B. Findings and Recommendations Relating to Pension and Compensation Arrangements

1. Cash balance plan

In converting the Enron Retirement Plan into a cash balance plan, Enron did not adopt many of the plan features that gained media attention in the 1990s when several large plans were converted to cash balance plans. Enron did not adopt a "wearaway" and took steps to protect the expectation interests of plan participants close to retirement under the old plan formula. The review of the plan has been pending in the IRS National Office for almost three years pursuant to a 1999 IRS moratorium on the issuance of determination letters for cash balance conversions pending clarification of applicable legal requirements. The Treasury Department has recently issued proposed regulations which, when finalized, would address many, but not all issues relating to cash balance plans.

The Joint Committee staff believes that the lack of clear guidance with respect to cash balance plan conversions and cash balance plans in general creates uncertainty for employers and employees. Thus, the Joint Committee staff recommends that clear rules with respect to such plans should be adopted in the near future.

2. Blackout periods under qualified plans

Enron implemented a change of recordkeepers under the Enron Savings Plan in October and November of 2001. As part of this change, plan participants experienced a "blackout" period of approximately two and one-half weeks during which investment changes could not be made. During this time, the price of Enron stock fell from $15.40 to $9.98.

Changes in plan recordkeepers or other third-party service providers is a normal part of qualified retirement plan operations. The Joint Committee staff review of the change in recordkeepers with respect to the Enron Savings Plan indicates that Enron had legitimate reasons for changing recordkeeepers, and undertook an extensive search in order to find a new recordkeeper that would meet its needs.

The main issue raised with respect to the change in recordkeepers under the Enron Savings Plan is whether plan fiduciaries, including the Enron Savings Plan Administrative Committee, acted in accordance with their fiduciary obligations in implementing the blackout period or whether they should have stopped the blackout from occurring given the falling price of Enron stock and its financial circumstances. Members of the Administrative Committee interviewed by the Joint Committee staff indicated that they viewed their responsibilities as relatively narrow, and did not focus on the possible effects of the proposed blackout on plan participants until after the blackout had begun. Whether there was a breach of fiduciary responsibilities in this case will be resolved through litigation.

The blackout also raises questions regarding whether plan participants received notice of the blackout sufficient to allow them to make appropriate decisions in anticipation of the blackout. The information reviewed by the Joint Committee staff indicates that Enron provided a variety of advance notices to plan participants explaining the proposed blackout. The Joint Committee staff did not undertake to review whether all participants in fact received notice of

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the blackout; however, the Joint Committee staff determined that not all participants received the same notices. In particular, certain active employees received additional reminders of the blackout that were not sent to other participants.

The Sarbanes-Oxley Act of 2002, enacted after the Enron bankruptcy, includes a notice requirement with respect to blackout periods under qualified plans. Thus, the Joint Committee staff does not recommend further legislative changes in this area at this time.

3. Investments under the Enron Savings Plan

Many Enron Savings Plan participants lost considerable amounts of retirement savings due to a high level of investment in Enron stock. Plan design features which required Enron's matching contributions to be invested in Enron stock contributed to the significant investment in Enron stock. Other factors may also have played a role, including a lack of understanding of the importance of diversification and the actions (or inactions) of plan fiduciaries. The Joint Committee staff believes that an overwhelming factor was a corporate culture that actively promoted investment in Enron stock.

The Joint Committee staff believes that the importance of diversification of retirement savings cannot be overemphasized. The Joint Committee staff recommends that that a variety of changes should be made to reduce the likelihood that participants in plans that allow participant directed investments will have high concentrations of assets in a single investment.

The Joint Committee staff recommends that plans should provide participants with investment education in a manner consistent with fiduciary standards. This should include periodic notices describing sound investment practices and individualized notices to plan participants whose plan investments are over concentrated in a single asset.

The Joint Committee staff recommends that plans should not be permitted to require that employee elective deferrals or after-tax contributions be invested in employer securities. In addition, plan participants should be given greater opportunity to diversify the investment of employer matching and certain other employer contributions made in the form of employer securities.

The Joint Committee staff recommends certain changes with respect to ERISA fiduciary rules. The experience at Enron points out the difficulties that may arise when individuals play more than one role, particularly roles as a fiduciary and as an executive of the employer. These two roles may conflict and cause confusion among plan participants. The experience at Enron demonstrates that plan fiduciaries may have difficulty determining what actions are consistent with their dual roles. The Joint Committee staff believes that fiduciary rules should apply to the statements of senior executives, whether or not they are otherwise plan fiduciaries, regarding qualified plans or plan investments. The Department of Labor should also take steps to educate plan fiduciaries regarding their fiduciary duties.

Because of the strong corporate culture that encouraged Enron stock ownership by Enron employees, it is not clear that the outcome would have been any different if these measures had been in place prior to the bankruptcy. Further, Enron is not alone it its high concentration of investment in employer stock. A recent study of 219 large 401(k) plans found 25 plans that had

over 60 percent of their assets invested in employer securities.[26] Given these factors, the Joint Committee staff is concerned that, absent legal restrictions on the amount of employer securities that can be held in defined contribution plans, situations such as Enron's may occur again. Such restrictions would involve a major policy change from present law.

4. Nonqualified deferred compensation

Through Enron's nonqualified deferred compensation programs, executives were able to defer more than $150 million in compensation from 1998 through 2001. The key motivating factor in deferring compensation was the desire of Enron's employees to avoid current income inclusion with respect to their compensation. In the weeks preceding the bankruptcy, apparently in accordance with the terms of the deferred compensation arrangement, Enron paid executives $53 million in accelerated distributions of nonqualified deferred compensation. In addition to the accelerated distributions, participants were able to direct investment of their accounts and to make subsequent elections to change the timing of distributions.

The nonqualified deferred compensation arrangements of Enron illustrate the common practice of allowing executives to defer tax on income, but also to maintain security and control over the amounts. Given the significant amounts of compensation deferred by Enron executives, it appears that the risks and restrictions associated with deferring compensation were not viewed as impediments to deferral.

Enron's deferred compensation plans allowed executives to receive benefits similar to those of qualified plans. To the extent that it is possible for executives to defer taxes and have security and flexibility through nonqualified arrangements, this undermines the qualified retirement plan system. If executives can obtain the result they desire through the use of nonqualified plans and arrangements, there will be less incentive for companies to maintain qualified plans, which will result in rank and file employees losing pension coverage.

Enron allowed its executives to defer significant amounts of compensation even though Enron had to forego a current deduction with respect to such amounts. The fact that Enron was apparently indifferent to the deferral of its deduction provides further support for the need for changes to the tax treatment of nonqualified deferred compensation. Changes to the present-law rules regarding the taxation of deferred compensation would reduce the amount of income deferred.

Rules should be developed to require current income inclusion in the case of plan features that give taxpayers effective control over amounts deferred. The Joint Committee staff believes that the existence of plan provisions that allow accelerated distributions, participant-directed investment, or subsequent elections should result in current income inclusion. In addition, the Joint Committee staff believes that consideration should given to whether rabbi trusts are appropriate for deferred compensation and whether the rules relating to such arrangements

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[26] *See, Enron Debacle Will Force Clean Up of Company Stock Use in DC Plans,* DC Plan Investing (Institute of Management & Administration), at 1-2 (Dec. 11, 2001).

should be tightened. The use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed.

In addition, the Joint Committee staff believes that section 132 of the Revenue Act of 1978 should be repealed. This would allow the Treasury Department to issue much needed guidance in the nonqualified deferred compensation area. The lack of guidance over the last 25 years has given taxpayers latitude to use creative nonqualified deferred compensation arrangements that push the limit of what is allowed under the law.

The Joint Committee staff also believes that reporting of deferred amounts should be required to provide the IRS greater information regarding such arrangements.

5. Stock-based compensation

Enron utilized considerable amounts of stock-based compensation, including stock options, restricted stock, and phantom stock arrangements. The use of stock-based compensation was not limited to executives. Enron had all-employee stock option arrangements and, as described above, also facilitated the ownership of Enron stock through Enron's qualified plans. The use of stock-based compensation was part of Enron's overall compensation philosophy, and also reflected the views of the Compensation Committee that a significant amount of executive compensation should be dependent on shareholder return.

The amount of compensation generated from stock-based compensation arrangements was significant, and increased dramatically over the period 1998 through 2000. Over this period, Enron's deduction attributable to stock options increased by more than 1,000 percent; from $125 million in 1998 to over $1.5 billion in 2000. Income attributable to restricted stock for the top-200 most highly compensated employees rose from $24 million in 1998 to $132 million in 2000.

Although the intent of many of Enron's stock-based compensation programs was to align the interests of shareholders and executives, the Enron experience raises a potential conflict between short-term earnings from which executives can reap immediate rewards and longer-term interests of shareholders.

In addition, the use of stock options highlights the differences between the treatment of stock options for Federal income tax purposes and accounting purposes. The accounting rules and the income tax rules have different purposes, and therefore the two sets of rules may be necessary in order to accomplish their intended purposes.

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.

6. Employee loans

While Enron did not have a formal policy regarding employee loans, it nevertheless made a variety of loans to certain executives, including top management. The loans raise Federal tax issues as well as corporate governance issues.

In some cases, loan agreements provided that the loan would be forgiven if the executive stayed with Enron for a certain period of time. For example, such an arrangement was provided for Mr. Skilling.[27] While these arrangements were treated by Enron and the executives involved as loans, it is difficult to distinguish such arrangements factually from the pre-bankruptcy bonuses paid by Enron, which had to be repaid if the employee did not remain with Enron for a certain period of time and which were treated by Enron as taxable compensation. Loans of this type raise the question of whether the arrangement at the outset should have been treated as taxable compensation.

Other loans did not have a provision regarding forgiveness, but were forgiven by Enron. In such cases, the amount forgiven was treated as compensation to the executives.

The loan transactions raise corporate governance issues of whether corporate funds are in essence being used for personal purposes. A line of credit for Mr. Lay provides an example of the issues raised. Pursuant to his $7.5 million line of credit, in a series of 25 transactions in 2001 alone, Mr. Lay withdrew a total of over $77 million (all but $7.5 million of which was repaid). The total amount withdrawn under the line of credit was over $106 million; over $94 million of this amount was repaid with Enron stock. Mr. Lay's attorneys have stated that the loan transactions related to Mr. Lay's personal investment.

The Sarbanes-Oxley Act of 2002 contains a prohibition on executive loans. Thus, the Joint Committee staff is not making any recommendation regarding loans at this time.

7. Split-dollar life insurance contracts

Enron had split-dollar life insurance contracts for three top executives, ranging from $5 million to $30 million of coverage. The Treasury Department has issued notices and proposed regulations offering more detailed guidance than was previously available with respect to split dollar life insurance. This guidance generally requires the inclusion of income of the value of the economic benefit received by the employee under the arrangement. This guidance provides clear rules and should be finalized expeditiously.

8. Limitation on deduction of compensation in excess of $1 million

The $1 million deduction limitation on the compensation of top executives did not appear to have a major affect the overall structure of Enron's compensation arrangements or the total amount of compensation paid to Enron employees. For 1998 through 2000, total compensation for Enron's top executives was $433.6 million. Although most of this compensation was treated by Enron as qualifying for the exception for performance-based compensation (86 percent), Enron paid a significant amount of nondeductible compensation during this period ($48.5 million which was11 percent of total compensation).[28] Given Enron's net operating loss carryovers, the

[27] Mr. Skilling did not remain with Enron for the period specified in his loan agreement, and he repaid the loan. According to Enron, some interest on the loan is still outstanding.

[28] As explained in this Report, the compensation numbers presented here are approximate, due to inconsistencies in information obtained from Enron. These numbers are from information provided by Enron to the IRS.

nondeductiblity of this compensation may not have had a significant impact on Enron's overall tax liability.

The $1 million deduction limitation was designed to address corporate governance concerns that top executives were receiving excessive compensation. The experience with Enron indicates that the limitation is not effective in achieving its purposes. Taxpayers may choose to pay nondeductible compensation, and accept the potential adverse tax consequences. In the case of Enron, there may in fact be little adverse tax impact.

The Joint Committee staff recommends that the limitation be repealed, and that any concerns regarding the amount and types of compensation be addressed through laws other than the Federal income tax laws.