its prior owners, executives, and salespersons.[228] 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.

> 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 (3d ed. 2002).

226. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. at 19,236 (emphasis added).

227. *See* MALSBERGER, *supra* note 225, at ix (discussing how businesses are "increasingly relying upon post-employment covenants not to compete to protect [their] investments").

228. *See* Peter J. Klarfeld, *Introduction to the Second Edition* of FORUM ON FRANCHISING, COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS, at xvi (Peter J. Klarfeld ed., 2d ed. 2003) ("Covenants against competition have been used in employment agreements and contracts for the sale of businesses for hundreds of years.").

Numerous problems ensue if 409A applies to a noncompete agreement. For example, 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."[229] Alternatively, if there is an acceleration or subsequent deferral of the payments under a noncompete, a 409A violation could occur.[230] Finally, if a payment under the noncompete agreement is accelerated following 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.[231]

E. Reimbursement of Business Expenses

A company's agreement to reimburse an employee in a future year for business expenses is typically a NQDC arrangement subject to 409A.[232] Such business expenses include: car expenses; outplacement services; a loss on a sale of a residence; moving expenses; airplane travel; and country-club

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229. An employer is permitted to make payments under a NQDC plan upon a "separation from service." *See* I.R.C. § 409A(a)(2)(A)(i) (Supp. 2007) (including a separation from service as a permissible payment event). Whether a switch to part-time employment is a "separation from service" 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%] 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.* ("An employee is presumed to have separated from service where the level of bona fide services performed decreases to a level equal to [20%] or less of the average level of services performed by the employee during the immediately preceding 36-month period."). The NQDC agreement could provide for a percentage above 20%, but not in excess of 50%, which would determine whether the employee separated from service for 409A purposes. *See id.* ("No presumption applies to a decrease in the level of bona fide services performed to a level that is more than [20%] and less than [50%] . . . .").

230. Generally the acceleration of a NQDC payment violates 409A, I.R.C. § 409A(a)(3), but the final regulations contain exceptions, including situations when the employee's total NQDC benefit is below the I.R.C. § 402(g)(1)(B) amount ($15,500 in 2008). *See* Treas. Reg. § 1.409A-3(j)(4) (2007) (explaining that a plan may provide for the acceleration of payments); I.R.S. News Release IR-2007-171, IRS Announces Pension Plan Limitations for 2008 (Oct. 18, 2007) (announcing that the amount for 2008 is $15,500). Generally, a subsequent deferral will violate 409A unless the parties (1) agree to the subsequent deferral at least one year before the employer otherwise would pay the deferred amount, and (2) extend the date of payment for at least five years. I.R.C. § 409A(a)(4)(C)(i)–(ii) (Supp. 2007); Treas. Reg. § 1.409A-2(b)(1) (2007).

231. Treas. Reg. § 1.409A-3(i)(5) (2007).

232. *Id.* § 1.409A-1(b)(9)(v).

dues.[233] The reimbursement agreement, however, is not subject to 409A if it satisfies a series of requirements.[234] First, the employee must pay the expense (or incur the loss) within two years of a separation from service.[235] Second, the employer must reimburse the employee for the amount within three years of the separation from service.[236] Third, the agreement to reimburse must be on a *fixed schedule*.[237]

A reimbursement agreement must meet four conditions to be on a *fixed schedule*.[238] First, the plan must provide "an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement."[239] Second, the employer must reimburse expenses for "an objectively and specifically prescribed period."[240] Third, the right to reimbursement cannot be exchanged for another benefit.[241] Finally, "[t]he . . . 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.*"[242]

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,[243] 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.[244]

> *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. In 2010, the company adds a new provision that for the first five years after a "separation from service" (under I.R.C. § 409A(a)(2)(A)(i)), Land-Lover, Inc. will reimburse Mark Matey for computers, software, and any other technological products that he desires, up to a cumulative total of

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233. I.R.C. § 162(a)(2000); Treas. Reg. § 1.274-2 (as amended in 1996).

234. Treas. Reg. § 1.409A-1(b)(9)(v)(E) (2007).

235. *Id.*

236. *Id.* § 1.409A-1(b)(9)(v); Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,248 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1).

237. Treas. Reg. § 1.409A-3(i)(1)(iv) (2007).

238. *Id*. § 1.409A-3(i)(1)(iv)(A)(1)–(5).

239. *Id.* § 1.409A-3(i)(1)(iv)(A)(1).

240. *Id.* § 1.409A-3(i)(1)(iv)(A)(2).

241. *Id.* § 1.409A-3(i)(1)(iv)(A)(5).

242. *Id.* § 1.409A-3(i)(1)(iv)(A)(3) (emphasis added). The same requirements apply if the employer agrees to provide "in kind" benefits. *Id*. § 1.409A-3(i)(1)(iv)(A).

243. *Id*. § 1.409A-3(i)(1)(vi).

244. *Id.* A violation also occurs if the company agrees to provide "in-kind" benefits in a similar situation. *See id*. § 1.409A-3(i)(1)(iv)(A) (providing conditions that reimbursement plans, or in-kind benefits, must meet in order to satisfy the fixed schedule requirement of 409A).

> $15,000 retail over five years. Because the arrangement fails to satisfy the last requirement listed above,[245] a 409A violation occurs. As a result, Mark Matey will be required to pay the Terrible Triple Tax.[246]

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."[247]

A vexing problem in applying this anti-abuse rule will be determining the "purposes of Section 409A." The regulations fail to provide a list of these "purposes," and the legislative history is sparse.[248] As a result, the regulations set the stage for disputes over the application of the anti-abuse rule and the purposes of 409A.

CONCLUSION

Current laws allow top executives to plunder publicly held corporations with impunity.[249] In 1976, CEOs made thirty-six times more than the average worker; today CEOs make 369 times more than the average worker.[250] The government's latest attempt to restrict CEO pillaging with income-tax rules will not limit the looting. Section 409A imposes no

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245. *See id.* § 1.409A-3(i)(1)(iv)(A)(3) (requiring that a reimbursement agreement not affect eligible expenses "in any other taxable year" in order for the agreement to qualify as having a "specified date or fixed schedule of payments").

246. The regulations provide relief from the final requirement if the employer is reimbursing medical expenses (described in I.R.C. § 105(b)). Treas. Reg. § 1.409A-3(i)(1)(iv)(B) (2007).

247. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, at 19,235 (Apr. 17, 2007) (to be codified at 26 C.F.R. pt. 1) (emphasis added).

248. *See* H.R. REP. NO. 108-548, pt. 1, at 343 (2004) (devoting few words to the explanation of the deferral-of-compensation rule). The House Report states:

> Executives often use arrangements that allow deferral of income, but also provide security of future payment 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.

Id. 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. *Id.*

249. *See supra* Part II (discussing why CEOs plunder with impunity).

250. Smith, *supra* note 30, at B13.

constraints on the *amount* of CEO compensation, and imposes mere *timing* requirements on NQDC arrangements, which represent a trivial portion of total CEO compensation.[251] 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.

Even worse, 409A imposes outrageous administrative costs on small businesses and charities, which are forced to comply with the ninety-one-page preamble and final regulations package,[252] the two sets of technical corrections,[253] and the IRS's eleven notices.[254] 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.[255] Section 409A is a disaster and should be repealed retroactively.[256]

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.[257] These stock options enjoy two huge income-tax benefits that should be reevaluated. First, no income tax is imposed until the employee actually exercises the stock option.[258] This provides tax-deferred wealth even though

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251. *See* Drennan, *supra* note 12, at 424, 428 (arguing that even at Enron, NQDC represented less than 5% of the top executives' compensation).

252. Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. at 19,234–325 (Apr. 17, 2007).

253. *See* Application of Section 409A to Nonqualified Deferred Compensation Plans; Correction, 72 Fed. Reg. 38,477 (July 13, 2007) (providing technical corrections to the final regulations published on Apr. 17, 2007); Application of Section 409A to Nonqualified Deferred Compensation Plans; Correction, 72 Fed. Reg. 41,620 (July 31, 2007) (providing additional technical corrections to the final regulations published on Apr. 17, 2007).

254. *See supra* note 16 (identifying the eleven IRS notices).

255. *See supra* Part VI.A (discussing the Terrible Triple Tax).

256. Congress can amend federal tax laws retroactively if the change does not impose excessive hardships. *See* 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].").

257. "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 52, at 143 (quoting Warren Buffett) (internal quotations omitted). *See supra* Part I.A (explaining that stock options are sources of executive pay).

258. Treas. Reg. § 1.83-7(a) (as amended in 2004); MANCOFF & WEINER, *supra* note 55, at 4-17. 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. *See* Rev. Proc. 98-34, 1998-1 C.B. 984 ("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) . . . .").

the executive has complete flexibility to obtain the cash at any time.[259] Second, stock options are exempt from the $1 million cap of I.R.C. § 162(m), which limits a corporation's tax deduction for fixed compensation paid.[260] As a practical matter, this allows a corporation to claim an unlimited tax deduction for stock-option compensation.[261] I.R.C. § 162(m) treats stock options as "performance-based compensation," even though a CEO who performs miserably may receive enormous wealth from stock options.[262]

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

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259. 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 *qualified* stock options enjoy an even greater tax benefit—the gain is not taxed until the executive actually sells the stock. MANCOFF & WEINER, *supra* note 55, at 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. I.R.C. § 422(a)(1) (2000). Nevertheless, the amount of qualified stock options available is severely restricted. *See id.* § 422(d)(1) (indicating that 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 majority of stock-option wealth transferred to highly paid CEOs is from nonqualified stock options.

260. *See* I.R.C. § 162(m)(4)(C) (2000) (exempting "performance based compensation" from the $1 million restriction); MANCOFF & WEINER, *supra* note 55, at 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, *supra* note 193, 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 solely based on an increase in the price of the corporation's stock.").

261. Technically, the total amount of compensation that can be deducted must be reasonable under I.R.C. § 162(a)(1) (2000). However, as a practical matter, the IRS does not apply the "reasonableness" test to publicly held corporations. As one commentator states:

> Virtually all challenges by the IRS to the deductibility of compensation have occurred in the context of salary arrangements between related parties, involving either dealings between corporations and shareholders or relatives of shareholders, or dealings between partners or proprietors and their relatives . . . .
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> . . . .
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> . . . This suggests that any amount of compensation paid by a publicly held corporation should be 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.

Moran, *supra* note 193, at A-12 to A-13.

262. *See* Nocera, *supra* note 37, at C1 ("[M]ost so-called pay for performance plans are really 'pay for pulse' plans."). I.R.C. § 162(m) does not apply to stock options. *See supra* note 192, at 27 (discussing the provisions of I.R.C. § 162(m)). Part II discusses the ability of a CEO to profit from stock options despite his or her poor performance. *See also* Ending Corporate Tax Favors for Stock Options Act, S. 2116, 110th Cong. § 3 (2007) (making executive stock option compensation deductions subject to the one million dollar cap of I.R.C. § 162(m)).