PART FOUR: ISSUES RELATING TO COMPENSATION

I. INTRODUCTION TO COMPENSATION-RELATED ISSUES

A. Overview of Issues Relating to Compensation

In general

The compensation arrangements of Enron have received considerable media attention in the aftermath of the Enron bankruptcy.

Some of this attention has focused on the broad-based retirement plans maintained by Enron that receive special tax benefits ("qualified retirement plans"). The decline of Enron's stock price and Enron's subsequent bankruptcy has affected the benefits that Enron employees are or may be entitled to under the Enron qualified retirement plans. Much of the media attention regarding the effect of the bankruptcy on employees' benefits relates to the significant plan holdings in Enron stock, particularly in the Enron ESOP and the Enron Savings Plan.[1179] For many Enron employees, the benefits provided under the Enron qualified retirement plans may have been the individual's primary source of retirement income.

Attention has also focused on the overall compensation arrangements of Enron, particularly the magnitude and forms of compensation provided to executives. This Part Four addresses both of these aspects of Enron's compensation arrangements. Issues relating to the qualified retirement plans are discussed first.[1180]

Enron qualified plans

During the period covered by the Joint Committee staff review, Enron maintained three main qualified retirement plans: the Enron Corp. Employee Stock Ownership Plan (the "Enron ESOP"); the Enron Corp. Retirement Plan (the "Enron Retirement Plan"), which was modified and renamed the Enron Corp. Cash Balance Plan (the "Enron Cash Balance Plan"); and the Enron Corp. Savings Plan (the "Enron Savings Plan").

The discussion relating to Enron qualified retirement plans begins with an overview of present law relating to qualified retirement plans generally, with particular attention paid to the rules relating to the types of qualified retirement plans maintained by Enron.[1181] This is followed

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[1179] Enron stock represented 62 percent of Savings Plan at the end of 2000. 2000 SEC Form 11-K of the Enron Savings Plan.

[1180] Qualified retirement plan issues are discussed in Part II, and other compensation-related issues are discussed in Part III of this Part Four.

[1181] *See* Part II.A., below. All cross references within this Part Four refer to this Part Four unless otherwise indicated.

by a description of each of the qualified retirement plans maintained by Enron, both currently and historically.[1182]

Certain specific issues relating to the qualified plans, and their impact on retirement benefits of Enron employees are addressed in detail, including a description of relevant present law, factual background, and a discussion of tax and other issues. The specific qualified plan issues addressed in this manner are: (1) the phase out of the ESOP offset under the Enron Retirement Plan; (2) the conversion of the Enron Retirement Plan into the Enron Cash Balance Plan; (3) investment of the ESOP in Enron stock; (4) a change in recordkeeper under the Enron Savings Plan shortly before the bankruptcy that resulted in a blackout period during which investment changes could not be made, including selling Enron stock; (5) investments under the Enron Savings Plan; and (6) a claim made by a former Enron employee that benefit funds were allegedly misused by Enron.[1183]

Other compensation-related issues

Part III of this Part Four discusses Enron's general compensation structure and arrangements. The section begins with a general overview of compensation of Enron, including philosophies and tools used in determining how compensation for Enron employees would be structured.[1184] This is followed with an overview of executive compensation, including a general discussion of Enron's executive compensation structure and philosophy, as well as a description of particular executive compensation arrangements.[1185] The principal forms of compensation used by Enron are discussed in detail.

The section concludes with a detailed analysis of certain compensation arrangements, including a description of present law, factual background, and a discussion of issues. These issues were chosen for discussion based on a variety of factors, including the prevalence of use of the arrangement, the media and other attention the arrangement has received, and potential tax issues. The matters addressed in this manner are: (1) Enron's nonqualified deferred compensation arrangements; (2) stock-based compensation (3) employee loans; (4) the purchase by Enron of annuity contracts from Kenneth L. Lay and his wife; (5) split-dollar life insurance arrangements; and (6) the application of the $1 million limitation on the employer deduction for certain executive compensation.[1186]

1182 *See* Part II.B., below.

1183 *See* Part II.C., below.

1184 *See* Part III.A., below.

1185 *See* Part III.B., below.

1186 *See* Part III.C., below.

B. Overview of Enron Internal Functions Relating to Compensation

In order to understand how decisions relating to compensation matters were made at Enron, it is helpful to be familiar with the structure of the Enron Corp. Human Resources Department. Enron's corporate and departmental structure changed from time to time. The description here is intended as a general overview of the structure preceding the bankruptcy.

Different departments within the Human Resources Department handled different matters. The Benefits Department handled matters generally relating to all employees, including qualified retirement plans, health and welfare plans, and miscellaneous employee benefits, such as parking. The Compensation Department handled compensation matters relating to executives, generally vice presidents and above. Specific arrangements handled by the Compensation Department include nonqualified deferred compensation plans and bonuses. These departments had various names over time. In addition, each business unit might have its own human resources department that handled employee benefit matters for that business unit.

Specialized compensation arrangements for particular individuals were not handled in the same manner as other arrangements. Interviews with Enron employees indicated there was no single department or person that handled such arrangements; many of them did not appear to be handled by the Human Resources Department. The Office of the Corporate Secretary was responsible for compiling the information for the top-five executives for proxy purposes, and therefore may have become aware of various arrangements, but was not responsible for setting up or implementing the arrangements. Based on interviews with Enron employees, it was difficult to identify the persons who were knowledgeable about specialized arrangements, particularly arrangements involving top management.

II. QUALIFIED PLANS

A. Overview of Present Law Relating to Qualified Retirement Plans

1. In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code[1187] ("a qualified retirement plan") is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee's income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified retirement plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified retirement plan. Pre-tax employee contributions may be made to a qualified cash or deferred arrangement, i.e., a 401(k) plan. Such contributions are referred to in the Code as "elective deferrals" and are generally treated the same as employer contributions for Federal tax purposes.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status.[1188] One of these requirements is that a qualified retirement plan must be maintained for the exclusive benefit of employees. In particular, a qualified retirement plan must prohibit the diversion of assets for purposes other than the exclusive benefit of employees and their beneficiaries (the "exclusive benefit rule").

In addition, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees. Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees;[1189] (2) the plan benefits a percentage of nonhighly

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[1187] Except as otherwise indicated, this discussion refers to rules in the Internal Revenue Code. The Employee Retirement Income Security Act of 1974 ("ERISA") also contains rules relating to qualified plans. In some cases the ERISA requirements are identical or substantially similar to Code requirements. ERISA's requirements generally may be enforced through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

[1188] In some cases, special provisions apply to certain types of plans, such as qualified retirement plans maintained by State and local governments and churches. This document discusses the rules applicable to qualified retirement plans without regard to such special provisions, except as specifically mentioned.

[1189] Under present law, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2002) or (b) at compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test which compares the benefits received by highly compensated employees and nonhighly compensated employees.[1190] Present law also contains a general nondiscrimination requirement which provides that a qualified retirement plan may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights, and features under the plan, not just to contributions and benefits.[1191] Special rules apply to plans that primarily benefit key employees (called "top-heavy plans").[1192]

The plan qualification standards also define certain rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified retirement plans. A limit of $200,000 (for 2003) applies to the amount of a participant's compensation that may be taken into account for qualified retirement plan purposes.[1193] Limits apply also to the benefits or contributions provided to a participant and to the amount an employer may deduct for contributions to a qualified retirement plan, based on the type of plan.[1194]

Certain rules that apply to qualified retirement plans are designed to ensure that the amounts contributed to such plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from qualified retirement plans,[1195] and the ability to obtain distributions prior to termination of employment from certain types of qualified retirement plans, including defined benefit plans, is restricted.[1196]

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. The qualification requirements under the Internal Revenue Code are

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the election of the employer had compensation for the preceding year in excess of $90,000 (for 2002) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee. Sec. 414(q).

1190 Sec. 410(b).

1191 Sec. 401(a)(4).

1192 Sec. 416.

1193 Sec. 401(a)(17).

1194 *See* secs. 404 and 415. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

1195 Sec. 72(t).

1196 *See, e.g.*, sec. 401(k)(2).

enforced by the IRS.[1197] If a plan fails to meet the Code's qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.

Certain of the Internal Revenue Code rules relating to qualified plans are enforced through an excise tax rather than through disqualification. For example, a failure to satisfy the minimum funding requirements for defined benefit plans, discussed below, does not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

After a plan's initial establishment, the employer may find it necessary or desirable to change its terms and provisions by amending it. Amendment of a plan may be necessary to ensure the plan's continued qualification, or may be discretionary, implementing design changes desired by the plan sponsor. Additionally, a plan, including amendments, may be restated from time to time, that is, a new version of a plan document incorporating legal and design changes will be produced to reflect all current provisions.

2. Types of qualified retirement plans

In general

Overview

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contributions plans, based on the nature of the benefits provided. A defined benefit plan promises to provide a specific benefit specified in the plan. Defined contribution plan benefits are based on the contributions to and investment returns on individual accounts. Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance. Floor offset arrangements are another type of hybrid plan. These arrangements consist of a defined benefit plan, which provides a floor benefit, and a defined contribution plan, which offsets the benefit under the floor plan. Cash balance plans and floor-offset arrangements are discussed below.

Defined benefit plans

Under a defined benefit plan, benefits are determined under a plan formula, typically based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

[1197] Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Internal Revenue Code.

Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan.[1198] An employer is generally subject to an excise tax for a failure to make required contributions.[1199] Benefits under a defined benefit plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC").

Defined contribution plans

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. A plan must designate the type of plan it is intended to be.[1200]

Different types of contributions may be made to a defined contribution plan. The type of contributions made to a defined contribution plan depends on the design of the plan. Many plans provide for different types of contributions. Contributions fall into two general types: employee contributions and employer contributions. Further distinctions apply within each type.

Employee contributions can be made on a pre-tax or an after-tax basis. Employee elective deferrals under a 401(k) plan are pre-tax employee contributions. Elective deferral contributions are generally treated the same as employer contributions for income tax purposes and are not subject to tax until distributed from the plan.

Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Depending on the type of defined contribution plan and the plan terms, employer nonelective contributions may be required or may be discretionary. Matching contributions are employer contributions that are made only if the employee makes contributions.

Within the three general types of defined contribution plans are plan designs that contain special features, such as qualified cash or deferred arrangements (or 401(k) plans) and employee stock ownership plans ("ESOPs"), discussed below.

Cash balance plans

A cash balance plan is a type of defined benefit plan with benefits resembling the benefits usually associated with defined contribution plans. Under a "cash balance" formula, the benefit

[1198] Sec. 412.

[1199] Sec. 4971.

[1200] While certain rules apply only to certain types of plans, the differences between these types of plans have been blurred over time and are largely historical with respect to some plan characteristics. For example, contributions under a profit-sharing plan are no longer required to depend on the employer's profits.

is typically defined by a hypothetical account balance, which is periodically credited with an amount based on the participant's compensation (a "pay credit") and interest thereon (an "interest credit").

Benefits paid to the participant are based on the value of the hypothetical account even though the plan does not allocate assets to individual accounts to participants. The hypothetical account is only a method of computing participants' promised benefits. A participant's hypothetical account balance is typically credited with hypothetical contributions and hypothetical earnings designed to mimic the allocations of actual contributions and actual earnings to a participant's account that would occur under a defined contribution plan.

Qualified cash or deferred arrangements ("401(k) plans")

A 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a "qualified cash or deferred arrangement."[1201] Thus, such arrangements are subject to the rules generally applicable to qualified retirement plans. In addition, special rules apply to such arrangements.[1202]

Under a 401(k) plan, an employee may elect to have the employer pay compensation as contributions to a qualified retirement plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $12,000 for 2003.[1203] Starting in 2002, an individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a 401(k) plan. The limit on elective deferrals is increased for an individual who has attained age 50 by $2,000 for 2003.[1204] An employee's elective deferrals must be fully vested.

A special nondiscrimination test applies to elective deferrals under a 401(k) plan, which compares the elective deferrals of highly compensated employees with elective deferrals of

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[1201] Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement.

[1202] Other arrangements are similar to 401(k) plans, but are not subject to all the same rules, such as section 457 plans of State and local governments, and tax-sheltered annuity plans (sec. 403(b)).

[1203] Sec. 402(g). The dollar limit on elective deferrals increases to $13,000 for 2004, $14,000 for 2005, and $15,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The increases in the limit are subject to the general sunset provision of EGTRRA.

[1204] Sec. 414(v). The additional amount permitted for catch-up contributions increases to $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The increases in the limit are subject to the general sunset provision of EGTRRA.

nonhighly compensated employees.[1205] Employer matching contributions and after-tax employee contributions under a defined contribution plan are also subject to a special nondiscrimination test.[1206]

Employers are not required to offer matching contributions based on employee elective deferrals. Many employers provide a match because doing so makes it easier for the plan to satisfy applicable nondiscrimination rules by encouraging employees to make elective deferrals. For example, a plan could provide that the employer will make matching contributions equal to 50 percent of an employee's elective deferrals, up to a maximum of three percent of compensation.

In addition to or in lieu of matching contributions, some employers make "qualified nonelective contributions" for employees participating in a 401(k) plan, which may be taken into in account applying the special nondiscrimination test for elective deferrals test. Like matching contributions, qualified nonelective contributions may make it easier for plans to satisfy the applicable nondiscrimination rules. "Qualified nonelective contributions" are contributions that are made by the employer without regard to whether the employee makes elective deferrals, that are 100 percent vested, and that meet certain other requirements.

Under a safe harbor,[1207] a 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule if the employer either: (1) satisfies a matching contribution requirement; or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules. A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for 401(k) plans are deemed to satisfy the special nondiscrimination test for such contributions-test. Certain alternative matching arrangements also can be used to satisfy the safe harbor.

[1205] Sec. 401(k)(3). (This test is called the actual deferral percentage test or the "ADP" test).

[1206] Sec. 401(m). (This test is called the actual contribution percentage test or the "ACP" test.)

[1207] Sec. 401(k)(12).

Employee stock ownership plans ("ESOPs")

An ESOP is a defined contribution plan that is designated as an ESOP, is designed to invest primarily in securities of the employer, and meets certain other requirements.[1208] An ESOP can be an entire plan or it can be a component of a larger defined contribution plan.[1209] ESOPs are subject to additional requirements that do not apply to other plans that hold employer securities. For example, voting rights must generally be passed through to ESOP participants, employees must generally have the right to receive benefits in the form of employer securities, and certain ESOP participants must be given the right to diversify a portion of their account into investments other than employer securities.[1210]

In addition, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer securities. For example, an ESOP may be "leveraged," i.e., employer securities held in an ESOP may be purchased with loan proceeds. In a leveraged ESOP, the ESOP typically borrows from a financial institution. The loan is typically guaranteed by the employer and the employer securities are pledged as security for the loan. Alternatively, the loan can be made directly by the employer to the ESOP, or the employer may borrow from a financial institution, and then make a loan to the ESOP. Contributions to the plan are used to repay the loan. Dividends on employer securities may also be used to repay the loan. The employer securities are held in a suspense account and released to participants' accounts as the loan is repaid.

Special tax benefits also apply to ESOPs. For example, the employer may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participant's election.[1211] In addition, special deduction rules apply to ESOPs that do not apply to other types of plans.[1212]

Prior law also provided additional tax benefits for ESOPs that were in effect during the period covered by the Joint Committee staff review of Enron. Prior law provided that banks and

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[1208] Sec. 4975(e)(7); Treas. Reg. sec. 54.4975-11. The plan must be either a stock bonus plan or a stock bonus and money purchase pension plan.

[1209] An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a 401(k) feature that permits employees to make elective deferrals. Such an ESOP design is sometimes referred to as a "KSOP."

[1210] *See* secs. 401(a)(28), 409(e), and 409(h).

[1211] Sec. 404(k). The ability to deduct dividends reinvested at the election of the participant is effective for taxable years beginning after December 31, 2001.

[1212] Sec. 404(a)(9). Additional special rules also apply to ESOPs that hold employer securities that are not publicly traded.

other financial institutions could exclude from income 50 percent of the interest received with respect to a loan used to acquire employer securities for an ESOP.[1213]

In addition, prior law allowed for the transfer of defined benefit plan assets to an ESOP without imposition of the excise tax on reversions.[1214] Under present and prior law, an excise tax is imposed on employer reversions from a qualified plan equal to 20 percent of the reversion (50 percent if the employer does not establish a replacement plan or provide certain benefit increases). [1215] Prior law provided that, if certain requirements are satisfied, the reversion tax did not apply to the extent a reversion upon plan termination was transferred to an ESOP.

In order for the exception for transfers to an ESOP to apply, the following requirements had to be satisfied: (1) within 90 days, or such longer period as the IRS allowed, after the transfer, the amount transferred had to be invested in employer securities or used to repay loans used to purchase employer securities; (2) certain allocation requirements had to be met which generally required that the employer securities be allocated ratably over no more than seven years;[1216] (3) at least half of the participants in the qualified plan had to be participants in the ESOP as of the close of the first plan year for which an allocation of the securities was required; (4) under the plan, employer securities, the acquisition of which satisfied the first condition, had to, except to the extent necessary to meet plan qualification requirements relating to diversification of assets, remain in the plan until distributed to participants in accordance with the provisions of the plan; and (5) the amount had to be transferred after March 31, 1985, and before January 1, 1989, or after December 31, 1988, pursuant to a termination which occurred after March 31, 1985, and before January 1, 1989.

3. General rules relating to investment of qualified retirement plan assets

Risk of investment loss

The person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit plan or a defined contribution plan.

[1213] The exclusion was added in section 133 of the Code by the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984), generally effective for loans used to acquire employer securities after July 18, 1984. Significant changes were made to the interest exclusion by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989), including a provision generally limiting the exclusion to cases in which the ESOP owned more than 50 percent of the stock of the corporation. The exclusion was subsequently repealed, generally effective for loans made after August 20, 1996. Pub. L. No. 104-188, sec. 1602(a) (1996).

[1214] Sec. 4980(c)(3). This provision was utilized by Enron to provide funding for the Enron ESOP. A "reversion" is any amount of cash or the fair market value of property received by an employer from a qualified plan. A reversion can occur, for example, if a defined benefit plan is terminated and plan assets are greater than plan liabilities.

[1215] Sec. 4980.

[1216] Sec. 4980(c)(3)(C).

In a defined benefit plan, investment risk is generally on the employer as a result of the minimum funding requirements, under which the employer must make contributions in the amount necessary to fund promised benefits, as discussed above. The minimum funding rules also require periodic valuation of defined benefit plan assets. If the plan suffers investment losses, the employer may be required to increase plan contributions to maintain the funded status of the plan.

Benefits under most defined benefit plans are guaranteed (within limits) by the PBGC.[1217] In the event a plan terminates with assets insufficient to pay promised benefits, the PBGC will pay benefits up to the maximum guaranteed amount.[1218] For 2003, the maximum guaranteed benefit for an individual retiring at age 65 is $3,664.77 per month, or $43,977.24 per year.

In a defined contribution plan, the benefit to which the participant is entitled is the account balance. Thus, the plan participant bears the risk of investment losses, regardless of whether investment decisions are made by the participant or a plan fiduciary. Defined contribution plans are not insured by the PBGC.

General fiduciary rules and investment responsibility

Overview

Except with respect to certain investments in employer securities, discussed below, generally neither the Internal Revenue Code nor ERISA imposes restrictions on the specific investments that can be made with qualified retirement plan assets. Rather, ERISA imposes general standards applicable to the conduct of plan fiduciaries. In addition, except with respect to investment in employer securities and the ability of plan participants to direct investments, discussed below, defined benefit plans and defined contribution plans are generally subject to the same rules regarding the investment of plan assets.

Definition of fiduciary

ERISA provides, in relevant part, that a person is a fiduciary with respect to a plan to the extent he or she exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of plan assets or has any discretionary authority or discretionary responsibility in the administration of the plan.[1219] Fiduciary status extends to those aspects of the plan over which the fiduciary exercises authority or control. The determination of whether an individual is a plan fiduciary often involves significant factual inquiry. Corporate officers and directors are not considered plan fiduciaries merely because of their corporate position--whether they are fiduciaries is determined by reference to whether they have or exercise the requisite authority

[1217] ERISA sec. 4021.

[1218] *See* ERISA sec. 4022.

[1219] ERISA sec. 3(21)(A)(i) and (ii).

and control over the plan. Under ERISA, a person who makes investment decisions with respect to a qualified retirement plan is generally a plan fiduciary.

ERISA also provides that every plan must have one or more named fiduciaries.[1220] Named fiduciaries must be named in the plan document (or by the employer, employee organization, or the two acting jointly, pursuant to a procedure specified in the plan). The named fiduciary must have authority to control and manage the operation and administration of the plan. In practice, a committee is often identified as the named fiduciary and has employer officers as its members.

Generally, the plan trustee has exclusive authority and responsibility for managing and controlling plan assets and is thus responsible for investing plan assets. However, the plan may make the trustee subject to the direction of the named fiduciary, or the authority for managing plan assets may be delegated to an investment manager.[1221] An investment manager is a registered investment advisor, bank, trust company, or insurance company that is appointed by a named fiduciary of the plan with the power to manage, acquire, or dispose of plan assets. The investment manager must acknowledge in writing its status as a fiduciary.[1222]

General standard of conduct for plan fiduciaries

ERISA contains general fiduciary standards that apply to all fiduciary actions,[1223] including investment decisions made by fiduciaries. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and:

- for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of plan administration;
- with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- in accordance with plan documents insofar as they are consistent with ERISA.[1224]

[1220] ERISA sec. 402(a).

[1221] In such case, ERISA provides that the trustee is obligated to follow the instructions of the named fiduciary unless the directions are contrary to the provisions of ERISA or the plan or trust. *See* ERISA sec. 403(a)(1) and (2).

[1222] ERISA sec. 3(38).

[1223] Although the focus of this discussion is plan investments, fiduciary actions and liability are not limited to issues regarding investment of plan assets.

[1224] ERISA sec. 404(a)(1).

In the case of a defined contribution plan, the diversification requirement and the prudence requirement (only to the extent it requires diversification) are not violated by the acquisition or holding of employer securities.[1225] The application of the fiduciary rules to plans holding employer securities is discussed in more detail in Part II.C.3, below.

The fiduciary rules under ERISA are subject to enforcement through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries. Plan fiduciaries may be held personally liable for losses resulting from a breach of fiduciary duty.[1226]

In some circumstances, a plan fiduciary may be liable for a breach of fiduciary duty by another fiduciary of the plan.[1227] A fiduciary may be liable for a breach of duty by another fiduciary if the fiduciary: (1) knowingly participates in, or undertakes to conceal, an act or mission of the other, knowing that the act or omission constitutes a breach of duty; (2) enables another fiduciary to commit a breach by failing to comply with their own duty; or (3) knows of a breach by another fiduciary and fails to make reasonable efforts[1228] under the circumstances to remedy it. For purposes of these provisions, constructive knowledge, rather than actual knowledge is sufficient to establish cofiduciary liability. For example, a fiduciary may be liable for the actions of another if the fiduciary knew or should have known of the breach and failed to make reasonable efforts to correct the breach.

Plan investment decisions made by plan fiduciaries may in some cases violate the exclusive benefit rule under the Internal Revenue Code. However, not all fiduciary violations relating to plan investments are violations of the exclusive benefit rule.

Special fiduciary rules for participant-directed investments in defined contribution plans

A defined contribution plan may permit participants or beneficiaries to make investment decisions with respect to their individual accounts. For example, it is common for 401(k) plans to provide participants with investment authority with respect to their own elective deferrals.

Under a so-called safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants in deferred contribution plans if plan participants control the investment of their individual accounts.[1229] Many employers design plans so that they can take advantage of this rule in order to minimize fiduciary responsibilities. If the safe harbor applies, a

[1225] ERISA sec. 404(a)(2).

[1226] ERISA sec. 409.

[1227] ERISA sec. 405. Such liability is often referred to as cofiduciary liability.

[1228] Department of Labor regulations clarify that if a fiduciary takes reasonable steps to remedy a breach by another, the fiduciary generally is not liable under cofiduciary liability merely because the remedial efforts fail. 29 C.F.R. sec. 2509.75-7, at FR-10.

[1229] ERISA sec. 404(c).

plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions made by participants. This includes investments in employer securities made at the direction of the participant. Failure to satisfy the safe harbor rule means that plan fiduciaries may be held liable for the investment decisions of participants. The safe harbor rule is discussed in detail below.[1230]

4. Rules relating to investments of qualified retirement plan assets in employer securities

In general

In addition to the general ERISA rules relating to the investment of qualified retirement plan assets, special rules apply to the investment of plan assets in stock or other securities issued by the employer or an affiliate of the employer.[1231] The assets of either a defined contribution plan or a defined benefit plan may be invested in employer securities. However, the rules relating to such investments differ for defined benefit plans and defined contribution plans, as discussed below.

Application of fiduciary rules to plans holding employer securities

As mentioned above, the general diversification standard applicable to plan fiduciaries (and the general prudence requirement to the extent it requires diversification) generally are not violated by the acquisition or holding of employer securities by a defined contribution plan.[1232] However, under case law, this does not mean that the holding of such securities by such plans never involves a breach of fiduciary duty. This issue, and applicable cases, is discussed in detail below.[1233]

Limits on investments in employer securities

ERISA imposes restrictions on the investment of qualified retirement plan assets in employer securities. ERISA prohibits defined benefit plans (and money purchase pension plans other than certain pre-ERISA plans) from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities.[1234] Most defined contribution plans, such as profit-sharing plans, stock bonus plans, and certain pre-ERISA money purchase pension plans are not subject to any limit on the amount of employer contributions that can be invested (or required to be invested) in employer securities.[1235]

[1230] *See* Part II.C.5.

[1231] Special rules apply also to the investment of plan assets in employer real property.

[1232] ERISA sec. 404(a)(2).

[1233] *See* Part II.C.3.

[1234] *See* ERISA sec. 407.

[1235] ERISA sec. 407(b)(1).

In the case of a 401(k) plan, no more than 10 percent of elective deferrals can be required to be invested in employer securities. However, this restriction does not apply if: (1) the amount of elective deferrals required to be invested in employer securities does not exceed more than one percent of any employee's compensation; (2) the fair market value of all individual account plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP. In addition, there is no limit on the amount of elective deferrals that an employee can choose voluntarily to invest in employer securities.[1236]

The Code requires that ESOP plan participants who are age 55 and have 10 years of plan participation must be permitted to diversify the investment of the participant's account (i.e., to invest the account in assets other than employer securities).[1237] The participant must be given a period each year for six years in which to diversify up to 25 percent (or 50 percent in the last year) of the participant's account, reduced by the portion of the account diversified in prior years. As an alternative to providing diversified investment options in the plan, the plan can provide that the portion of the participant's account that is subject to the diversification requirement is distributed to the participant.

Definition of employer securities

Under ERISA, a qualified retirement plan may hold only a "qualifying employer security."[1238] Any stock issued by the employer or an affiliate of the employer is a qualifying employer security.[1239] In the case of a defined benefit plan (and money purchase pension plans other than certain pre-ERISA plans), in order for stock to be a qualifying employer security, the plan cannot hold more than 25 percent of the aggregate amount of the issued and outstanding stock of the same class, and at least 50 percent of the aggregate amount of that stock must be held by persons independent of the issuer.[1240]

For purposes of ESOP investments, employer securities (or "qualifying employer securities") are defined in the Code to mean only:

(1) publicly traded common stock of the employer or a member of the same controlled group;

[1236] ERISA sec. 407(b)(2).

[1237] Sec. 401(a)(28).

[1238] ERISA sec. 407(a)(1)(A).

[1239] ERISA sec. 407(d)(5). Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). *Id.*

[1240] ERISA sec. 407(f).

(2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or

(3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.[1241]

5. Other rules

Prohibited transaction rules[1242]

Both the Internal Revenue Code and ERISA contain prohibited transaction rules that prohibit the employer, plan fiduciaries, and other persons with a close relationship to a qualified retirement plan from engaging in particular transactions with the plan. These rules are not targeted toward particular types of investments, but rather seek to prevent self-dealing transactions.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Certain transactions are exempt from prohibited transaction treatment. In addition, the Department of Labor may grant administrative exemptions in particular circumstances.

If a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax under the Code. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

Limitations on contributions and benefits

Limits apply to the contributions or benefits provided to a participant under a qualified retirement plan, based on the type of plan.[1243]

[1241] Secs. 4975(e)(7) and 409(l). This document uses the term "employer securities" to refer generally to qualifying employer securities as defined under ERISA and the Code.

[1242] *See* sec. 4975 and ERISA secs. 407 and 408.

Under a defined contribution plan, the annual additions to the plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation ($40,000 for 2003). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Under a defined benefit plan, the maximum annual benefit payable to a participant at retirement cannot exceed the lesser of (1) 100 percent of the participant's average compensation, or (2) a dollar amount, indexed for inflation ($160,000 for 2003). The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

Deductions for plan contributions

Employer contributions to qualified retirement plans are deductible subject to certain limits.[1244] In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.[1245]

In the case of a defined contribution plan, the amount of deductible contributions is generally limited by compensation. In general, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is 25 percent of compensation of the employees covered by the plan for the year.[1246]

In the case of a defined benefit plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. In order to encourage plan sponsors to fully fund defined benefit plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability. In the case of a plan that terminates during the year, the maximum deductible is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

If an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees, the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet

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[1243] Sec. 415. EGTRRA increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[1244] Sec. 404. EGTRRA increased many of the limits relating to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[1245] Sec. 4972.

[1246] Additional amounts may be deductible in the case of an ESOP as described in the discussion of ESOPs in Part II.A.2.

the minimum funding requirements of the defined benefit plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

Taxation of qualified retirement plan contributions and distributions

Employer contributions and employee elective deferrals (and earnings) to a qualified retirement plan generally are not includible in an employee's income until distributed.

A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to another employer-sponsored retirement plan or IRA, and distribution of employer securities.[1247]

Early distributions from qualified retirement plans generally are subject to an additional 10-percent early withdrawal tax. That is, includible amounts distributed prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the distribution is due to death or disability, is made in the form of certain periodic payments, is made to an employee after separation from service after attainment of age 55, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income.[1248]

Distributions from a qualified retirement plan are required to begin no later than the participant's required beginning date. The required beginning date is April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2, or (2) the calendar year in which the employee retires. In the case of an employee who is a five-percent owner, the required beginning date is April 1 of the calendar year following the calendar year the employee attains age 70-1/2. Distributions after the participant's death also must meet certain minimum distribution requirements.[1249]

The sanction for failure to make a minimum required distribution to an employee (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed. The tax is imposed on the individual required to take the distribution. However, in order to satisfy the qualification requirements, a plan must expressly provide that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.[1250]

[1247] Sec. 402.

[1248] Sec. 72(t). Certain other exceptions to the tax may also apply.

[1249] Sec. 401(a)(9).

[1250] Sec. 4974.

Qualified retirement plan reporting and disclosure requirements

A qualified retirement plan is subject to annual reporting and disclosure requirements under both the Internal Revenue Code and ERISA.

The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan to the Department of Labor.[1251] The plan administrator must also to file an annual registration statement with the IRS with respect to certain participants who separate from service during the year.[1252] The plan administrator must also furnish an individual statement to each participant who separates from service and is listed in the annual registration statement described above.[1253]

The plan administrator must automatically provide participants with a summary of the annual report.[1254] A plan administrator is also required to furnish participants with a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan.[1255] The plan administrator must also furnish participants with a summary of any material modification in the terms of the plan and any change in the information required in the summary plan description within 210 days after the end of the plan year in which the modification or change occurs.[1256] Under ERISA, a plan administrator must also furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement.[1257] This requirement applies in the case of any plan that is subject to ERISA, including defined contribution and defined benefit plans.

1251 ERISA secs. 103 and 104. Defined benefit plans must also provide certain reports or notices if the plan is underfunded (ERISA secs. 4010 and 4011), if a plan amendment significantly reduces the rate of future benefit accrual (sec. 4980F and ERISA sec. 204(h)), or if plan assets are transferred to health benefit accounts pursuant to sec. 420 (sec. 101(e) of ERISA).

1252 Sec. 6057.

1253 ERISA secs. 101(a)(2) and 105(c).

1254 ERISA secs. 101(a) and 104(b)(3).

1255 ERISA secs. 101(a), 103, and 104(3). The summary plan description must also be furnished to the Department of Labor on request. ERISA sec. 104(a)(6).

1256 ERISA secs. 102 and 104(b).

1257 ERISA sec. 105.

IRS compliance

The IRS has three programs to ensure that plans comply with the numerous requirements under the Code for a retirement plan to receive the tax benefits of qualified plan status: (1) the determination letter program; (2) the examination program; and (3) the Employee Plans Compliance Resolution System ("EPCRS").

The IRS permits plan sponsors to voluntarily submit plans for review to ensure that plans comply with tax law requirements for retirement plans. The IRS reviews the plan design reflected in the plan documents and certain operational requirements. The determination letter program involves the issuance of determination letters to requesting plan sponsors, which are a statement of the IRS' determination that a plan meets the qualification requirements of the Code.

The examination program involves the IRS' examination of plans to determine whether the qualification requirements are met in operation. The qualified plan examination program reviews issues of plan design as well as those arising in plan operation. For example, a plan that, by its terms, provides for contributions in a manner satisfying tax law requirements may in operation result in contribution levels that impermissibly favor highly compensated employees.

Additionally, the IRS has established EPCRS, which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), or section 403(b), as applicable.[1258] EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program generally permits a plan sponsor that has established compliance practices to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

[1258] Rev. Proc. 2002-47, 2002-29 I.R.B. 1.

B. Overview of Enron's Qualified Retirement Plans

This part provides an overview of qualified retirement plans maintained by Enron during the period covered by the Joint Committee review: the Enron Corp. Retirement Plan ("Enron Retirement Plan"), which was modified and is now the Enron Corp. Cash Balance Plan ("Enron Cash Balance Plan"); the Enron Corp. ESOP ("Enron ESOP"); and the Enron Corp. Savings Plan ("Enron Savings Plan").[1259] The plans collectively are referred to as the Enron qualified plans. The Enron Retirement Plan and the Enron Cash Balance Plan are referred to collectively as the Enron Retirement Plan/Cash Balance Plan. Additionally, this part describes matters common to all of Enron's qualified retirement plans, plan administration, and pending legal matters involving the plans.

1. In general

Over time, the Enron Qualified Plans have been amended and restated to comply with legal requirements and, in some instances, to implement design changes. Because of changes in plan design, Enron employees may have earned benefits under more than one retirement formula within the same plan. Additionally, Enron employees may earn benefits under more than one plan.

The Enron Retirement Plan, a defined benefit plan was initially established effective July 1, 1986, as an amendment and restatement of the InterNorth, Inc. Retirement Income Plan II. At the same time, the Houston Natural Gas Corporation Retirement Plan, maintained by the Houston Natural Gas Corporation, an Enron subsidiary ("HNG"), was merged into the Enron Retirement Plan. The Enron Retirement Plan was amended and restated and renamed the Enron Corp. Cash Balance Plan effective January 1, 1996.

Enron established the Enron ESOP effective November 1, 1986.[1260] During 1986, Enron loaned the Enron ESOP $335 million to purchase shares of Enron Corp. common stock that had previously been held as treasury stock. As a result of this purchase, the Enron ESOP held approximately 19 percent of Enron's outstanding common stock. During 1987, $230 million of the principal amount of the loan was repaid with proceeds received from the terminating InterNorth, Inc. Pension Plan I.[1261] The final payment on the Enron ESOP loan was made in March 1993.

[1259] Other qualified retirement plans were maintained by other members of Enron's controlled group. For example, PGE maintained a separate defined benefit plan. This report focuses on the retirement plans or Enron Corp. which were the largest plans within the Enron controlled group, and generally available to employees of Enron Corp. and related entities.

[1260] Materials reviewed by the Joint Committee staff indicate that Enron also sponsored a "tax-credit ESOP" which was effective in 1975 and terminated in 1988. Joint Committee staff did not review this plan.

[1261] Notes to Financial Statements, 1990 Form 5500 for the Enron Savings Plan, at 5. Descriptions of the mechanics of the repayment vary. Other sources explain that a block of Enron stock was purchased by the Enron ESOP in February 1987 with $230 million received by

Enron established a floor-offset arrangement, involving the Enron Retirement Plan and the Enron ESOP effective January 1987. The Enron Retirement Plan was amended effective January 1, 1995, to eliminate the offset arrangement between the Enron Retirement Plan and the Enron ESOP for benefits accruing after 1994 and to freeze the amount of the offset over the period 1996 to 2000. The amendment of the floor-offset arrangement is discussed in detail in Part II.C.1., below.

The Enron Savings Plan began as a plan originally effective June 1, 1956.[1262] The Enron Savings Plan is a defined contribution plan which includes a qualified cash or deferred arrangement (i.e., it is a so-called "section 401(k)" plan). Participants may make elective deferrals and after-tax contributions to the Enron Savings Plan, and have a range of investment choices available for their contributions. In addition, Enron made matching contributions based on employee elective deferrals. The matching contributions were invested in Enron stock pursuant to the plan terms; participants could elect to invest the matching contributions in another investment only after attaining age 50. The Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002, with the result that the provisions of the Enron Savings Plan generally replace the provisions of the Enron ESOP in their entirety.[1263]

2. Recent and pending legal matters involving the Enron qualified plans

IRS audit[1264]

The IRS has performed only one audit with respect to the Enron qualified plans.[1265] In 1998, the Tax Exempt and Government Entities Division of the IRS ("TE/GE") audited the plans with respect to 1995 and 1996. IRS personnel informed the Joint Committee staff that the audit came about due to a request made by the Large and Mid-Size Business division of the IRS ("LMSB"), which was conducting an audit of Enron tax's return. LMSB did not identify any issues for audit, but asked TE/GE if they could perform what the IRS refers to as a "support audit." TE/GE personnel said that they determined they had the time and the resources and agreed to perform the audit.

Enron as the reversion. *See* Enron's July 21, 1994, request for an advisory opinion from the Department of Labor.

[1262] Forms 5500 for the Enron Savings Plan.

[1263] "Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan," EC 000899959-000899961. Pursuant to the merger, the assets held under the ESOP were transferred to the Enron Savings Plan to be held under the trust maintained thereunder.

[1264] This information was obtained primarily through interviews conducted by the Joint Committee staff of IRS personnel.

[1265] The IRS noted that Enron has qualified plans other than the Enron Savings Plan, Enron ESOP, and Enron Retirement Plan/Cash Balance Plan. In conducting the audit, they focused on these three plans because they are the largest.

IRS personnel said the audit was a long, labor intensive process. Among other things, the IRS reviewed Forms 5500 for the Enron qualified plans and checked Enron's deductions for qualified plan contributions. They had a computer audit specialist make an examination to determine if the Enron qualified plans were qualified in form, but spent the bulk of the time looking at plan operations.

PBGC actions

In connection with Enron's filing for bankruptcy protection on December 2, 2001, the PBGC filed claims against Enron in October 2002.[1266] The PBGC's claim for unfunded benefit liabilities of the Enron Cash Balance Plan was approximately $270 million. The PBGC's estimate of the underfunding may increase if the IRS rules adversely on the amendment to phase out the floor-offset arrangement[1267] and the benefits attributable to offset amounts become liabilities of the Enron Cash Balance Plan.[1268]

Department of Labor actions

Following Enron's filing of voluntary petitions for Chapter 11 bankruptcy organization protection on December 2, 2001, the Department of Labor and Enron agreed in February 2002 to replace the Administrative Committee with an independent fiduciary to administer the Enron Qualified Plans. On March 14, 2002, the Department of Labor announced that a team of experts from State Street Bank and Trust had been selected to act in that capacity.[1269]

[1266] *See, e.g.*, Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at ¶ 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York.

[1267] This issue is discussed in detail in Part II.C.1., below.

[1268] The PBGC estimates that could increase by as much as 100 percent or more. if the phasing out of Enron's floor-offset arrangement (Part II.C.1, below) is determined by the IRS to fail the qualification requirements and the benefits attributable to offset amounts again become liabilities of the Enron Cash Balance Plan. Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at paragraph 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York.

[1269] First Amendment to Enron Corp. Cash Balance Plan, EC01747538-EC01747541. *See* Department of Labor news release, *Department Of Labor Announces Enron Independent Fiduciary State Street To Replace Enron's Retirement Administrative Committee*, www.dol.gov/opa/media/press/opa/OPA2002145.

The Department of Labor is investigating Enron's qualified retirement plans.[1270] The investigation is ongoing and comprehensive. The Department of Labor has been deposing "scores of witness and review[ing] literally millions of documents."[1271]

Private lawsuits

Additionally, several lawsuits involving the Enron qualified plans have been filed. The lead case involving the plans is *Tittle v. Enron Corp.*, pending in U.S. District Court in the Southern District of Texas.[1272] *Tittle* was filed on behalf of an estimated 24,000 current and former participants in the Enron Savings Plan, the Enron ESOP, and the Enron Cash Balance Plan. A consolidated and amended complaint in the case was filed April 8, 2002.[1273] The case was brought by Enron workers who allege that their retirement accounts lost millions of dollars when Enron collapsed.[1274] They allege that the defendants were fiduciaries of the Enron retirement plans and that, rather than act prudently and solely in the interests of the Enron retirement plans and their participants and beneficiaries, the fiduciaries did nothing to protect the participants and beneficiaries from suffering huge losses even though the defendants knew or should have known that the plans were paying too much for Enron stock and that financial misstatements threatened the integrity of the retirement benefits.

The complaint seeks to recover losses incurred by participants or beneficiaries of the Enron Savings Plan, the Enron ESOP and the Enron Cash Balance Plan who were affected by a variety of alleged misconduct by the various defendants relating to the Enron stock in the Enron Plans. The complaint is framed to recover on behalf of the Enron Qualified Plans as a whole

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[1270] Speech by Assistant Secretary of Labor Ann L. Combs to the Annual Conference of the Society of American Business Editors and Writers (delivered Nov. 4, 2002), www.dol.gov/pwba.

[1271] *Id.*

[1272] The plaintiffs in *Tittle* seek class action status.

[1273] The following cases were consolidated by orders of the U.S. District Court for the Southern District of Texas, dated December 12, 2001, and January 18, 2002: *Tittle v. Enron Corp.*, No. H-01-3913; *Rinard v. Enron Corp.*, No. H-01-4060; *Harney v. Enron Corp.*, No. H-01-4063; *Kemper v. Enron Corp.*, No. H-01-4089; *Clark v. Enron Corp.*, No. H-01-4125; *Ricketts v. Enron Corp.*, No. H-01-4128; *Pottratz v. Enron Corp.*, No. H-01-4150; *Stevens v. Enron Corp.*, No. H-01-4208; *Prestwood v. Gathman*, No. H-01-4209; *Walt v. Lay*, No. H-01-4299; *Moore v. Enron Corp.*, No. H-01-4236.

[1274] The plaintiffs in *Tittle* are Pamela M. Tittle, Thomas O. Padgett, Gary S. Dreadin, Janice Farmer, Linda Bryan, John L. Moore, Betty J. Clark, Shelly Farias, Patrick Campbell, Fanette Perry, Charles Prestwood, Roy Rinard, Steve Lacey, Catherine Stevens, Roger W. Boyce, Wayne M. Stevens, Norman L. and Paula H. Young, Michael L. McCown, Dan Shultz, on behalf of themselves and a class of persons similarly situated, and on behalf of the Enron Corp. Enron Savings Plan, the Enron Corp. Employee Stock Ownership Plan and the Enron Corp. Cash Balance Plan.

whether or not a class or classes are certified. The complaint covers alleged misconduct during January 20, 1998, through December 2, 2001.

Among the defendants named in *Tittle*, in addition to Enron itself, are certain current and former Enron directors and officers and the members of the Administrative Committee for the Plans, who were all Enron employees appointed by Enron.[1275] Defendants in the case moved to dismiss the action on May 8, 2002, generally arguing that there is no set of facts that the plaintiffs have alleged that would make them liable for the losses suffered by the Enron plans and the retirement accounts of these workers.

The Department of Labor filed a brief as *amicus curiae* opposing the defendants' motion to dismiss. According to the brief, based on the allegations in the complaint, ERISA required the fiduciaries to take action to protect the interests of the Enron plans, their participants and beneficiaries, and ERISA provides remedies for the failure to have done so. The Department of Labor argues that the allegations of the complaint are sufficient to withstand motions to dismiss and that the plaintiffs should be allowed to conduct discovery to prove the allegations.

In its brief, the Department of Labor makes a number of points. First, it argues that the fiduciaries responsible for monitoring the Administrative Committee that directly manages the Enron Savings Plan (the "appointing fiduciaries") have a duty under ERISA to ensure that the Committee is properly performing its duties, and that it has the tools and the information necessary to do its job. Initially, the Department of Labor concludes that because the appointing fiduciaries had the power to appoint, retain, and remove the members of the Administrative Committee, the Appointing Fiduciaries have discretionary authority over the management and administration of the plan and are thus plan fiduciaries under ERISA.

[1275] The parties named as defendants in *Tittle* are: Enron Corp., Enron Corp. Savings Plan Administrative Committee, Enron Employee Stock Ownership Plan Administrative Committee, Cindy K. Olson, Mikie Rath, James S. Prentice, Mary K. Joyce, Sheila Knudsen, Rod Hayslett, Paula Rieker, William D. Gathmann, Tod A. Lindholm, Philip J. Bazelides, James G. Barnhart, Keith Crane, William J. Gulyassy, David Shields, John Does Nos. 1-100 Unknown Fiduciaries of the Enron Corp. Savings Plan or the ESOP, the Northern Trust Company, Kenneth L. Lay, Jeffrey K. Skilling, Andrew S. Fastow, Michael Kopper, Richard A. Causey, James V. Derrick, Jr., The Estate of J. Clifford Baxter, Mark A. Frevert, Stanley C. Horton, Kenneth D. Rice, Richard B. Buy, Lou L. Pai, Robert A. Belfer, Norman P. Blake, Jr., Ronnie C. Chan, John H. Duncan, Wendy L. Gramm, Robert K. Jaedicke, Charles A. Lemaistre, Joe H. Foy, Joseph M. Hirko, Ken L. Harrison, Mark E. Koenig, Steven J. Kean, Rebecca P. Mark-Jusbasche, Michael S. McConnell, Jeffrey McMahon, J. Mark Metts, Joseph W. Sutton, Arthur Andersen & Co. Worldwide Societe Cooperative, Arthur Andersen, LLP, UK Arthur Andersen, David B. Duncan, Thomas H. Bauer, Debra A. Cash, Roger D. Willard, D. Stephen Goddard, Jr., Michael M. Lowther, Gary B. Goolsby, Michael C. Odom, Michael D. Jones, William Swanson, John Stewart, Nancy A. Temple, Don Dreyfus, James Friedlieb, Joseph F. Berardino, Does 2 Through 1800 Unknown Partners in Andersen LLP, Merrill Lynch & Co., Inc., J.P. Morgan Chase & Co., Credit Suisse First Boston Corporation, Citigroup, Inc., Salomon Smith Barney Inc., Vinson & Elkins, LLP, Ronald T. Astin, Joseph Dilg, Michael Finch, and Max Hendrick III.

The Department of Labor also argues that fiduciaries may not deceive plan participants or allow others to do so. Rather, fiduciaries are obligated to take appropriate actions to carry out their responsibilities. This may include investigating allegations of fraud, disclosing facts to participants, other fiduciaries, or the public, and stopping further investment in company stock, as required by a standard of prudence.

Additionally, the Department of Labor asserts, fiduciaries have an obligation to ensure that investments in employer securities in a defined contribution plan are prudent, notwithstanding plan provisions that favor such investments. Further, the Department of Labor states that even if fiduciaries have "insider information" about the value of employer securities, Federal securities law does not prevent the fiduciaries from taking some action to protect the Enron qualified plans, such as public disclosure or temporarily suspending further purchase of employer securities. Finally, the Department of Labor argues that directed trustees cannot follow directions that they know or should know are imprudent or violate ERISA.

Defendants' motion to dismiss *Tittle* is pending.

3. Administration of the Enron qualified retirement plans

In general

The Administrative Committee

The Enron Cash Balance Plan, the Enron Savings Plan, and the Enron ESOP generally vest responsibility for plan administration in an administrative committee consisting of one or more individuals appointed by Enron.[1276] Each Plan provides for a separate administrative committee for that Plan. In practice, however, the same individuals (typically senior Enron officials appointed by the Chairman of the Board of Enron), served on all three Committees and issues with respect to all three Plans were addressed in a single Committee meeting. This document uses the term "Administrative Committee" to refer to the all three committees provided for under the Enron qualified plans. The members of the Administrative Committee are fiduciaries under ERISA.

The duties of each Plan Administrative Committee are specified in detail in each Plan document. Many of these duties are similar for all three Plans. There are, however, responsibilities which are specific to each Plan. An overview of the Administrative Committee's duties and activities is provided here; a detailed discussion follows.

According to interviews with former Administrative Committee members, there was no formal process for the selection of Administrative Committee members; suggestions for new members were typically made by the Enron Benefits Department to the Office of the Chairman. The Chairman would then make an appointment.

[1276] Under the Enron ESOP, the Administrative Committee is also the "named fiduciary" with respect to general administration of the Enron ESOP. Under the Enron Cash Balance Plan and the Enron Savings Plan, however, Enron is the "named fiduciary" with respect to general administration.

The Joint Committee staff interviewed former members of the Administrative Committee, including two former chairmen, and reviewed minutes of Administrative Committee meetings. The view presented of the activities of the Administrative Committee is similar. The interviews confirm that the members of the Administrative Committee viewed their role as relatively narrow. In practice, the main activities of the Administrative Committee were: (1) review of the investment performance under the Enron Cash Balance Plan; (2) review of the performance of the various investment options under the Enron Savings Plan (other than Enron stock)[1277]; and (3) participant appeals with respect to all three plans. These appeals generally related to the denial or calculation of benefits. One former member of the Administrative Committee said that the two main issues addressed during his five-year tenure on the Administrative Committee involved a change in a family of investment funds offered under the Enron Savings Plan and the merging of a PGE plan and the Enron Savings Plan.

The Administrative Committee generally did not evaluate Enron stock as an appropriate investment under either the Enron ESOP or the Enron Savings Plan. As described by one Administrative Committee member, the Enron ESOP plan terms provided for investment of plan assets in Enron stock, so there was no need to review that investment. The Administrative Committee questioned for the first time whether it should be examining Enron stock as an investment under the Enron qualified plans on November 1, 2001.[1278]

Administrative Committee meetings were generally attended by a member of the Enron Benefits Department and the Enron Treasury Department (who focused on investment matters, particularly with respect to the Enron Cash Balance Plan). Others also attended on an as needed basis, including in-house counsel, Enron counsel, and the Administrative Committee's counsel. The Committee received advice on numerous occasions from outside Enron ERISA counsel. The role of these parties may not always have been clear to Committee members; one former member indicated he was not sure whether the Enron ERISA counsel lawyer represented the Committee or Enron.

The Administrative Committee was briefed on occasion regarding their duties by Enron's ERISA counsel. In once such briefing, the Committee members were counseled to think of their fiduciary role as a "parable of hats." They were advised that each member has four hats, an Enron hat, an Enron Cash Balance Plan hat, an Enron Savings Plan hat, and an Enron ESOP hat; the member could wear only one hat at a time. Interviews with Administrative Committee members indicated that they generally understood that they were plan fiduciaries and that they were to act in the best interests of plan participants. It is not clear whether the members understood the special nature of ERISA fiduciary duties; one member told the Joint Committee staff that he missed a briefing on ERISA fiduciary duties, but that he had experience in fiduciary matters and therefore understood his obligations.

[1277] In reviewing investment performance under the Enron Cash Balance Plan and the Enron Savings Plan, the Administrative Committee relied on the advice of third parties, as well as in-house personnel.

[1278] Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001). EC000001847.

The Enron qualified plans provide that Enron will indemnify Administrative Committee members against expenses and liabilities arising out of their administrative functions or fiduciary duties (other than expenses and liabilities arising out of gross negligence or willful misconduct).

There was no set schedule for Administrative Committee meetings, although there appeared to be a general intent to meet at least quarterly. There may be some lapse in the recordkeeping with respect to such meetings; Enron informed the Joint Committee staff that the Administrative Committee did not meet during the one-year period from October 19, 1998, to October 26, 1999. However, documents provided by Enron and interviews with former Administrative Committee members indicate that during this period the Administrative Committee was actively involved in issues relating to the merging of the Enron and PGE Plans.

The Administrative Committee started having weekly, then daily meetings near the end of 2001 as the stock price of Enron was falling rapidly. These frequent meetings focused at first on the change of recordkeepers and the blackout under the Enron Savings Plan, and later on the questions involving Enron stock as a suitable investment and pending law suits.

As described above, on March 14, 2002, the Department of Labor announced that a team of experts from State Street Bank and Trust had been selected to administer the Enron qualified plans.[1279]

Role of Enron

The day-to-day operations of the Enron qualified plans were generally performed by the Enron Benefits Department.[1280] According to interviews with current and former Enron personnel, the Benefits Department processed distributions, prepared retirement packages, provided customer service, and answered telephone calls. The Benefits Department was generally responsible for employee communications with respect to Enron's retirement plans. Additionally, Benefits Department employees interviewed by Joint Committee staff reported varying levels of discretion and involvement in amendments to the plans. The Administrative Committee generally did not oversee the activities of the Enron Benefits Department.

[1279] First Amendment to Enron Corp. Cash Balance Plan (Jan. 1, 2001, restatement), EC01747538-EC01747541. According to the Department of Labor announcement of the selection of State Street Bank and Trust, State Street is responsible for, among other things, the investment of Enron qualified plan assets, the selection and monitoring of investment managers, the investment of Enron qualified plan assets in employer securities, representation of the interests of the Enron qualified plans in litigation. This includes representation of the plans' interests in the Enron bankruptcy and the selection and monitoring of funds and investment options offered under the Enron Savings Plan. Department of Labor news release, *Department Of Labor Announces Enron Independent Fiduciary State Street To Replace Enron's Retirement Administrative Committee*, www.dol.gov/opa/media/press/opa/OPA2002145.

[1280] Third-parties, such as recordkeepers, also had responsibilities with respect to some plan activities. The appointment of State Street Bank and Trust to administer the Enron qualified plans does not appear to affect these responsibilities.

Enron, not the Administrative Committee was responsible for plan design and plan amendments. The Administrative Committee would receive briefings regarding proposed Plan changes, but typically was not involved in the decision-making process.

Role of the Compensation Committee

The Compensation Committee of the Board also had a role with respect to Enron Plans. The Committee approved Plan amendments; in some cases this approval was final, in other cases amendments were approved for action by the full Board of Directors. The extent to which the members of the Compensation Committee understood their role with respect to the Enron qualified plans is unclear; one former member of the Compensation Committee interviewed by the Joint Committee staff indicated he did not remember having any responsibilities with respect to such plans.

Membership of the Administrative Committee

During the period reviewed by Joint Committee staff, there appears to have been no formal, written process for the selection of members to the Administrative Committee. Rather, membership on the Administrative Committee was generally subject to the discretion of the Chairman of Enron. Individuals in Enron's Benefits Department would typically recommend individuals for Committee membership to the Chairman's office. If the Chairman agreed with the recommendation of the Benefits Department, he would send a letter to the individuals requesting that they volunteer for the Administrative Committee. A former chair of the Administrative Committee indicated to the Joint Committee staff that, in looking for Administrative Committee members, the general approach was to look for someone at the officer level who would be interested in serving on the Administrative Committee and who would be qualified either by background or interest. He also indicated that changes to the Administrative Committee were not made very often, so the issue did not arise very much. Another former chair of the Administrative Committee stated that he believed people within Enron viewed serving on the Administrative Committee as an honor.

The Enron qualified plans provide that Administrative Committee members served until they resigned, died, or were removed by Enron. The Enron qualified plans provide that Administrative Committee members are not compensated for their Administrative Committee service.

There was no established number of persons on the Administrative Committee. Former Administrative Committee members told the Joint Committee staff that typically, there were four to eight individuals on the Administrative Committee at various points in time.

Meetings of the Administrative Committee

The Administrative Committee did not have a regular meeting schedule. Meetings of the Administrative Committee were generally held at the discretion of the Administrative Committee chair.

During the period of the Joint Committee staff review, the frequency of Administrative Committee meetings varied. Minutes of Administrative Committee meetings[1281] as well as interviews with former Administrative Committee members demonstrate a general intent to meet quarterly. However, this did not always happen, and attendance was sometimes an issue.[1282]

A major gap in meetings appears to have occurred for slightly more than one year, from the October 19, 1998, meeting until the October 26, 1999, meeting. Enron informed the Joint Committee staff that the Committee did not meet during this period. However, documents provided by Enron, as well as interviews with former Administrative Committee members indicate that the Administrative Committee conducted business during this time. These sources indicate that the Enron and PGE plans were being merged, and that the Administrative Committee was involved in this merger. One member of the Administrative Committee at this time said the merger of these plans was one of the two major issues addressed during his tenure on the Administrative Committee. There are briefing materials prepared for the Administrative Committee regarding the merger dated November 1998. There are no other indications of what the Administrative Committee did during this time period. It may be that there is a gap in recordkeeping for this period.

In 2001, the Administrative Committee met quarterly until October/November, when they started meeting as frequently as weekly. In late 2001, the Administrative Committee met on a daily basis. The reason for more frequent meetings was, at first, primarily to address the issue of the change in recordkeepers and blackout period under the Enron Savings Plan.[1283] Later, the meetings addresses issued related to Enron's financial problems, including the possibility of obtaining an investment advisor to assess the suitability of Enron stock as an investment and pending lawsuits.

In addition to Administrative Committee members, meetings were attended by others. An Enron benefits department representative and an Enron Treasury Department representative would usually attend. The Enron Treasury Department representative generally addressed issues relating to investments under the Enron Cash Balance Plan. Others also attended on an as-needed basis, including legal counsel for Enron (in-house as well as outside counsel) and legal counsel for the Administrative Committee. The sources of legal advice for the Administrative Committee are discussed further, below.

Plan provisions regarding the Administrative Committee

Under the Enron qualified plans, the Administrative Committee is to "supervise the administration and enforcement of the Plan[s] according to the terms and provisions [t]hereof and shall have all powers necessary to accomplish these purposes." Under all of the Plans, the Administrative Committee's powers include, but not by way of limitation, the right, power, authority, and duty:

1281 Minutes of the Administrative Committee Meeting (Sept. 26, 2000).

1282 *Id.*

1283 This issue is discussed in detail in Part II.C.4., below.

- to make rules, regulations, and bylaws for the administration of the Plan that are not inconsistent with the terms and provisions of the Plan, provided such rules, regulations, and bylaws are evidenced in writing, and to enforce the terms of the Plan and the rules and regulations promulgated thereunder by the Administrative Committee;
- to construe in its discretion all terms, provisions, conditions, and limitations of the Plan, and, in all cases, the construction necessary for the Plan to qualify under the applicable provisions of the Code shall control;
- to correct any defect or to supply any omission or to reconcile any inconsistency that may appear in the Plan in such manner and to such extent as the Administrative Committee deems expedient in its discretion to effectuate the purposes of the Plan;
- to employ and compensate such accountants, attorneys, investment advisors, and other agents, employees, and independent contractors that the Administrative Committee may deem necessary or advisable for the proper and efficient administration of the Plan;
- to determine in its discretion all questions relating to eligibility;
- to make a determination in its discretion as to the right of any person to a benefit under the Plan and to prescribe procedures to be followed by distributees in obtaining benefits;
- to prepare, file, and distribute, in such manner as the Administrative Committee determines to be appropriate, such information and material as is required by the reporting and disclosure requirements of ERISA;

With respect to the Enron Savings Plan only, the Administrative Committee also has the power:

- to require and obtain from Enron and the Plan and their beneficiaries any information or data that the Administrative Committee determines is necessary for the proper administration of the Plan;
- to instruct the trustee as to the loans to participants;
- to direct the Trustee as to the investment of the trust fund in Enron stock or Enron Oil & Gas stock as the Administrative Committee may deem to be appropriate and in accordance with the provisions of the Enron Savings Plan;
- to appoint investment managers; and
- to direct the trustee as to the exercise of rights or privileges to acquire, convert, or exchange Enron stock or Enron Oil & Gas stock.

With respect to the Enron ESOP only, the Administrative Committee has the power:

- to make a determination as to the right of any person to a benefit under the Enron ESOP;
- to receive and review reports from the Plan trustee as to the financial condition of the trust fund established under the Plan, including its receipts and disbursements;
- to instruct the trustee in the voting of Enron stock, provided, that the Administrative Committee shall follow the directions of the members to the extent required by the Plan and further provided that the Administrative Committee may in its discretion

appoint a voting fiduciary to receive voting directions from the participants and direct the trustee with respect thereto;
- to select an appraiser to value Enron stock held by the Plan;
- to direct the trustee as to the purchase and sale of Enron stock, including, but not limited to, tender or exchange decisions in accordance with Members' decisions...and decisions as to the purchase of Company Stock pursuant to the option granted to the trustee...and to cause the trustee to enter into an Exempt Loan and to purchase Enron stock for the Trust Fund with the proceeds of such Exempt loan;
- to instruct the trustee as to the loans to participants; and
- to instruct the trustee as to the management, investment and reinvestment of the trust fund generally.

With respect to the Enron Cash Balance Plan only, the Administrative Committee has the power:

- to issue directions to the trustee concerning all benefits that are to be paid from the trust fund according to the plan; and
- to receive and review reports from the trustee as to the financial condition of the trust fund, including its receipts and disbursements.

No supplemental written guidelines specifying the Administrative Committee's responsibilities were provided to Administrative Committee members.

Review of the minutes of Administrative Committee meetings and interviews with former Administrative Committee members provide a picture of the specific issues addressed by the Administrative Committee with respect to each Plan in practice. The Administrative Committee would oversee and review the performance of investments of Enron Retirement Plan/Cash Balance Plan assets made by the professional investment managers. One former Administrative Committee member described this process as follows: typically, the Administrative Committee reviewed investment performance of plan assets for the previous quarter. However, the Administrative Committee would normally not act based on a single quarter's performance. Rather, it tended to take a long-term view. If an investment manager was not performing in at least the fiftieth percentile for their family of managers, the Administrative Committee would instruct the Enron Finance or Treasury Department to analyze the performance. If the investment manager was consistently underperforming, the Administrative Committee was authorized to change investment managers. Experts would appear before the Administrative Committee and recommend investments.

The Administrative Committee would also oversee the investment options under the Enron Savings Plan. The Administrative Committee would review the investments and consider whether they were adequate and whether the participants had adequate choices. The Administrative Committee would also periodically change investment options available to Enron Savings Plan participants.

The Administrative Committee also handled participant appeals with respect to benefit determinations and other issues under all three Plans. Pursuant to Plan terms, the Enron ESOP was invested primarily in Enron stock. As a result, the Administrative Committee generally did not review Enron ESOP Plan investments. The primary activity of the Administrative Committee with respect to the Enron ESOP was participant appeals.

Sources of legal advice for the Administrative Committee

Legal counsel was available to the Administrative Committee from Enron's in-house lawyers and also from legal advisors outside Enron. The Administrative Committee had counsel that represented the Committee. In addition, the Committee received advice from outside counsel for Enron. This individual was referred to by former Administrative Committee members and Enron employees as the "ERISA counsel." Here, he is referred to as Enron's ERISA counsel. While the Enron ERISA counsel represented Enron, not the Committee, he provided advice to the Committee, as well as Enron benefits personnel, regarding a variety of matters. For example, as discussed below, the Enron ERISA counsel briefed the members of the Committee regarding their fiduciary duties.

Some Committee members may not have fully understood the precise relationship between the various legal counsel and the Committee. For example, one former Committee member indicated he was not sure whether the Enron ERISA counsel represented the Committee or Enron, but that he was consulted periodically by the Committee.

Overview of briefings provided to Administrative Committee members regarding their duties

Members of the Administrative Committee received periodic briefings regarding their obligations under ERISA. During the period 1996 through 2001,[1284] the Administrative Committee received two briefings regarding their duties and fiduciary responsibilities. These briefings occurred at the Administrative Committee meetings of December 6, 1996, and March 9, 2000. In addition, as described below, selected issues with respect to the Administrative Committee's duties were addressed at other meetings.[1285]

In the meeting on December 5, 1996, the Administrative Committee was advised in a presentation by Enron's ERISA counsel that each Plan sponsored by Enron had a separate Administrative Committee, and that each Administrative Committee is a fiduciary with respect to the Plan it administers. The Administrative Committee was also advised that Enron Corp. is a fiduciary with respect to each Plan, and that the individual committee members are plan fiduciaries.

The briefing materials provided to the Committee include a summary of the basic ERISA fiduciary standards,[1286] including the exclusive purpose rule, the prudent man rule, the rule

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[1284] The first year for which the Joint Committee staff reviewed Administrative Committee minutes was 1996.

[1285] The materials describing the duties of the Administrative Committee presented at these meetings are included in Appendix D to this Report.

[1286] ERISA's fiduciary rules are described in Part II.A.3., above.

relating to diversification of investments, and the duty to act in accordance with plan documents and the "reasonable person" standard. The materials note the existence of the prohibited transaction rules, as well as rules regarding investment duties. The materials also discuss the Committee's responsibilities with respect to appeals by plan participants.

Minutes for the March 9, 2000, Administrative Committee meeting indicate that the meeting had been called for the purpose of reviewing of the members' duties and responsibilities. Enron's ERISA counsel made a presentation to the members describing the members and Enron's respective Administrative, trustee, and fiduciary duties as defined in the Enron qualified plans. The minutes state that the information was presented as documented. Unlike the December 1996, briefing, this briefing did not focus on fiduciary issues, but also addressed issues such as the role of Enron, the specific powers and duties of the Administrative Committee under the terms of the Plans, and the role of third parties. There were follow-up items that were to be researched by Enron's ERISA counsel, including the appointing of a voting fiduciary, differentiation between "power to" versus "responsibility" and whether the Administrative Committee has shared or sole responsibility for the administration of the Enron qualified plans.

Minutes for the meeting of September 26, 2000, state that the Chair stressed the need to have Administrative Committee meetings quarterly and emphasized the importance of attendance. The minutes state that the Administrative Committee revisited the responsibilities of the Administrative Committee and referenced the March 9, 2000, meeting. The representatives from the Enron Finance and Benefits Departments were charged to list their duties and responsibilities for supporting the Administrative Committee.

In response to this last item, the September 26, 2000, minutes include the following list of duties of the Administrative Committee secretary:

- Record and hold minute records,
- Facilitate addition and removal of Committee members,
- Type agenda items as determined by the Committee,
- facilitate meeting location and time,
- distribute agenda to committee members as well as review materials provided by presenters or members themselves.

This list also indicates that the Enron Service Director of Benefits brings appeals requiring an Administrative Committee vote to the question of the Administrative Committee and that the Administrative Committee determines meeting times and agendas.[1287]

At the November 2, 2000, Administrative Committee meeting, there was a discussion of the Administrative Committee's responsibilities with respect to the decision of the outsourcing of the Enron qualified plans and whether the Administrative Committee was responsible for reviewing the expenses of outsourcing. The Committee Secretary advised the Administrative Committee that, based on the presentation made by ERISA counsel at the March 9, 2000,

[1287] The materials presented at this meeting are included in Appendix D to this Report.

meeting, this issue was specifically addressed and determined to be the role of Enron and not the Administrative Committee. The Committee Secretary was directed to obtain written documentation of this from Enron ERISA counsel.

4. The Enron Corp. Retirement Plan ("Enron Retirement Plan")

Historical background

Enron established the Enron Corp. Retirement Plan, a defined benefit plan, effective July 1, 1986, as an amendment and restatement of the InterNorth, Inc. Retirement Income Plan II. At the same time, the Houston Natural Gas Corporation Retirement Plan, maintained by HNG, was merged into the Enron Retirement Plan. For the period preceding July 1, 1986, participants in the Enron Retirement Plan were generally credited with their service in amounts equal to all service credited under predecessor plans as such plans existed on June 30, 1986.

The Enron Retirement Plan was amended and restated and renamed the Enron Corp. Cash Balance Plan effective January 1, 1996.

Plan features

Participation

Individuals employed by Enron, one of its subsidiaries, or affiliated companies on its domestic payroll who were age 21 or older generally were eligible to participate in the Enron Retirement Plan. In general, such employees could participate in the Enron Retirement Plan beginning on the first day of the month of their first anniversary of employment, as long as they had worked at least 1,000 hours during that year. Collective bargaining unit employees were generally not eligible to participate in the Enron Retirement Plan.

Benefits

Participants in the Enron Retirement Plan accrued benefits under a final average pay formula. Under the formula, participants were generally entitled to benefits based upon the sum of different percentages of their final average pay multiplied by years of accrued service.[1288] Contributions to the Enron Retirement Plan by participants were not permitted.[1289]

[1288] For example, the January 1, 1989, restatement of the Enron Retirement Plan, provided that participants who retire on or after their normal retirement date are entitled to receive a benefit that is the actuarial equivalent of a pension beginning on the first day of the month coinciding with or next following the date of their retirement, each monthly payment is equal to: (1) 1.45 percent of participant's final average pay multiplied by years of accrual service not in excess of 25 years; plus (2) 0.45 percent of the participant's final average pay multiplied by years of accrual service in excess of 25 years, up to a maximum of 10 years; plus (3) 0.45 percent of final average pay in excess of a factor related to Social Security integration; plus (4) 1 percent of final average pay multiplied by years of accrual service in excess of 35 years; plus (5) one-twelfth of an amount equal to 25 percent of the aggregate contributions (without interest) made by the participant to the Houston Natural Gas Corporation Retirement

Effective January 1987, Enron established a floor-offset arrangement, involving the Enron Retirement Plan and the Enron ESOP.[1290] Under the floor-offset arrangement, a participant's accrued benefit in the Enron Retirement Plan is offset by the annual annuity value[1291] of Enron stock held in the participant's Retirement Subaccount as of certain determination dates, generally the date that benefit payments from the Enron Retirement Plan commence. However, distributions from the Enron ESOP before the determination date were also taken into account.

Depending on the value of Enron stock, the amount of the offset might be greater than the value of a participant's benefit under the Enron Retirement Plan at any given time. If so, the excess in the Enron ESOP Retirement Subaccount would have been used to offset the participant's future benefits under the final average pay formula. If the offset amount was less than the benefit under the Enron Retirement Plan, the Enron Retirement Plan would pay the portion of the benefit that is not offset by the Enron ESOP Retirement Subaccount. In 1994, the Enron Retirement Plan was amended to provide that the offset would not apply with respect to benefits accrued after 1994 and the amount of the offset for prior years would be set over the period 1996-2000. These amendments are discussed in detail in Part II.C.2., below.

Vesting

Participants were fully vested in their benefits under the Enron Retirement Plan after five years of service with Enron.

Plan before February 1, 1980, excluding any contributions refunded to the participant; minus (6)(a) the monthly benefit payable from the normal retirement date under the life annuity form used to determine the value of assets transferred from the InterNorth, Inc. Retirement Income Plan, or a lump sum amount paid with respect to a period of employment include in accrual service otherwise factored in and (b) the monthly benefit commencing at age 65 the participant has received or is entitled to receive under any other qualified defined benefit plan to the extent attributable to a period of service or employment for which the participant is credited with accrual service under the plan. Sec. 5.1, Enron Retirement Plan (Jan. 1, 1989, restatement). (Items (1) through (4) of the computation appears to describe annual benefit amounts, and so must be divided by 12 for a monthly amount.)

[1289] However, according to sec. 11.1 of the Enron Retirement Plan (Jan. 1, 1989, restatement), contributions were made to the Plan by participants through prior plans.

[1290] The floor-offset arrangement does not affect benefits earned before 1987. *See* the discussion of the Enron ESOP in Part II.B.5.

[1291] The annual annuity value is the dollar amount available each year if the account balance at retirement were used to purchase an annuity, using standard assumptions for life expectancy and interest. The value of the ESOP offset was based on the amount of a monthly single life annuity that could be purchased by the value of an individual's ESOP offset as of certain determination dates. For purposes of this calculation, Enron assumed annuity returns of 8.5 percent annually.

Distributions

Benefits under the Enron Retirement Plan were generally payable in the case of retirement, disability, or death and were paid in the form of an annuity. The automatic form of benefit was a single life annuity or a joint and survivor annuity in the case of married participants. Participants could also choose certain other optional forms of benefit, including a term certain annuity and a lump sum, in certain cases.

Compliance

The IRS issued favorable determination letters with respect to the tax-qualified status of the Enron Retirement Plan on June 2, 1988, and December 20, 1995. The Plan was amended and restated effective as of January 1, 1989.[1292]

On July 24, 1994, Enron requested an advisory opinion from the Department of Labor[1293] concerning the Enron Retirement Plan and Enron ESOP as to whether a proposed restructuring of the plans and dismantling of the floor-offset arrangement with respect to future benefit accruals would cause it to be newly "established" such that it would lose its grandfathered status under ERISA.[1294] Enron proposed to split the Enron ESOP from the defined benefit plan and

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[1292] Certain documents provided to Joint Committee staff indicate that Enron entered into a closing agreement for 1989 and 1990 in order for the Enron Retirement Plan to remain qualified.

[1293] An advisory opinion is an opinion of the Department of Labor as to the application of one or more sections of ERISA, regulations promulgated under ERISA, ERISA interpretive bulletins, or exemptions from certain ERISA provisions issued by the Department of Labor to a specific factual situation. ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976). The advisory opinion is a written statement issued to an individual or organization, or to the authorized representative of such individual or organization, and typically applies only to the situation described in the request and provides reliance only to the parties described in the request for the opinion. *Id.*

[1294] Previously, in December 1992, Enron requested an advisory opinion from Department of Labor for the Enron ESOP and for the Enron Retirement Plan. Letter from Vinson & Elkins to Department of Labor, (Dec. 8, 1992). Pursuant to a series of intercorporate transactions, Enron intended to transfer certain of its affiliates' assets and liabilities to Enron Oil Trading & Transportation Company ("EOTT"), a wholly-owned subsidiary of Enron. *Id.* After completion of such transfers, the Enron ESOP was to receive EOTT shares incident to the spinoff in the same manner as any other shareholder of Enron. *Id.* EOTT shares received by the Enron ESOP were to be credited to participants' accounts in the ESOP with reference to the shares of Enron Stock credited to such accounts. *Id.* Enron sought the Department of Labor's opinion (1) that the grandfather provision of sec. 9345(a)(3) of OBRA 1987 would not be rendered inapplicable by the Enron ESOP's retention of the EOTT shares; (2) that the sale by the Enron ESOP of the EOTT shares pursuant to the spinoff and the investment of the proceeds of such sale in Enron stock would not render the grandfather provision of sec. 9345(a)(3) of OBRA 1987 inapplicable; and (3) that the sale by the Enron ESOP of the EOTT shares pursuant to the allocate no additional shares of Enron stock to the offset account as of December 31, 1994. Enron proposed to permanently fix the value of one-fifth of the shares of Enron stock allocated to each participant's offset account each January 1 during the period 1996-2000. In connection with the restructuring, the Enron Board of Directors adopted an amendment to the Enron Retirement Plan to temporarily suspend accruals. If the Department of Labor had not issued favorable opinions regarding the restructuring, the suspension of accruals under the Enron Retirement Plan would have been retroactively rescinded as though the suspensions had never been made.[1295]

Advisory Opinion 94-42A was issued to Enron by the Department of Labor on December 9, 1994. According to the Advisory Opinion, Enron's dismantling of the floor-offset arrangement over a five-year period would not adversely affect the application of the special provision.

5. The Enron Corp. Employee Stock Ownership Plan ("Enron ESOP")

Historical background

Enron Corp. established the Enron ESOP effective November 1, 1986. The Plan document and summary plan description state that the primary purpose of the Plan was to enable plan participants to acquire stock ownership interests in Enron. The Enron ESOP also provided that it could be used to meet Enron's general financing requirements, including capital growth and transfer in the ownership of Enron stock. The Plan document also provides that the Enron ESOP may receive loans (or other extensions of credit) to finance the acquisition of Enron stock, secured primarily by a commitment by Enron to make contributions to the plan sufficient to repay principal and interest on the loan and employer securities acquired with the loan. The Enron ESOP was funded from two transactions, the proceeds of an exempt loan transaction and a reversion from a terminating pension plan within the Enron controlled group.

During 1986, Enron loaned the Enron ESOP $335 million to purchase shares of Enron Corp. common stock that had previously been held as treasury stock. As a result of this purchase, the Enron ESOP held approximately 19 percent of Enron's outstanding common stock. During 1987, $230 million of the principal amount of the loan was repaid with proceeds received from the terminating InterNorth, Inc. Pension Plan I.[1296] Stock acquired with the loan proceeds

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spinoff and the investment of the proceeds of such sale in assets other than Enron stock would not render the grandfather provision of sec. 9345(a)(3) of OBRA 1987 inapplicable. *Id.* By letter dated January 18, 1994, Enron withdrew its request for an advisory opinion.

[1295] Notice of Temporary Suspension of Accruals under the Enron Corp. Retirement Plan, EC000020212.

[1296] Notes to Financial Statements, 1990 Form 5500 for the Enron Savings Plan, at 5. The mechanics of this repayment are described variously in different sources. Enron's July 21, 1994, request for an advisory opinion from the Department of Labor explains that a block of Enron stock was purchased by the Enron ESOP in February 1987 with $230 million received by Enron as the reversion.

and the reversion were held in suspense accounts in the Plan and allocated to participants over the period required under applicable law (in the case of the reversion) and the terms of the exempt loan (in the case of the exempt loan amount). Cumulative cash dividends paid on Enron stock held by the trustee were used to make the periodic payments of principal and interest necessary to retire the loan.[1297] The final payment on the Enron ESOP loan was made in March 1993.[1298]

The Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002, with the result that the provisions of the Enron Savings Plan generally replace the provisions of the Enron ESOP in their entirety.[1299] Pursuant to the merger, the assets held under the Enron ESOP would be transferred to the Enron Savings Plan to be held under the trust maintained thereunder. Participants in the Enron Savings Plan who participated in the Enron ESOP are entitled to benefits at least equal to the benefit they would have been entitled to receive immediately before the merger if the Enron ESOP was then terminated. Enron ESOP participants who did not otherwise participate in the Enron Savings Plan as of the date of the merger became participants in the Enron Savings Plan as of that date.

Plan features

Participation

As originally adopted, the Enron ESOP covered most full-time employees and certain part-time employees of Enron and other entities adopting the Enron ESOP. Full-time employees could begin participating in the Enron ESOP on the date they began working for Enron. Part-time or temporary employees could generally begin participating in the Enron ESOP on the January 1 following their one-year anniversary of working for Enron. Employees generally excluded from Enron ESOP participation were: employees whose terms and conditions of employment were governed by a collective bargaining agreement, nonresident aliens receiving no earned income from U.S. sources, and leased employees. Beginning January 1, 1995, new Enron employees were no longer allowed to participate in the Enron ESOP.

Contributions/allocations

The Enron ESOP provided that contributions by Enron were to be made in amounts authorized by the Board of Directors and were payable in cash or in shares of Enron stock, as determined by the Board of Directors. Although the Enron ESOP provided for discretionary employer contributions, Enron has never made any direct contributions to it (i.e., account balances are attributable to the shares purchased with the 1986 loan and the 1987 reversion).[1300]

[1297] 1993 Form 5500, Notes to Financial Statements.

[1298] *Id.*

[1299] "Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan," EC 000899959-000899961, http://www.enron.com/corp/proofsofclaim/plans.html.

[1300] Form 5300 Attachment I, Item 11b.

Participants in the Enron ESOP were neither required nor permitted to make contributions to the plan. Rollovers from amounts received from an IRA or annuity or from another qualified plan were accepted.

Each participant's account in the Enron ESOP was comprised of separate subaccounts: a Savings Subaccount and a Retirement Subaccount. In general, at the end of each year, shares of Enron common stock were allocated (1) to each participant's Savings Subaccount in an amount equal to 10 percent of the participant's compensation for the year and (2) to each participant's Retirement Subaccount based on the participant's length of service with Enron, age, and compensation. Additionally, Enron made a five percent allocation to a Special Allocation Subaccount for participants who were actively employed by Enron on December 31, 1994.[1301] This five percent allocation was made in lieu of an accrual for 1995 to the Enron Retirement Plan.[1302]

The initial loan made in 1986 to fund the Enron ESOP was held in a Suspense Account, which was credited with Enron stock acquired with the proceeds of the exempt loan. The Enron ESOP provided that as of the last day of each plan year, a certain number of shares of financed stock held in a stock suspense account would be allocated to participants' accounts. Allocations to participants from the suspense account were made over periods required (1) under applicable law (in the case of the reversion amount) and (2) by the terms of the exempt loan (in the case of the exempt loan amount). All payments on the exempt loan were made out of dividends on the stock held in the suspense account as well as out of allocated stock held by the Enron ESOP.

Beginning January 1, 1987, the Enron ESOP was integrated with the Enron Retirement Plan as part of the floor-offset arrangement. Significant changes were made to the operation of the offset in 1994.[1303]

The Enron ESOP was amended to provide final allocations to participants' Retirement Subaccounts and Savings Subaccounts for 1994. Although the Enron ESOP was ongoing, no further allocations were made to participants' accounts.

Vesting

Participants were vested in their Enron ESOP accounts at a rate of 25 percent for each year they worked for Enron. Any amounts forfeited by participants who were not fully vested

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[1301] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D. The allocations made under the Enron ESOP are discussed in Part II.C.1.

[1302] *Id.* Enron estimated that the shares actually allocated to participants' accounts would be approximately 4.4 to 4.6 percent of base pay, net of dividends. *Id.* Questions and answers for use by Enron human resources personnel in responding to questions from employees state that the difference would be made up in the allocation under the Enron Cash Balance Plan for 1996. *Id.*

[1303] The floor-offset arrangement is discussed in detail in Part II.C.1., below.

upon termination of employment were available, after a five-year holding period, for allocation to a Special Allocation Subaccount for participants who are eligible to receive them. Participants terminating employment with Enron for reasons other than retirement, total or permanent disability, or death were entitled to their vested interest in their account. Participants who attained normal retirement age under the Plan or terminated employment with Enron due to business circumstances, layoff, or corporate reorganization were 100 percent vested in amounts allocated to their accounts.

An Enron ESOP participant who was actively employed by Enron as of December 31, 1994, the date the plan was frozen, was 100 percent vested in his or her Retirement Subaccount, as required by law.

Loans

Under the 1989 restatement of the Enron ESOP, loans to participants were permitted. The amount of any loan could not exceed the lesser of 50 percent of the total value of a participant's vested interest in the participant's Savings Subaccount and $50,000. Loans are not permitted under the 1999 restatement of the Enron ESOP.

Distributions and withdrawals

In general, the Enron ESOP provided that participants were entitled to a benefit based on the total value of their accounts as of the date they turn age 65 or terminate employment with Enron. Participants are generally required to begin receiving distributions by the April 1 following the calendar year in which they turn age 70½. If participants left Enron before turning age 65, they generally were entitled to receive the vested portion of their Retirement Subaccount balance upon turning age 55[1304] and the vested portion of their Savings Subaccount 90 days after leaving Enron.[1305]

Initially, participants in the Enron ESOP could elect to receive their benefits in a lump sum or periodic installment payments for a term not longer than fifteen years.[1306] In general, participants could elect to receive their distributions from the Enron ESOP in shares of Enron stock.[1307] Beginning in 1989, participants could elect to receive benefits in the form of an annuity purchased from an insurance company, but could no longer elect installment payments.[1308] Effective November 1, 1996, the Enron ESOP was amended to provide that the

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[1304] This rule also applied to the Special Allocation Account which held a special allocation made to participants' accounts in 1994. *See* Part II.C.1., below.

[1305] Sec. 12.1(a)(iii), Enron ESOP (Jan. 1, 1999, restatement).

[1306] Sec. 11.02(a), Enron ESOP (effective Nov. 1, 1986).

[1307] Sec. 11.02(c), Enron ESOP (effective Nov. 1, 1986), Sec. 12.2, Enron ESOP (Jan. 1, 1989, restatement), and Sec. 12.2(c), Enron ESOP (Jan. 1, 1999, restatement).

standard benefit generally was a joint and survivor annuity for married participants and a single life annuity for unmarried participants.[1309] However, the 1999 restatement of the Enron ESOP provided that an annuity was an alternative form of benefit to the standard lump sum. As described below, effective August 15, 2001, the Enron ESOP was amended to eliminate all forms of benefit other than lump sums.

In connection with the phasing out of the floor-offset arrangement, the Enron ESOP was amended effective March 1, 1994, to provide eligible participants access to the shares of Enron stock allocated to their Savings Subaccount.[1310]

Beginning in 1996, dividends from shares of Enron stock in all of participants' subaccounts, including those to which they had not yet gained access, began to be paid directly to them each quarter.[1311]

Under the version of the Enron ESOP effective in 1989, participants could withdraw (1) from his or her Enron ESOP Savings Subaccounts amounts held for 24 months or more which were not in excess of the greater of 100 shares of Enron stock or 25 percent of the vested balance of his or her account or (2) allocations of company contributions, financed stock, or reversion amounts credited to his or her Enron ESOP Savings Subaccount for at least 60 cumulative months, but any case not more than the greater of 100 sharers of Enron stock or 25 percent of the value of the vested interest in his or her ESOP Savings Subaccount.[1312] Under the 1999 restatement of the Enron ESOP, the limits were changed to the vested interests of participants' ESOP Savings Subaccount.

Compliance

The IRS issued a favorable determination letter for the Enron ESOP on June 2, 1988. The Enron ESOP was amended and restated effective January 1, 1989.

[1308] Sec. 12.2, Enron Corp. ESOP (Jan. 1, 1989, restatement). The annuity distribution option was initially added by Enron effective January 1, 1990, under the Fifth Amendment to the Enron Corp. ESOP (effective Nov. 1, 1986).

[1309] Twelfth Amendment to the Enron ESOP (Jan. 1, 1989, restatement), effective Nov. 1, 1996. Under the amendment, the Enron ESOP provided that the annuity was the standard form of benefit with respect to the portion of participants' accounts not subject sec. 409(h). Sec. 409(h) provides that a participant who is entitled to a distribution from the plan has the right to demand that his or her benefit be distributed in the form of employer securities or if the employer securities are not readily tradeable on an established market has a right to require that the employer repurchase employer securities under a fair valuation formula.

[1310] The details of this process are discussed in Part II.C.1., below.

[1311] *Enron - Benefit Plans and Related Programs, Policies and Practices--Employee Stock Ownership Plan* (Dec. 14, 2001), EC000021272-EC000021280.

[1312] Enron ESOP section 13.2 (Jan. 1, 1989, restatement).

By letter dated January 6, 1993, Enron submitted to the IRS requests for rulings with respect to the Federal income tax consequences of proposed transactions involving the Enron ESOP. Enron intended to transfer certain assets and liabilities to Enron Oil Trading & Transportation Company ("EOTT"), a wholly-owned subsidiary of Enron. After completing such transfers, Enron would distribute all of its EOTT shares to its shareholders in a spinoff transaction. After the spinoff, Enron would no longer own any EOTT shares, EOTT would not own any equity interest in Enron and EOTT would not maintain or sponsor the Enron ESOP for its employees. As a holder of Enron stock, the Enron ESOP would receive EOTT shares incident to the spinoff in the same manner as any other shareholder of Enron. EOTT shares received by the Enron ESOP would be credited to participants' accounts in the Enron ESOP. Enron requested rulings with respect to the applicability of certain excise taxes relating to prohibited transactions and employer reversions from qualified plans.[1313]

In general, in a letter dated December 20, 1993,[1314] the IRS ruled that, for purposes of the section 4975(a) excise tax on prohibited transactions, it would not be a violation of the requirement that an ESOP invest primarily in qualifying employer securities if shares of EOTT stock or assets other than Enron stock purchased with the proceeds from the sale of such shares are allocated to participants accounts on the same basis as are Enron shares. As such, the excise tax on prohibited transactions would not apply.[1315]

Additionally, the IRS ruled that the spinoff transaction would satisfy an exception to the section 4980(a) excise tax on the amount of an employer reversion from a qualified plan.[1316] Specifically, the IRS ruled that the retention by the Enron ESOP of the shares of EOTT stock which are allocated to a reversion suspense account under the Enron ESOP until distribution to participants would not be treated as a disposition of Enron shares.[1317] The IRS also ruled favorably on the sale by the Enron ESOP of the shares of EOTT stock which are allocated to the reversion suspense account and the use of the proceeds from such sale to acquire Enron stock.[1318] However, the IRS ruled that the sale of EOTT shares and the use of the proceeds from such sale to acquire assets other than Enron stock would violate the requirement that employer securities purchased with a reversion amount remain in the Enron ESOP until distribution to participants in accordance with the plan terms.[1319]

[1313] Specifically, Enron requested rulings as to the applicability of secs. 4975(a) and 4980(a).

[1314] Priv. Ltr. Rul. 9411038 (Dec. 20, 1993).

[1315] *Id.*

[1316] *Id.*

[1317] *Id.*

[1318] *Id.*

[1319] *Id.*

The IRS issued favorable determination letters for the Enron ESOP on August 20, 1993, and March 6, 1996. The Plan was amended and restated effective January 1, 1999.

In late February or early March 2000, the Enron ESOP was referred to the IRS National Office for technical advice in connection with the issue of whether the Enron ESOP was at all times required to offer a joint and survivor spouse annuity as the standard form of benefit rather than as an alternative form of benefit to the Enron ESOP's standard lump sum distribution form.[1320] The IRS is currently reviewing this issue.

An application for determination of the tax-qualified status of the Enron ESOP was submitted to the IRS on February 15, 2002. The application requested that the IRS take into account all of the plan qualification requirements of the Uruguay Round Agreements Act, the Small Business Job Protection Act of 1986, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Taxpayer Relief Act of 1997, the Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

Plan provisions in effect in 2001 and 2002

Effective January 1, 2001, the Enron ESOP was amended to preclude that Enron would make any contributions to the Enron ESOP.[1321]

Beginning August 15, 2001, all forms of distribution from the Enron ESOP except lump sums were eliminated.[1322] Additionally, the Enron ESOP was amended effective November 1, 2001, to provide that regular withdrawals from the Enron ESOP would be paid in company stock unless the participant elected to receive a withdrawal in cash.

As described above, the Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002.[1323] The assets held under the Enron ESOP were transferred to the Enron Savings Plan. Participants in the Enron Savings Plan who participated in the Enron ESOP are entitled to benefits at least equal to the benefit they would have been entitled to receive immediately before the merger if the Enron ESOP was then terminated. Enron ESOP participants who did not otherwise participate in the Enron Savings Plan as of the date of the merger became participants in the Enron Savings Plan as of that date.

[1320] Attachment I to Form 5300 for Enron ESOP, submitted to the IRS on February 15, 2002.

[1321] Adoption of Administrative Procedures Relative to the Suspension of Contributions to the Enron Corp. Employee Stock Ownership Plan (executed Feb. 12, 2002), EC2000008923.

[1322] As described below, the IRS is currently reviewing this issue.

[1323] "Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan", EC 000899959-000899961, http://www.enron.com/corp/proofsofclaim/plans.html.

6. The Enron Corp. Cash Balance Plan ("Enron Cash Balance Plan")

Historical background

Effective January 1, 1996, the benefit formula under the Enron Retirement Plan was changed from the traditional defined benefit formula to a cash balance formula.[1324] Additionally, the Plan was amended, restated, and renamed "the Enron Corp. Cash Balance Plan."

Plan features

Participation

Employees of Enron who were age 21 or older were generally eligible to participate in the Enron Cash Balance Plan, except nonresident aliens who receive no earned income from sources within the United States, leased employees, individuals who are designated, compensated, or otherwise classified or treated by Enron as an independent contractor or other non-common law employee, and any employees whose terms and conditions of employment are governed by a collective bargaining agreement unless such agreement provides for coverage under the Plan.

Benefits

On conversion to the cash balance formula, each participant under the Enron Retirement Plan retained the benefit of their final average pay formula benefit based on their compensation and service as of December 31, 1994, which was the last day prior to the 1995 plan year during which all accruals under the Enron Retirement Plan were suspended. Thus, the benefit under the Enron Cash Balance Plan is equal to this preserved benefit plus amounts earned under the cash balance formula.

Hypothetical accounts are maintained for the participants in the Enron Cash Balance Plan. Such accounts are generally credited with five percent of participants' monthly base pay.[1325] Additionally, at the end of each calendar month for which participants have cash balance accounts, their accounts are credited interest based on 10-year Treasury bond yields.

The Enron Cash Balance Plan does not accept rollover contributions from other qualified plans or IRAs.

[1324] For a general description of the characteristics of cash balance plans, see Part II.A.2., above.

[1325] A special accrual was credited to the accounts of participants hired on or before Dec. 31, 1995. Their accounts were credited with 1.223 percent of their annualized base pay for each calendar month in 1994, EC000020097. Second Amendment to Enron Corp. Cash Balance Plan (effective Jan. 1, 1996) (executed May 6, 1997).

Vesting

Participants in the Enron Cash Balance Plan are fully vested in their benefit under the plan on the earlier of completing five years of service or attaining the normal retirement age under the plan, which is age 65. If an Enron Cash Balance Plan participant accrued benefits under the Enron Retirement Plan under the final average pay formula, they are 100 percent vested in those benefits at all times.

Distributions

The standard form of benefit for a participant who is married on his or her annuity starting date is a joint and survivor annuity. The standard form of benefit for a participant who is not married is an annuity payable for the life of the participant. Participants in the Enron Cash Balance Plan could also elect one of the following optional forms of benefit:

(1) A single life annuity for the participant's life;

(2) An annuity for the joint lives of the participant and any joint annuitant designated by the participant providing 50 percent or 100 percent benefits to the surviving joint annuitant;

(3) For the portion of the participant's benefit consisting of a final average pay benefit, an annuity for a term certain of five, ten, or fifteen years and continuous for the life of the participant if the participant survives such term certain or continuing to the end of such term certain to the beneficiary or beneficiaries designated by the participant in the event of the participant's death before the end of such term certain; or

(4) A single lump sum cash payment for the portion of the participant's benefit under the cash balance formula.

Participants in the Enron Cash Balance Plan can receive their benefits upon normal and early retirement, disability, termination, and on an employee's death. Payment of benefits generally begins after a participant reaches the Plan's normal retirement age of 65. However, participants may withdraw the vested portion of their benefit that accrued after 1995 if they leave Enron for any reason. The Enron Cash Balance Plan also provides for an early retirement benefit.

Compliance

The IRS issued favorable determination letters to the Enron Cash Balance Plan on December 20, 1995, November 14, 1996, and January 22, 1997.

An IRS examination of the Enron Cash Balance Plan resulted in a request by IRS examiners for technical advice from the IRS National Office during 2000. The request arrived in National Office of the IRS on March 17, 2000, and is currently under review.

On April 12, 2000, Enron submitted to the IRS a request for a determination of the tax-qualified status of the Enron Cash Balance Plan.

On September 5, 2000, the Enron Cash Balance Plan was submitted to the National Office for review, in accordance with a September 15, 1999, directive from the National Office of the IRS that all qualification determination filings and field audits with respect to defined benefit plans which have been or are being converted from one formula into a cash balance formula be referred to the National Office of the IRS in connection with its ongoing review of technical issues relating to such conversions.[1326] The IRS notified Enron that its request for a determination letter would be associated with the 2000 request for technical advice from IRS examiners.

An application for determination of the tax-qualified status of the Enron Cash Balance Plan was submitted to the IRS on February 15, 2002. The application requested that the IRS take into account all of the plan qualification requirements of the Uruguay Round Agreements Act, the Small Business Job Protection Act of 1986, the Uniformed Services Employment and Reemployment Rights Act of 1994), the Taxpayer Relief Act of 1997, the Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

Plan provisions in effect in 2001 and 2002

The Enron Cash Balance Plan was amended and restated effective January 1, 2001.

In general, participation in the 2001 version of the Enron Cash Balance Plan was open to the same Enron employees as under the January 1, 1996, version of the Plan.

Participants in the Enron Cash Balance Plan are generally credited with a cash balance accrual equal to five percent of their compensation for each month during which they are employed by Enron and otherwise qualify to participate in the Plan. Enron Cash Balance Plan participants are at all times 100 percent vested in their final average pay benefit under the Enron Retirement Plan benefit formula.

In general, the normal retirement benefit under the Enron Cash Balance Plan is equal to the sum of participants' monthly final average pay benefit under the Enron Retirement Plan benefit formula and the monthly amount derived by converting their cash balance benefit as of their annuity starting date into a single life annuity. A portion of the final average pay benefit otherwise payable under the Enron Cash Balance Plan will be offset by the equivalent annuity value of a participant's interest in the Enron ESOP as determined over the period 1996-2000. The normal form of retirement benefit for a participant who is married on their annuity starting date will be a joint and survivor annuity. For a participant who is not married on their annuity starting date, the normal form of benefit will be an annuity payable for the life of the participant.

[1326] Announcement 2003-1, 2003-2 I.R.B. 281, http://www.irs.gov/pub/irs-drop/a-03-1.pdf.

In October 2002, the PBGC filed claims against Enron in its bankruptcy proceeding.[1327] The PBGC's claim for unfunded benefit liabilities of the Enron Cash Balance Plan was approximately $270 million.[1328] The PBGC's estimate of the underfunding may increase if the IRS rules adversely on the phasing out of the floor-offset arrangement[1329] and the benefits attributable to offset amounts become liabilities of the Enron Cash Balance Plan.[1330]

Accruals under the Enron Cash Balance Plan were frozen as of December 31, 2002.

7. The Enron Corp. Savings Plan ("Enron Savings Plan")

Historical background

The Enron Savings Plan began as a plan originally effective June 1, 1956.[1331] The Enron Savings Plan is a defined contribution plan which provides for elective deferrals pursuant to section 401(k),[1332] and after-tax contributions. Additionally, Enron contributed as matching contributions to the Enron Savings Plan amounts equal to a percentage of participants' contributions. Enron's matching contributions were discontinued effective November 28, 2001.[1333]

[1327] *See, e.g.*, Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at paragraph 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York.

[1328] This represents the PBGC's estimate of the Plan's underfunding.

[1329] The phasing out of the floor-offset arrangement is discussed in detail in Part II.C.1., below.

[1330] The PBGC estimates that the unfunded benefit liabilities could increase by as much as 100 percent or more if the phasing out of the floor-offset arrangement is deemed to have been illegal and the benefits attributable to offset amounts again become liabilities of the Enron Cash Balance Plan. *See, e.g.*, Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at paragraph 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York, discussed in Part II.B.2., below.

[1331] Forms 5500 for the Enron Savings Plan.

[1332] The Enron Savings Plan refers to elective deferrals as "Before-Tax Contributions." *See* discussion in Part II.A.2., above.

[1333] First Amendment to Enron Corp. Savings Plan (As Amended and Restated Effective July 1, 1999), DOL020351-DOL020354.

Plan features

Participation

In general, all employees of Enron are eligible to participate in the Enron Savings Plan. Exceptions include nonresident aliens with no U.S. source income, leased employees, and employees whose terms and conditions of employment are governed by a collective bargaining agreement. Participation is voluntary and generally begins on the first day of the first month coincident with or next following the date on which an employee first works for Enron.[1334]

The HNG Savings Plan was merged into the Enron Savings Plan effective July 1, 1986. Participants in the HNG Savings Plan were immediately covered by the provisions of the Enron Savings Plan. The Enron Savings Plan was amended and restated effective January 1, 1989, January 1, 1994, and July 1, 1999. From time to time, other plans were merged into the Enron Savings Plan as a result of corporate events.[1335]

Contributions

Participants may contribute to the Enron Savings Plan from one percent to 15 percent of their base pay[1336] in any combination of elective deferrals or after-tax contributions, subject to certain limits prescribed by the Code.[1337] The Enron Savings Plan also accepts certain qualifying

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[1334] Additionally, a number of participants in the Enron ESOP who did not otherwise participate in the Enron Savings Plan as of the August 30, 2002, merger of the plans may have become participants in the Enron Savings Plan as of that date.

[1335] Effective June 1, 1999, the portion of the Koch General Holdings, Inc. Retirement Savings Plan consisting of the accounts of those individuals who became employed by EOTT Energy Corp. as a result of that entity's acquisition in 1998 of certain assets of Koch Industries, Inc. were merged into the Enron Plan. The OmniComp Inc., Salary Savings Plan, Bentley Engineering Co. Savings Plan, and Portland General Holdings, Inc. Retirement Savings Plan were also merged into the Enron Savings Plan as of June 1, 1999. Effective September 1, 1999, a portion of the Cogen Technologies 401(k) Savings Plan, consisting of accounts attributable to Cogen participants who became employed by Enron were merged into the Enron Savings Plan. Effective February 1, 2001, the WarpSpeed Communications 401(k) Plan was merged into the Enron Savings Plan. Source: Form 5300 Application for Determination for Employee Benefit Plan, Attachment I, Item IX (February 12, 2002).

[1336] The Enron Savings Plan generally defines "base pay" as a participant's basic rate of compensation for a payroll period (or other period established by the Administrative Committee) based on the hourly pay rate, weekly salary, established benefit rate, or similar unit of base compensation applicable to the participant under regular payroll accounting as of the last day of the period. The plan provides that the base pay of any participant taken into account for purposes of the plan is limited to the applicable limit under sec. 401(a)(17).

[1337] The maximum amount of the permitted employee contribution as a percentage of based pay varied historically.

contributions rolled over from individual retirement accounts and annuities and other qualified plans ("rollover contributions").

Additionally, Enron contributed as matching contributions to the Enron Savings Plan amounts equal to a percentage of participants' contributions. Enron's matching contributions were credited to a separate account called the "company contribution account." The amount of the matching contribution made by Enron varied over time.[1338] As described above, Enron's matching contributions were discontinued effective November 28, 2001.[1339]

On at least one occasion, Enron also made a special cash contribution to the Enron Savings Plan on behalf of active, regular full-time Enron employees.[1340]

Investments

Investments under the Enron Savings Plan are discussed in detail in Part II.C.5., below. A general overview is provided here.

The Enron Savings Plan permits participants to direct the investment of their elective deferrals, after-tax contributions, and rollover contributions to the Enron Savings Plan. Participants have approximately 20 investment options to choose from, including Enron stock and a self-directed brokerage account subject to certain restrictions defined by the Plan.[1341] Plan participants can change their investment mix on a daily basis.[1342]

The Enron Savings Plan provides that all Enron matching contributions are invested in the common stock of Enron corp. Only upon attaining age 50, participants can elect to reallocate their company contribution account balances to other investment options offered under the Enron Savings Plan.

[1338] The amount of the matching contribution made by Enron is discussed in detail in Part II.C.5.

[1339] Third Amendment to Enron Corp. Savings Plan (July 1, 1999, restatement).

[1340] *EnSight* (Nov. 1996), EC000020134-EC000020137.

[1341] *Enron Explains Basic Facts About Its 401k Savings Plan*, http://www.enron.com/corp/pressroom/releases/2001/ene/100-121401ReleaseLtr.html; *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 32 (Feb. 5, 2002). Beginning July 1, 1999, participants could also begin choosing to invest their contributions through a Schwab self-directed brokerage account, subject to certain restrictions, as defined by the plan. 1999 SEC Form 11-K.

[1342] *Enron - Benefit Plans and Related Programs, Policies and Practices--Savings Plan* (May 31, 2002), http://www.enron.com/corp/proofsofclaim/plan/SavingsPlanSPD.pdf.

Vesting

Under the Enron Savings Plan, participants are fully vested at all times in their elective deferrals, after-tax contributions and rollover contributions. Participants vest in their company contribution accounts at a rate of 25 percent per year of service but are automatically 100 percent vested in such accounts upon attaining age 65. For plan years 1998 and later, the Plan was amended to provide that participants are fully vested in their company contribution accounts.[1343] In connection with the July 1, 1999, restatement of the Enron Savings Plan, the plan was amended to provide that participants hired by Enron prior to July 1, 1999, were 100 percent vested in their company contribution accounts and the actual earnings thereon. Participants hired on or after July 1, 1999, would become vested in the company contribution account after completing one year of service (or, prior to one year of service, upon reaching age 65, becoming totally and permanently disabled, involuntary termination, or upon death while an employee).

Loans

Additionally, participants can borrow a minimum of $1,000, up to a maximum amount equal to the lesser of $50,000 or 50 percent of their vested balance under the Enron Savings Plan but cannot have more than one loan outstanding at a time. Loan terms cannot exceed five years, except for loans used to purchase a primary residence. Additionally, the Enron Savings Plan provides that effective January 1, 1998, participants can withdraw from their company contribution account amounts that were allocated prior to such date if held for 24 months or more, but not in excess of their vested interest in such amounts.[1344]

Distributions and withdrawals

The Enron Savings Plan provides that participants may receive a distribution of the vested balance under the Plan due to termination of service, death, disability, or retirement. Distributions must begin no later than April 1 following the calendar year in which they attain age 70½. Normal retirement date under the Enron Savings Plan is the date a participant turns age 65.

Historically, such distributions could be paid out in the form of a joint and survivor annuity for married persons, a single life annuity for unmarried persons, or in the form of a single lump sum payment. As discussed at below, effective August 15, 2001, all forms of benefit payable from the Enron Savings Plan except lump sum distributions were eliminated.

Participants who choose to leave Enron and whose vested balance is greater than $5,000 can leave their balance in the Plan or receive it as an annuity or lump sum. Balances of $5,000 or less are automatically distributed in a lump sum.

[1343] Sixth Amendment to Enron Corp. Savings Plan (Jan. 1, 1999, restatement). DOL020424-DOL020425.

[1344] *Id.*

Participants in the Enron Savings Plan can make certain withdrawals from the Enron Savings Plan while they are still employed by Enron.[1345]

Compliance

The IRS issued favorable determination letters to the Enron Savings Plan on June 22, 1988, and March 5, 1996. The Plan was amended and restated effective January 1, 1989, January 1, 1994, and January 1, 1999.

An application for determination of the tax-qualified status of the Enron Savings Plan was submitted to the IRS on February 15, 2002. The application requested that the IRS take into account all of the plan qualification requirements of the Uruguay Round Agreements Act, the Small Business Job Protection Act of 1986, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Taxpayer Relief Act of 1997, the Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

Plan provisions in effect in 2001 and 2002

Effective August 15, 2001, all forms of benefits payable from the Enron Savings Plan except lump sum distributions were eliminated. Any individual who had a right to receive a distribution from the Enron Savings Plan and had elected payment or commencement of payment before August 15, 2001, had the right to elect any form of payment as provided under the then current terms of the plan.

The Enron Savings Plan was amended effective November 28, 2001, to eliminate Enron's matching contributions unless they were required to continue the tax-qualified status of the Enron Savings Plan. Any matching contributions made after November 28, 2001, (other than contributions attributable to periods before such date) were made in cash. At the same time, the Enron Savings Plan was amended to provide that participants may invest the amounts in their company contribution account among the investment alternatives offered under the Plan.

Effective February 15, 2002, the Plan was amended to provide that the portion of a rollover contribution including Enron stock or other "employer securities" will continue to be so invested until the participant elects to convert it into another investment under the Plan. Effective March, 15, 2002, the Enron Savings Plan was amended to provide that participants may not elect to convert any investment of any portion of their account into an investment in Enron stock or any other "employer security."

As described above, the Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002, with the result that the provisions of the Enron Savings Plan

[1345] In general, participants can withdraw any amount not in excess of the value of the after-tax contributions or rollover contributions in their account. Withdrawals can be made from the company contribution account so long as the amount is attributable to contributions allocated thereto prior to 1987 and in certain other limited cases. Participants aged 59½ or older may withdraw an amount not in excess of the value of the elective deferrals in their account. Enron Savings Plan sec. 11.1 (July 1, 1999, restatement).

generally replace the provisions of the Enron ESOP in their entirety.[1346] Pursuant to the merger, the assets held under the Enron ESOP were transferred to the Enron Savings Plan to be held under the trust maintained thereunder. Participants in the Enron Savings Plan who participated in the Enron ESOP are entitled to benefits at least equal to the benefit they would have been entitled to receive immediately before the merger if the Enron ESOP was then terminated. Enron ESOP participants who did not otherwise participant in the Enron Savings Plan as of the date of the merger became participants in the Enron Savings Plan as of that date.

Coincident with the August 30, 2002, merger of the Enron ESOP with and into the Enron Savings Plan, participants' Enron ESOP accounts were initially invested in Enron stock, notwithstanding any pre-existing investment direction of an Enron Savings Plan participant. After the initial transfer of Enron ESOP accounts to the Enron Savings Plan, the plan amendment provided that participants would be permitted to direct the investment of their Enron ESOP plan accounts in accordance with the Enron Savings Plan. Upon investment by a participant of any portion of their Enron ESOP plan account in any investment other than Enron stock, the amount would no longer be part of the Enron ESOP and would become part of the Enron Savings Plan.[1347]

[1346] "Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan", EC 000899959-000899961, http://www.enron.com/corp/proofsofclaim/plans.html.

[1347] *Id.*

C. Discussion of Specific Issues

1. Phase out of the ESOP offset under the Enron Corp. Retirement Plan

Present Law

Floor-offset arrangements in general

A "floor-offset arrangement" coordinates benefits from a defined benefit plan with those of a defined contribution plan.[1348] The defined benefit plan, the "floor," establishes a minimum benefit level in accordance with the benefit formula specified by the plan. The defined contribution plan provides the "offset." The projected value of the participant's benefit under the defined contribution plan offsets the amount of the participant's benefit payable under the defined benefit plan. If the offset provides a benefit at least equal to the minimum established under the floor, the participant receives the balance of the defined contribution plan account. In such cases, no benefit is paid from the floor plan. If, however, the defined contribution plan provides less than the minimum benefit established under the floor plan, e.g., as a result of investment performance, benefits will be paid from the floor plan to make up the shortfall in the defined contribution plan benefit. That is, the different between the floor benefit and the defined contribution plan benefit will be paid from the defined benefit plan. The benefit under a typical floor-offset arrangement payable at normal retirement age generally can be determined through the following steps:

(1) the initial monthly vested benefit under the defined benefit Plan formula is determined (the "gross benefit");

(2) the vested account balance in the defined contribution plan is determined;

(3) the accumulated vested account balance is converted to an actuarially equivalent monthly accrued benefit, using the interest and mortality factors in the plan document;[1349] and

(4) if the amount determined in step (3) is greater than that determined in step (1), no benefits are due from the defined benefit plan and all benefits will be paid from the defined contribution plan. If the amount determined in step (1) is greater than the amount determined in step (3), the participant is entitled to the vested account balance in the defined contribution plan plus--from the defined benefit plan--an amount equal to the difference between step (1) and step (3).

[1348] *See* Part II.A.2., above, for a definition of defined benefit plans and defined contribution plans.

[1349] Although this actuarially equivalent benefit is used as the offset amount, the defined contribution plan is not actually required to provide such a benefit to participants.

If the benefit is payable prior to normal retirement age, then the vested account balances in the defined contribution plan is projected to normal retirement age, using the interest factor specified in the plan, before performing step (3).

Floor-offset arrangements, particularly those involving ESOPs, can be attractive from the perspective of both employers and employees. Present law encourages the establishment of ESOPs by providing special tax benefits to employers that adopt such plans.[1350] A floor-offset arrangement involving an ESOP generally allows participants to benefit from an increase in value of the employer securities held by the ESOP, while protecting them from losses in value by providing a minimum floor benefit under the defined benefit plan. The benefit under the defined benefit plan is guaranteed by the PBGC, thus providing additional protection. A plan sponsor might establish a floor-offset arrangement because such arrangements may offer employees the better of two worlds: there is a defined contribution plan benefit and a minimum benefit from a defined benefit plan. As described below, floor-offset arrangements involving defined contribution plans with large investments in employer securities, such as ESOPs, were found to present additional exposure to the PBGC compared to a typical defined benefit plan, and rules relating to such plans were changed in 1986, which had the effect of prohibiting floor-offset plans involving ESOPs.

Code provisions relating to floor-offset arrangements

Background (Rev. Rul. 69-502, 1969-2 C.B. 89)

Prior to the enactment of ERISA in 1974, the IRS took the position in a Revenue Ruling that neither the defined benefit plan portion nor the defined contribution plan portion of a floor offset arrangement would meet the Code's qualification requirements.[1351] The Ruling involved a floor-offset arrangement consisting of a defined benefit plan and a defined contribution profit-sharing plan. In it, the taxpayer had established a defined contribution plan and a defined benefit plan for the same employees. The defined benefit plan provided a monthly retirement benefit after age 65 equal to 50 percent of each employee's average annual compensation, offset by the actuarial value of any amounts to which the employee might be entitled under the defined contribution plan. In the ruling, the IRS addressed whether the provision for offsetting benefits under the defined benefit plan by amounts received under the first affected the qualification of the plans.

With respect to the defined contribution plan, the IRS held that since the funds held in an employee's account under the defined contribution plan would be used to reduce the employee's benefits under the second plan, the employer will be relieved from contributing to the second plan to the extent of those funds. Thus, the first plan is not for the exclusive benefit of the

[1350] Present law affecting employers adopting ESOPs is discussed in Part II.A.2., above.

[1351] Rev. Rul. 69-502, 1969-2 C.B. 89

employees in general within the meaning of the regulations.[1352] Accordingly, it was held that the plan did not meet Code requirements for tax qualification.

Additionally, the IRS held that with respect to the defined benefit plan, because the amount of benefits payable out of the funds held under the plan was contingent upon the amount available under the defined contribution plan, the benefits an employee will receive under the second plan are not definitely determinable as required by applicable Treasury Regulations.[1353] In particular, the requirement that the amount of benefits not depend on the plan sponsor's profitability would be violated because the benefits under the defined benefit plan would depend on the assets in the profit-sharing plan, and the profit-sharing plan depended on the profits of the employer. Accordingly, it was held that the plan does not meet Code requirements for tax qualification.

Present-law rules

In 1976, the IRS reversed its position in a Revenue Ruling, citing a Code provision which was added by ERISA.[1354] Again considering a floor-offset arrangement involving a defined benefit pension plan and a defined contribution profit sharing plan, the IRS succinctly concluded that under the Code "as amended by ERISA an arrangement described in [the Revenue Ruling] does not fail to satisfy the requirements...of the Code...merely because of the type of such arrangement." Under the new Code provision, a defined benefit plan generally may qualify even though it provides benefits derived from employer contributions based partly on the balance of the separate account of participants.[1355] Such a hybrid plan is treated as a defined contribution plan for some purposes and a defined benefit plan for other purposes.[1356]

The 1976 Revenue Ruling provides that the defined benefit plan part of a floor-offset arrangement must specify the actuarial basis that will be used to determine the benefit after offset. Thus, the plan must specify the interest and mortality assumptions to be employed, as well

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[1352] Treas. Reg. sec. 1.401-1(b)(3), enacted before ERISA, provides that a qualified plan must benefit the employees in general even though it need not provide benefits for all the employees. That section also provides that a profit-sharing plan is not for the exclusive benefit of the employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees.

[1353] Treas. Reg. sec. 1.401-1(b)(1)(i), enacted before ERISA, provides that a pension plan, within the meaning of sec. 401(a), is a plan established and maintained by the employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Under Treas. Reg. sec. 1.401(a)-1(b)(i), the definitely determinable benefit requirement continues to apply under ERISA.

[1354] Rev. Rul. 76-259, 1976-2 C.B. 111.

[1355] Pub. L. No. 93-406, sec. 1015 (1974).

[1356] Sec. 414(k).

as the date as of which the determination shall be made, in a way that precludes discretion on the part of the employer. Additionally, the Revenue Ruling indicates that the benefits under a defined benefit plan will not fail to be definitely determinable merely because the defined contribution plan does not have a definite contribution formula. Thus, even though contributions to the defined contribution plan may vary from year to year, the defined benefit plan benefit is not precluded from being definitely determinable. The Revenue Ruling provides that the determination of whether the defined benefit plan satisfies accrual rules under the Code may be made based on the pre-offset benefit in certain cases. Finally, only the vested benefit in the defined contribution plan may be used to offset the benefit under the defined benefit plan.

Generally, any defined benefit plan may be part of a floor-offset arrangement. There are, however, restrictions on the types of defined contribution plans that may be part of a floor-offset arrangement. Specifically, defined contribution plans with section 401(k) cash or deferred arrangements may not be part of a floor-offset arrangement because of the requirement that no benefits other than matches may be conditioned on whether the employee makes or does not make elective deferrals.[1357] However, arrangements established by April 16, 1986, are not subject to this restriction.[1358]

Like other qualified plans, floor-offset arrangements are subject to the Code's qualification requirements. Because floor-offset arrangements combine the features of two different types of plans, special rules are applied in some cases, particularly to reconcile the differences between the rules that apply only to one type of plan. For example, defined benefit plans are subject to joint and survivor annuity requirements that do not apply to many defined contribution plans. To reconcile this difference, Treasury regulations provide that the defined contribution portion of a floor-offset arrangement must comply with qualified joint and survivor requirements even if the plan would not otherwise be subject to those requirements.[1359]

One of the generally applicable qualification requirements that is relevant to the Enron floor-offset arrangement is the "anticutback" rule, which provides that an amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.[1360] An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.[1361]

[1357] Sec. 401(k)(4)(A).

[1358] Pub. L. No. 99-514, sec. 1116(f)(5) (1986).

[1359] Treas. Reg. sec. 1.401(a)-(20), Q&A 5(a).

[1360] Sec. 411(d)(6) and sec. 204(g) of ERISA.

[1361] With respect to the effect of an amendment on future benefits, the Code and ERISA provide that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual (including any elimination or reduction of a significant early retirement benefit or retirement-

For purposes of these rules, a participant's accrued benefit under a defined benefit plan is generally the participant's accrued benefit determined under the plan and expressed in the form of an annuity beginning at normal retirement age.[1362] Consistent with this definition, the formula under the plan for determining the annuity payable to the participant beginning at normal retirement age (the "normal retirement annuity") is the basis for the participant's accrued benefit.

ERISA provisions

While defined contribution plans that invest in employer securities (including ESOPs), may be part of a floor-offset arrangement, ERISA generally provides that a defined benefit plan cannot invest more than 10 percent of its assets in qualifying employer securities.[1363] In 1987, ERISA was amended to clarify that the defined contribution plan in a floor-offset arrangement is treated as part of the defined benefit plan for this purpose.[1364] This clarification reflected concern that if individual accounts under a floor-offset arrangement are invested primarily or exclusively in employer securities, financial difficulties of the employer and a decline in the price of employer securities could cause the defined benefit plan to experience a funding deficiency at a time when the employer is least able to fund it, resulting in an unreasonable risk to the benefit security of the plan participants and to the PBGC.[1365]

This change had the practical effect of prohibiting floor-offset arrangements involving ESOPs or other defined contribution plans in which more than 10 percent of the combined asset values of the defined benefit plan and the defined contribution plan are invested in employer securities. However, the 1987 change applies only with respect to arrangements established after December 17, 1987.[1366] The Enron floor-offset arrangement was therefore unaffected by the provision.[1367]

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type subsidy) unless certain notice requirements are met. Sec. 4980F of the Code and sec. 204(h) of ERISA.

[1362] Sec. 411(a)(7)(A)(i) and sec. 3(23)(A) of ERISA.

[1363] ERISA sec. 407.

[1364] ERISA sec. 407(d)(3)(C) and (d)(9), as enacted by sec. 9345 of Pub. L. No. 100-203 (1987).

[1365] H.R. Rep. No. 100-391, at 116-117 (1987).

[1366] Pub. L. No. 100-203, sec. 9345(a)(3) (1987).

[1367] According to Steven Kandarian, Executive Director of the PBGC, Enron's floor-offset ESOP arrangement and those of about 150 other companies were permitted under the "grandfather" provision. Statement of Steven A. Kandarian, Executive Director, PBGC, to the Senate Finance Committee, on February 27, 2002, http://www.pbgc.gov/news/speeches/test_02_27_2002.htm.

ERISA contains general fiduciary duty standards that apply to all fiduciary actions. Among them are requirements that plan fiduciaries generally discharge their duties solely in the interest of participants and beneficiaries and with care, prudence, and diligence. A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets. A plan fiduciary may be liable also for a breach of responsibility by another fiduciary in certain circumstances.

As discussed above, under a so-called safe harbor provision, fiduciaries generally are not liable for the investment decisions of plan participants in a defined contribution plan if the participants control the investment of their account.[1368] The Department of Labor has stated this safe harbor[1369] does not apply to the defined contribution plan portion of a floor-offset arrangement.[1370] Thus, the general fiduciary rules apply, even with respect to decisions made by participants.

Factual Background

The floor-offset arrangement involving Enron's Retirement Plan and the Enron ESOP was established in 1987.[1371] Under the arrangement, benefits accrued by participants under the Enron Retirement Plan for service during 1987 through 1994 generally would be offset by the equivalent annuity value[1372] of Enron stock held in one of two main subaccounts maintained for participants in the Enron ESOP as of certain determination dates, generally the date that benefit payments from the Enron Retirement Plan commence. The portion of the Enron ESOP that was used as the basis for the offset was called the "ESOP Retirement Subaccount." The computation of the offset took into account previous distributions from the Enron ESOP. If the gross annuity value of a participant's ESOP Retirement Subaccount was greater than the benefit determined

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[1368] *See* Part II.A.4., above.

[1369] *See* Part II.A.3., below.

[1370] Preamble to the final regulations under ERISA sec. 404(c), 57 Fed. Reg. 46906, 46907, n.6 (Oct. 13, 1992).

[1371] At the time, the Enron ESOP was not subject to the 10-percent limitation on investment in qualifying employer securities. Further, because the floor-offset arrangement between the Enron Retirement Plan and the Enron ESOP was established before December 1, 1987, ERISA changes limiting such arrangements, as discussed above, did not apply to it.

[1372] This is defined by the Enron Retirement Plan as the single life annuity that could be purchased under the Metropolitan Life Insurance Company Group Annuity Contract No. 9373-0 (or any successor contract) based on a specified date of implementation of the purchase of an annuity contract, a specified date of the first benefit payment under an annuity contract, and an amount of distribution from a participant's ESOP Retirement Subaccount. Sec. 20.2(a) of the Enron Retirement Plan.

under the Enron Retirement Plan benefit formula, the participant would be entitled to the excess.[1373]

In general, depending on the value of Enron stock, the amount of the offset might be greater than the value of a participant's benefit under the Enron Retirement Plan at any given time. If so, the excess in the ESOP Retirement Subaccount would have offset the participant's future benefits under the final average pay formula. If the offset amount was less than the benefit under the Enron Retirement Plan, the Enron Retirement Plan would pay the portion of the benefit that is not offset by the ESOP Retirement Subaccount.

By 1994, Enron began to consider strategies for phasing out the floor-offset arrangement.[1374] Based on the prevailing price of Enron stock, there was concern that many Enron employees would be better off if the stock in their Enron ESOP accounts were made available to them instead of remaining in the plan.[1375] According to one Enron official, because the Enron ESOP did not allow for in-service distributions from the Retirement Subaccount, some employees had left Enron in order to access the value in their Enron ESOP accounts. Giving them access to their accounts, it was thought, might mitigate this trend.[1376] An Enron executive told the Joint Committee staff that a study performed for Enron by an outside consultant showed that 97 percent of Enron employees would be better off if the Enron ESOP assets were freed up and made available to them. This reportedly made freeing up the assets under the Enron ESOP preferable to maintaining the current plan. Materials prepared for Enron's human resources personnel for responding to employee questions explain that phasing out the floor-offset arrangement would "enabl[e] [employees] to take advantage of the strong performance of Enron stock in the Enron Employee Stock Ownership Plan (ESOP) and benefit directly from any excess value in [their] ESOP Retirement Subaccount[s]."[1377]

Enron would also benefit from the change. According to the materials prepared for Enron's human resources personnel, Enron would "receive an up-front reduction in the Enron Retirement Plan's expense for 1995 because of the ESOP."[1378]

[1373] *See Enron Retirement Program Guide,* included in Appendix D to this Report.

[1374] Facsimile memorandum dated May 26, 1994, from Patrick Mackin to Carol Jewett concerning alternative strategies for phasing out the floor-offset arrangement. EVE1214712-EVE1214724.

[1375] Additionally, according to one Enron executive interviewed by Joint Committee staff some employees had left Enron in order to get access to their ESOP accounts.

[1376] *Id.*

[1377] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report. *See also, The Enron Retirement Plan & ESOP Program Guide for Former Employees*, EC000020149-EC000020166.

[1378] *Id.*

Enron officials decided to phase out the floor-offset arrangement on a gradual, five-year schedule. For each year during the period 1996 through 2000, (1) the value of 20 percent of the stock in participants' Retirement Subaccounts would be frozen permanently and used to offset participant's final average pay benefit accrued during the period 1987 through 1994 and (2) participants generally would have access to 20 percent of their vested Enron ESOP Retirement Subaccount balances.[1379]

Each January during 1996 through 2000, 20 percent of participants' ESOP Retirement Subaccount was withdrawable at their election. As discussed in detail below, participants had four options with respect to each 20 percent increment of their ESOP Retirement Subaccount released to them. For participants who chose to leave their shares in the Enron ESOP, the value of that increment was fixed. A separate offset value was calculated for each 20 percent increment of participants' Retirement Subaccounts. The closing market stock price as of January 1 of each year determined the value of the offsets, permanently fixing that component of the offset.[1380] If no sale of Enron stock occurred on such date, the closing price for the next preceding day on which a sale occurred would be used. Subsequent changes in the value of Enron stock did not change the part of the offset that had been fixed. The floor-offset arrangement is discussed in further detail below.

The concept of locking in the stock price for the offset was developed by Enron employees and executives as well as outside counsel. According to Enron's outside counsel, Enron management wanted "to take extra-ordinary efforts to find a way, if at all possible, to avoid making all of the shares in the ESOP Retirement Account available at one time."[1381] Enron officials participating in the design of the phase out told the Joint Committee staff that they were generally motivated by an orderly roll out of employees' Enron ESOP accounts. They believed that staggering the availability of employees' shares in their Retirement Subaccounts would "avoid market distortions in the trading of Enron stock...reduce the risk of fixing the offsets based on an aberrant value, and...deter participants from making precipitous decisions regarding the disposition of amounts that become distributable from their Offset Accounts."[1382] The rationale was also explained as preventing "all of the shares [from] hit[ting] the market in a

[1379] Active employees with an ESOP Special Allocation Subaccount also had access to the vested portion of that account. In addition, employees who were active and who were at least age 50 and with at least five years of accrual service on January 1, 1995, received 100 percent access to their shares in the Retirement Subaccount in January 1996.

[1380] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995) states that the "specific day in January will probably be the closing price on the first trading day of the year." These materials are included in Appendix D to this Report.

[1381] Facsimile memorandum dated May 26, 1994, from Patrick Mackin to Carol Jewett of Vinson & Elkins, EVE1214721-EVE1214722.

[1382] Facsimile memorandum dated May 26, 1994, from Pat Mackin to Carol Jewett of Vinson & Elkins, EVE1214721-EVE1214722. *Also see* Department of Labor Advisory Opinion 94-42A (Dec. 9, 1994).

given year as this could have a negative impact on the stock price. In addition, this allows [employees] to lock in the offset at multiple points in time and continue to focus on increasing the value of Enron stock through [their] efforts."[1383]

In connection with the phasing out of the floor-offset arrangement, the Enron ESOP was frozen and the Enron Retirement Plan was continued as an independent plan.[1384] No additional shares of Enron stock were allocated to participants' ESOP Savings Subaccounts after December 31, 1994, and participants were deemed to be 100 percent vested in those accounts as of that date.[1385] Participants would vest in their Special Allocation Subaccounts over four years at a rate of 25 percent per year.[1386]

Enron ESOP participants who were actively employed by Enron on January 1, 1995, and who during such employment had both attained age 50 and completed five or more years of accrual service under the Enron Retirement Plan as of January 1, 1995, ("senior participants")

[1383] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

[1384] Enron effected a transitional benefit accrual freeze under the Retirement Plan conditioned on receipt of a favorable advisory opinion from the Department of Labor. *See* Department of Labor Adv. Op. 94-42A (Dec. 9, 1994). The freeze provided that no participant would be credited with accrual service for the 1995 plan year and any provisions of the Retirement Plan which affect accrued benefits by reason of changes pertaining to a participant's employment (including compensation changes) would not apply to affect a member's accrued benefit by reason of events occurring in 1995.

[1385] *See* Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report. Additionally, in late 1994, 1995 and 1996, small allocations were made to the accounts of existing ESOP participants. On December 31, 1994, participants received an allocation originally targeted to be five percent of their December 31, 1994, annualized base pay, adjusted for projected 1995 dividends. The actual 1994 allocation was 2.826 percent of base pay. In 1995, an additional 0.427 percent of base pay was allocated from nonvested shares forfeited by former participants. In 1996, an allocation of 0.524 percent was made. This represented the difference between the total allocation and the five percent target amount, 1.223 percent of December 31, 1994, base pay, which was to be provided as a credit under the Enron Cash Balance Plan. This allocation and the special credit to the Enron Cash Balance Plan were made in lieu of a Retirement Plan accrual for 1995. In 1996, participants in the Enron ESOP began to directly receive the dividends on shares held in their Retirement Subaccounts and Special Subaccounts, including those to which participants had not gained access, EC000021272-EC000021280. *Enron - Benefit Plans and Related Programs, Policies and Practices--Employee Stock Ownership Plan* (Dec. 14, 2001). The dividends are paid in cash on a quarterly basis to participants. *Id.*

[1386] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

could annually withdraw all of their vested interest in their ESOP Retirement Subaccounts as of that date.[1387] Beginning in January 1996, senior participants could also annually access in 20 percent increments special allocation subaccounts set up to hold special allocations made in 1994.

Also, beginning January 15, 1996, participants other than senior participants could withdraw 20 percent of (1) their ESOP Retirement Accounts and (2) the vested portions of the special allocation accounts set up to hold special allocations made in 1994.[1388] Any amount not withdrawn would be added to the future amounts available for withdrawal.[1389] Table 1 shows the schedule on which participants could withdraw shares from their accounts.

[1387] Tenth Amendment to the Enron Corp. Employee Stock Ownership Plan (Jan. 1, 1989 restatement), EC002674029. *See also* Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995). Participants electing to retire from active employment at retirement age who were 100 percent vested could withdraw their total benefit from the Enron ESOP. *Id.* The benefits of participants under the Enron Retirement/Cash Balance Plan who left Enron before retiring would also be subject to the phased out floor-offset arrangement.

[1388] The ESOP also provided that participants could withdraw (1) from their ESOP Savings Subaccounts amounts held for 24 months or more or (2) allocations of company contributions, financed stock or reversion amounts credited to their ESOP Savings Subaccount for at least 60 cumulative months, but in either case no amount in excess of the value of the vested interest in their accounts was withdrawable. ESOP section 13.1 (Jan. 1, 1999, restatement).

[1389] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995). Participants could also elect to receive a partial withdrawal and/or a partial rollover to an IRS or to the Enron Savings Plan. *Id.* However, only one such transaction could be processed each month. *Id.*

Table 1.–Amounts Available for Withdrawal under the Phase Out of the Floor-Offset Arrangement 1996-2000

Date First Withdrawable	Number of Shares of Enron Stock Becoming Withdrawable
January 15, 1996	One-fifth of total allocated shares.
January 15, 1997	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus one-fourth of the amount of any shares purchased with earnings after January 15, 1996, if any, to the extent such shares have not become previously withdrawable.
January 15, 1998	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus one-third of the amount of any shares purchased with earnings after January 15, 1996, if any, to the extent such shares have not become previously withdrawable.
January 15,1999	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus one-half of the amount of any shares purchased with earnings after January 15, 1996, if any, to the extent such shares have not become previously withdrawable.
January 15, 2000	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus all remaining shares which had have not become previously withdrawable.

For each year for which the floor-offset arrangement was phased out, the following four options were available to participants with respect to the portion of their Retirement Subaccount and Special Allocation Subaccount then accessible to them.[1390] Participants could:

[1390] *See* Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

(1) Leave it in the Enron ESOP where it would remain invested in Enron stock;[1391]

(2) Roll it over to the Enron Savings Plan where it would initially be invested in Enron stock but could be reinvested in the Enron Savings Plan's other investment options;

(3) Roll it over to an IRA; or

(4) Receive the shares of Enron stock (although partial shares were distributable in cash). [1392]

Enron communicated the phasing out of the floor-offset arrangement to employees in a variety of ways, including through Enron's employee benefits newsletter *EnSight*[1393] and special employee meetings.[1394] Enron also provided employees with statements during the second quarter of 1995 containing the estimated January 1, 1987, through December 31, 1994, accrued benefit under the Enron Retirement Plan.[1395] Employees would also receive a communication to assist them in comparing the estimated value of their ESOP Retirement Subaccounts as compared to their estimated Enron Retirement Plan accrued benefit for that time period.[1396]

Coincident with phasing out the floor-offset arrangement, Enron sought an advisory opinion from the Department of Labor. Enron wanted the Department of Labor's opinion as to whether progressively phasing out the floor-offset arrangement over a five-year period would

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[1391] If a participant elected to leave a portion of their Retirement Subaccount in the Enron ESOP at the time it first became withdrawable, the participant thereafter had rights to withdraw it or to roll it over to an IRA or the Enron Savings Plan.

[1392] *ESOP Subaccounts Summary of Options,* EC000021992; *see* Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

[1393] *EnSight* (Nov. 1994), EC000020204-EC000020211.

[1394] Memorandum dated January 11, 1995, from Phil Bazelides, Director of Enron Corporate Human Resources, to all Enron employees enclosing the *Enron Retirement Program* Guide and announcing schedule of employee meetings. EC000020294. In addition, participants were encouraged to review the International Association for Financial Planning's *Consumer Guide to Comprehensive Financial Planning*. Memorandum from Kenneth Lay and Richard Kinder to all Enron employees (July 26, 1995), EC000020144-000020146.

[1395] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

[1396] *Id.*

render the "grandfather" treatment for pre-1987 ESOPs inapplicable.[1397] The Department of Labor issued a favorable opinion on the phaseout on December 9, 1994.[1398]

Effective January 1, 1996, the final average pay benefit formula under the Enron Retirement Plan was converted to a cash balance formula and the plan was renamed the "Enron Corp. Cash Balance Plan." The phased out floor-offset arrangement was retained under the Enron Cash Balance Plan. Thus, under the Enron Cash Balance Plan, the portion of the final average pay benefit under the Enron Retirement Plan attributable to years of accrual service credited under the plan between January 1, 1987, and December 31, 1994 ("Offsetable Benefit") is offset according to the phasing out floor-offset arrangement. That is, the Offsetable Benefit is reduced (but not below zero) by reference to sum of the five separate Enron ESOP offset amounts (the total Enron ESOP Offset Amount).

An "Offsetable Amount" equal to the actuarially equivalent annuity for such 20 percent would be determined based on the market value of the 20 percent portion on the release dates. The annuity purchase values used to value the 20 percent increments were based on an interest rate of 8.5 percent.[1399]

Exhibits to the Enron Cash Balance Plan are described as the "definitive interpretations" of the floor-offset arrangement provisions.[1400] Using an example included in those exhibits, Table 2 shows how phasing out the floor-offset arrangement works for a participant who retires or is terminated having left all the stock in their ESOP Retirement Subaccount. The example includes a final average pay benefit attributable to years of service credited under the plan prior to January 1, 1987 ("Non-Offsetable Benefit").[1401]

[1397] According to Steven Kandarian, Executive Director of the PBGC, Enron's floor-offset arrangement and those of about 150 other companies were permitted under the "grandfather" provision. Statement of Steven A. Kandarian, Executive Director, PBGC, to the Senate Finance Committee, on February 27, 2002, http://www.pbgc.gov/news/speeches/test_02_27_2002.htm.

[1398] Department of Labor Adv. Op. 94-42A (Dec. 9, 1994).

[1399] Prior to the phase out of the floor-offset arrangement, annuity purchase values were determined under the Enron Retirement Plan as the single life annuity that could be purchased under the Metropolitan Life Insurance Company Group Annuity Contract No. 9373-0 (or any successor contract) based on a specified date of implementation of the purchase of an annuity contract, a specified date of the first benefit payment under an annuity contract, and an amount of distribution from a participant's ESOP Retirement Subaccount. First Amendment to Enron Corp. Cash Balance Plan (effective Jan. 1, 1996), EC000020095-EC000020100.

[1400] Enron Cash Balance Plan sec. 5.4 (effective Jan. 1, 1996). The exhibits are included in Appendix D to this Report.

[1401] In the case of participants who are eligible to begin receiving benefits before reaching normal retirement age, the benefit payable to such participants are reduced to reflect early commencement of payments in accordance with the schedule for early reduced retirement

Table 2.–Example of Benefit Calculation Under the Phased Out Floor-Offset Arrangement

Date of Birth	07/15/45
Date of Hire	09/15/84
Non-Offsetable Benefit, 12/31/94	$1,620
Offsetable Benefit, 12/31/94	$6,109
Total Final Average Pay Benefit before Offset, 12/31/94	$7,729
Enron ESOP Retirement Account Balance, 12/31/95	800 shares

History of ESOP Releases	Date of Release	# Shares Released	Share Price at Release	Market Value of Release
Release 1	01/01/1996	160	$31	$4,960
Release 2	01/01/1997	160	$34	$5,440
Release 3	01/01/1998	160	$34	$5,440
Release 4	01/01/1999	160	$37	$5,920
Release 5	01/01/2000	160	$39	$6,240

Calculation of ESOP Offset Amount	(a) Age at Release	(b) Actuarial Equiv. Annuity Factor	(c) Market Value of Release	(c)/(b) ESOP Offset Amount
Release 1	50 and 5 months	2.476355	$4,960	$2,003
Release 2	51 and 5 months	2.686845	$5,440	$2,025
Release 3	52 and 5 months	2.915227	$5,440	$1,866
Release 4	53 and 5 months	3.163021	$5,920	$1,872
Release 5	54 and 5 months	3.431878	$6,240	$1,818
				Total ESOP Offset Amount = $9,584

Calculation of Final Average Pay Benefit at Normal Retirement	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
	$1,620	$6,109	$9,584
			Normal Retirement Benefit = (1) + [(2) - (3), but not less than zero] = $1,620

benefits under the Enron Cash Balance Plan. Enron Cash Balance Plan (effective Jan. 1, 1996), sec. 5.4(b).

In the example shown in Table 2, the benefit payable to the participant is comprised of an Offsetable Benefit of $6,109 and a Non-Offsetable Benefit of $1,620. The total ESOP Offset Amount is $9,584 and the normal retirement benefit payable from the Enron Cash Balance Plan is $1,620. Thus, the final average pay benefit attributable to years of accrual service credited under the Enron Retirement Plan between January 1, 1987, and December 31, 1994, is entirely offset by the Enron ESOP Offset Amount.

During 1996 to 2000, Enron stock was trading between approximately $18 and $44.[1402] At the end of 2002, Enron's stock was trading at $0.62.[1403]

IRS review

Enron's floor-offset arrangement is currently under review by the IRS. The issues under review are discussed below.

Discussion of Issues

Calculation of benefits under floor-offset arrangements generally

In a typical floor-offset arrangement, when a participant retires, the value of the participant's benefit under the defined benefit plan is determined without regard to the offset. Then, the value of the participant's defined contribution plan account is converted to an annuity starting at retirement. This amount is then offset against the benefit determined under the defined benefit plan to determine how much of the participant's benefits will be paid from each plan. The defined benefit plan provides a floor so that if, for example, there is poor investment performance in the defined contribution plan, a plan participant will receive a benefit at least equal to the benefit under the defined benefit plan.

For example, suppose a participant has earned a benefit under the defined benefit plan portion of a floor-offset arrangement (determined before the offset) equal to an annuity of $60,000 per year starting at retirement, and that the annuity equivalent of the participant's defined contribution plan account is $5,000 per year. Under the floor-offset, the participant would not receive $65,000 a year -- the combination of the two -- rather only $60,000. The $5,000 per year annuity equivalent under the defined contribution plan is subtracted from the annuity under the defined benefit plan, so the participant receives an annuity of $55,000 per year under the defined benefit plan, plus the account balance under the defined contribution plan.

[1402] Split-adjusted stock prices are as reported in the Historical Market Data Center™ from Dow Jones & Company, Inc. According to an attachment to minutes of the November 1, 2001, meeting of the Administrative Committee, the price of Enron stock ranged from $36.63 to $63.81 during 1996 to 2000. *ESOP Facts*, attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC00001855. Although it is not clear from the attachment, the Enron stock prices listed in *ESOP Facts* do not appear to reflect stock splits that occurred during this time period.

[1403] *Id.*

On the other hand, suppose the annuity equivalent of the defined contribution account was $100,000 per year for offset purposes, the participant would be entitled only to the amount in the defined contribution plan and would not receive any benefit from the defined benefit plan.

The Enron floor-offset arrangement operated in this general manner, at least until it was phased out and the value of the offset was set over the period 1996 to 2000. Issues relating to the termination of Enron floor-offset arrangement, as well as other issues raised by the arrangement, are discussed below.

"Locking in" the offset

The IRS is reviewing the floor-offset arrangement to determine if it meets applicable qualification requirements. The main issue raised is the "locking in" of the value of the offset applicable to benefits earned under the Enron Retirement Plan during 1987 to 1994. As described above, during 1996 through 2000, Enron stock traded at approximately $18 to $44. At the end of 2002, the price of Enron stock was $0.62. Thus, for example, for a participant retiring in 2002, the locked in value of the ESOP offset is far higher than the offset would be if it were computed at retirement under the original terms of the plan.

As a result of its review, the IRS informed Enron that it was intending to issue an adverse determination with respect to the floor-offset arrangement. The IRS and Enron had a conference in December 2002, regarding the proposed adverse determination. During the conference, the IRS explained to Enron that the bases for the proposed adverse determination include that the locking in of the offset violates the anticutback rule and that the locking in results in an impermissible forfeiture. Enron has until February 24, 2002, to provide any additional information or legal arguments in support of its position that the locking in of the offset meets the qualification requirements.

The effect of the resolution of this issue on plan participants may vary depending on the participant's circumstances. For example, whether the locking in of the offset caused a reduction in a participant's accrued benefit may depend on whether the participant took a distribution at the time of the locking in or left his or her account balance in the ESOP.

The final resolution of the issue is made more complicated by the bankruptcy. Enron and its creditors have an interest in the potential liability Enron might have if the offset is determined to be invalid. The interest of the creditors may affect the actions Enron takes in connection with the proposed adverse determination. For example, Enron could agree to correct the problem and make appropriate additional contributions. However, depending on the amount involved, the creditors may or may not agree with such an approach. A variety of other resolutions are also possible at this point in time.

Other issues

In addition to the locking-in, other issues may arise under the floor-offset arrangement.

Under the applicable authorities, the defined benefit plan in a floor-offset arrangement must provide definitely determinable benefits taking into account the offset.[1404] Thus, the plan must specify the interest and mortality assumptions, as well as the date as of which the determination shall be made. Plan documents reviewed by Joint Committee staff indicate that for purposes of determining the offset amount associated with a particular ESOP release, the Enron Retirement/Cash Balance Plan used the single life annuity commencing at age 65 that is actuarially equivalent to the market value of the stock released under the Enron ESOP at the date of release based on the participant's age, an 8.5 percent interest rate assumption and post-age 65 mortality assumptions under the 1984 Unisex Pension Mortality Table set back one year.[1405]

Further, under a floor-offset arrangement, only the vested benefit in the defined contribution plan may be used to offset the benefit under the defined benefit plan.[1406] Materials reviewed by Joint Committee staff show that under Enron's floor-offset arrangement, the offset amount was based on shares of Enron stock in participants' Enron ESOP Retirement Subaccounts.[1407] Any Enron ESOP participant who was actively employed by Enron as of December 31, 1994, was 100 percent vested in his Retirement Subaccount.[1408] Thus, benefits accrued under the Enron Retirement Plan were offset by vested benefits under the Enron ESOP.[1409]

Additionally, under applicable regulations, the defined contribution portion of a floor-offset arrangement must comply with qualified joint and survivor requirements even if the plan would not otherwise be subject to those requirements. Thus, the Enron ESOP may be required to offer benefits in the form of a qualified joint and survivor annuity because the portion of the benefit accrued under the final average pay formula of the Enron Retirement Plan during 1996 to 2000 may be offset by a participant's vested benefit in the Enron ESOP. In some cases, prior to the November 1996 amendment to the Enron ESOP providing that the standard form of benefit for married participants generally was a joint and survivor annuity, participants in the Enron Retirement Plan/Cash Balance Plan whose accrued benefits under the Plan were completely

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[1404] Rev. Rul. 76-259, 1976-2 C.B. 111.

[1405] Sec. 5.2(1), Enron Cash Balance Plan (Jan. 1, 2001, restatement).

[1406] *See* Rev. Rul. 76-259, 1976-2 C.B. 111.

[1407] Sec. 5.4, Enron Cash Balance Plan (Jan. 1, 2001, restatement).

[1408] The offset-arrangement applies to benefits accrued under the Enron Retirement Plan from January 1, 1987, through December 31, 1994.

[1409] Prior to the phase out of the floor-offset arrangement, in the case of a distribution prior to retirement, the offset was based on the value of the amount distributed from the ESOP, which was vested amounts.

offset by their benefit under the Enron ESOP may not have been offered a qualified joint and survivor annuity.[1410]

2. Conversion of the Enron Retirement Plan to the Enron Cash Balance Plan

During 1994, Enron considered changing the design of the Enron Retirement Plan.[1411] By the end of 1994, plans were in place to convert the benefit formula under the Enron Retirement Plan to a cash balance formula.

Present Law

Overview

As described above,[1412] a cash balance plan is a defined benefit plan with benefits resembling the benefits associated with defined contribution plans. Under a cash balance formula, the benefit is defined by reference to a hypothetical account balance, which is credited with pay credits and interest credits. Although a participant's benefit under a cash balance plan is described in terms of a hypothetical account balance, as a defined benefit plan, a cash balance plan is required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age. This annuity is determined as the actuarial equivalent of the participant's account balance at normal retirement age, using interest and mortality factors specified in the plan. The annuity payable at normal retirement age serves as the basis for the participant's accrued benefit.

Cash balance plans are subject to the qualification requirements applicable to defined benefit plans generally. However, because such plans have features of both defined benefit plans and defined contributions plans, questions arise as to the proper application of the qualification requirements to such plans, particularly if a defined benefit plan with a typical benefit formula is converted to a cash balance plan formula. Issues that commonly arise include, in the case of a conversion to a cash balance plan formula, the application of the rule prohibiting a cutback in accrued benefits[1413] and the application of the age discrimination rules. These rules are discussed below. Other issues have been raised in connection with cash balance plans, including

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[1410] As described above, in Part II.B.5., in November 1996, the Enron ESOP was amended to provide that the standard form of benefit generally was a joint and survivor annuity for married participants and a single life annuity for unmarried participants. Under the 1999 restatement of the Enron ESOP, an annuity was an alternative form of benefit to the standard lump sum. The annuity form of benefit under the Enron ESOP was eliminated effective August 15, 2001.

[1411] Minutes of the Meeting of the Administrative Committee (Apr. 13, 1994), EC0000766692.

[1412] *See* Part II.A.2., above.

[1413] Sec. 411(d)(6).

the proper method for applying the accrual rules and the proper method for determining lump sum distributions.

There is little guidance under present law with respect to many of the issues raised by cash balance conversions. In 1999, the IRS imposed a moratorium on determination letters for cash balance conversions pending clarification of applicable legal requirements.[1414] Under the moratorium, all determination letter requests regarding cash balance plans are sent to the National Office for review; however, the National Office is not currently acting on these plans.[1415] As described below, the Treasury Department recently issued proposed regulations addressing certain issues relating to cash balance plans.

Under ERISA, employer decisions regarding plan design are generally considered "settler functions" that are not subject to ERISA's fiduciary rules. Implementation of plan design changes may, however, involve discretionary authority with respect to plan administration and, thus, may involve fiduciary obligations.

In addition to raising legal questions, conversions of cash balance plans in the 1990's also received considerable media attention. A major issue raised in the media was the treatment of longer-service workers, who were expected to receive greater benefits under a typical defined benefit plan than under a cash balance plan. Concerns were raised that, under certain plan designs, longer-service workers (who also tend to be older), were being treated unfairly (even if legal requirements had technically been met) upon conversion to a cash balance plan.

Protection of accrued benefits

In general

The Code generally prohibits an employer from amending a plan's benefit formula to reduce benefits that have already accrued (the "anticutback rule").[1416] For this purpose, an amendment is treated as reducing accrued benefits if it has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy or of eliminating an optional form or benefit.[1417]

The "anticutback rule" applies in the context of cash balance plan conversions. Because of this rule, after conversion to a cash balance design, a plan still must provide employees with

[1414] Announcement 2003-1, 2003-2 I.R.B. 281, http://www.irs.gov/pub/irs-drop/a-03-1.pdf.

[1415] *Id.*

[1416] Sec. 411(d)(6). The provisions do not, however, protect benefits that have not yet accrued but would have in the future if the plan's benefit formula had not changed.

[1417] Sec. 411(d)(6)(B).

the normal retirement benefit that he or she had accrued before the conversion.[1418] However, the plan may determine benefits for years following the conversion in a variety of ways, while still satisfying the anticutback rule. Common plan designs are discussed below.

Wearaway (or "greater of" approach)

Under a "wearaway" approach, a participant does not accrue any additional benefits after the conversion until the participant's benefits under the cash balance formula exceed their preconversion accrued benefit. Because of this effect, plans with a wearaway are also referred to as using the "greater of" method of calculating benefits. Plan design can greatly affect the length of any wearaway period.

Upon a conversion to a cash balance plan, participants are given an opening account balance. The pay and interest credits provided under the plan are then added to this opening account balance. The opening account balance may be determined in a variety of ways and is generally a question of plan design. For example, an employer may create an opening account balance that is designed to approximate the benefit a participant would have had, based on the participant's compensation and years of service, if the cash balance formula had been in effect in prior years. As another example, an employer may convert the preconversion accrued benefit into a lump sum amount and establish this amount as the opening account balance. Depending on the interest and mortality assumptions used, this lump sum amount may or may not equal the actuarial present value of the participant's accrued benefit as of the date of conversion, determined using the statutory interest and mortality assumptions required for lump sum calculations.

Under the wearaway approach, the participant's protected benefit is compared to the normal retirement benefit that is provided by the account balance (plus pay and interest credits), and the participant does not earn any new benefits until the new benefit exceeds the protected accrued benefit. For example, suppose the value of the protected accrued benefit is $40,000, and the opening account balance under the cash balance formula provides a normal retirement benefit of $35,000. The participant will not earn any new benefits until the hypothetical balance under the cash balance formula increases to the extent that it provides a normal retirement benefit exceeding $40,000.

No wearaway (or "sum of " approach)

Under a plan without a wearaway, a participant's benefit under the cash balance plan consists of the sum of (1) the benefit accrued before conversion plus (2) benefits under the cash balance formula for years of service after the conversion.[1419] This approach is more favorable to

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[1418] Certain other plan features, such as early retirement subsidies, must also be protected.

[1419] In some cases, the plan may convert the protected benefit into a lump sum equivalent for purposes of the opening account balance. Even if at the time of the initial calculation the opening balance equals the value of the protected benefit, the account balance may not continue to reflect the value of the protected benefit over time, depending on the actuarial assumptions plan participants than the wearaway approach, because they earn benefits under the new plan formula immediately. This approach is also sometimes referred to as the "A + B" method, where A is the protected benefit and B is benefits under the cash balance formula.

Grandfathering

For older and longer-service participants, benefits under a cash balance formula tend to be lower than the benefits a participant may have expected to receive under the traditional defined benefit formula (the "old" formula).[1420] The employer might therefore provide some type of "grandfather" to participants already in the plan or to older or longer-service employees. For example, the participants might be given a choice between the old formula and the cash balance formula for future benefit accruals, or, in the case or a final average pay plan, the plan may stop crediting service under the old formula, but continue to apply post-conversion pay increases, so the employee's preconversion benefit increases with post-conversion pay increases. This approach goes beyond preserving the benefit protected by the anticutback rules.

Age discrimination

In general, the Code prohibits reductions in the benefit accrual rates (including the cessation of accruals) for defined benefit plan participants on account of attainment of any age.[1421] Attainment of any age means a participant's growing older. Similarly, the Code prohibits a defined contribution plan from ceasing allocations, or reducing the rate at which amounts are allocated to a participant's account due to attainment of any age. Parallel requirements exist in ERISA and the Age Discrimination in Employment Act ("ADEA").[1422]

These provisions do not necessarily prohibit all benefit formulas under which a reduction in accruals is correlated with participants' age in some manner. Thus, for example, a plan may limit the total amount of benefits, or may limit the years of service or participation considered in determining benefits.[1423]

In general terms, an age discrimination issue arises under cash balance plans because there is a longer time for interest credits to accrue on hypothetical contributions to the account. Thus, for example, a $1,000 hypothetical contribution made when a plan participant is age 30

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used. Thus, a cash balance plan may not rely on the cash balance formula to protect accrued benefits because it may encounter problems under the anticutback rule (depending on the actuarial assumptions used).

[1420] This is sometimes the reduction in benefits that is referred to in connection with cash balance conversions, i.e., a reduction in expected benefits, not accrued benefits.

[1421] Sec. 411(b)(1)(H).

[1422] Parallel provisions are found in ERISA sec. 204(b)(1)(H) and ADEA, 29 U.S.C. sec. 623(i).

[1423] Sec. 411(b)(1)(H)(ii).

will be worth more at normal retirement age (e.g., age 65) and thus provide a higher annuity benefit at normal retirement age than the same contribution made on behalf of an older participant closer to normal retirement age. This issue is not limited to cash balance plan conversions, but applies to cash balance plans generally. Other age discrimination issues may also arise, depending in part on plan design, e.g., whether the plan has a "wearaway" (described below).

<u>Proposed regulations issued</u>

On December 10, 2002, the Treasury Department issued proposed regulations relating to the application of age discrimination prohibitions to defined benefit plans, including special rules for cash balance plans.[1424] The proposed regulations permit a participant's rate of benefit accrual for a year under a cash balance benefit plan to be determined without regard to interest credits, the right to which accrued before the beginning of the year. Therefore, compliance with the prohibition on a reduction in the rate of benefit accrual on account of the attainment of any age may be tested by reference to the pay credits provided under the plan. As a result, a plan that provides all participants with the same rate of pay credit generally will not violate this prohibition.[1425] However, the converted plan must qualify as an "eligible cash balance plan." In order to be an "eligible cash balance plan," a defined benefit plan must satisfy each of the following requirements for accruals in the current plan year:

(1) The normal form of benefit is stated as an immediate payment of the balance in a hypothetical account; and

(2) At the same time the participant accrues an addition to the hypothetical account, the participant accrues the right to annual (or more frequent) future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age. These interest credits must be provided for all future periods, including after normal retirement age. An eligible cash balance plan cannot treat interest credits after normal retirement age as actuarial increases that are offset against the otherwise required accrual.

[1424] Prop. Treas. Reg. sec. 1.411(b)-2. The proposed regulations provide guidance on how to determine the rate of benefit accrual or rate of allocation. The proposed regulations also address a number of other issues, including nondiscrimination testing for cash balance plans.

[1425] This approach is consistent with the court's interpretation of the age discrimination prohibition in *Eaton v. Onan Corporation,* 117 F. Supp. 2d 812 (S.D. Ind. 2000). In that case, the court rejected plaintiffs' argument that, for purposes of this prohibition, the rate of benefit accrual under a cash balance plan for a year should be determined by reference to the increase in a participant's normal retirement benefit that results from the pay credit for the year and any related future interest credits the right to which accrues in that year (similar to the manner in which the accrual rules apply to a cash balance plan).

Additionally, the proposed regulations provide that, if the plan was converted to a cash balance plan, the conversion must be accomplished in one of two ways. Specifically, the converted plan must either:

(1) Determine each participant's benefit as not less than the sum of the participant's benefits accrued under the traditional defined benefit plan and the cash balance account (the "sum of" method); or

(2) Establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's prior accrued benefit, using reasonable actuarial assumptions (the "greater of" method).[1426]

The preamble to the proposed regulations states that the regulations cannot be relied on until adopted in final form. Even if the proposed regulations are issued in final form, the preamble indicates that they will apply on a prospective basis only.

The IRS moratorium on determination letters for cash balance plans will not end before the proposed regulations are issued in final form.[1427]

Notice of a significant reduction in future benefit accruals

As a result of concerns that participants affected by conversions to cash balance plans had not received sufficient notice of the effect of the conversion, a specific notice requirement was enacted in 2001.[1428] Under present law, the plan administrator of a defined benefit plan or a money purchase pension plan must provide notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or significant reduction of an early retirement benefit for retirement-type subsidy.[1429] Details of the notice requirement are contained in Treasury regulations.[1430] An excise tax is imposed on failures to comply with the notice requirement.[1431]

[1426] Depending on the actuarial assumptions used, this amount may or may not equal the present value of a participants' protected accrued benefit, determined using statutory interest and mortality assumptions.

[1427] Announcement 2003-1, 2003-2 I.R.B. 281, http://www.irs.gov/pub/irs-drop/a-03-1.pdf.

[1428] Pub. L. No. 107-16, sec. 659(a)(1) (2001).

[1429] Sec. 4980F. There is also a comparable ERISA provision.

[1430] Treas. Reg. sec. 54.4980F-1.

[1431] Sec. 4980F. The excise tax is generally equal to $100 per day for each person with respect to whom a failure to comply occurs, subject to a maximum of $500,000 per taxable year in the case of unintentional failures.

Factual Background

Decision to convert to a cash balance formula

In 1994, Enron officials began to consider implementing a new benefit formula under the Enron Retirement Plan.[1432] The information provided to the Joint Committee staff does not contain much information regarding the reasons the Enron Retirement Plan was converted to a cash balance formula. Interviews with former Enron personnel familiar with the issue indicate that several reasons influenced the decision.

Enron envisioned its work force as increasingly mobile and consisting of "fewer full career or single career employees."[1433] It was thought that Enron's employees desired benefits which were more portable than their benefits under the Enron Retirement Plan.[1434] A cash balance formula was viewed as meeting the needs of Enron's workforce. Additionally, the new formula was described as better matching Enron's vision of future workforce benefit plans."[1435] In addition, a cash balance formula would be simpler, making it easier for employees to understand and track the value of their retirement benefit.[1436] The decision was described to employees as "an effort to align Enron's retirement program with the company's approach to business."[1437]

According to materials reviewed by Joint Committee staff, Enron's decision to convert to a cash balance formula was "not a cost savings decision."[1438] However, when the prospect of a conversion was presented to the Administrative Committee by Enron's Vice President for Human Resources, one of Enron's "benefit objectives" was described as "shared responsibility

[1432] Minutes of meeting of Enron Corp. Retirement Plan Administrative Committee (April 20, 1994), EC00766693-EC000766710.

[1433] Presentation to Administrative Committee - *Retirement Plan - from Defined Benefit to Cash Balance*, presented at April 20, 1994, meeting of Enron Corp. Retirement Plan Administrative Committee, EC000766696-EC000766710.

[1434] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report.

[1435] Presentation to Administrative Committee - *Retirement Plan - from Defined Benefit to Cash Balance*, presented at April 20, 1994, meeting of Enron Corp. Retirement Plan Administrative Committee, EC000766696-EC000766710.

[1436] *EnSight* (Dec. 1994), EC000020204-EC000020213.

[1437] *Id.*

[1438] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

for cost," in a shift away from the historical "paternalistic traditional defined benefit pension plan" and toward "individual responsibility."[1439]

While converting to a cash balance formula would mean a reduction in Enron's expense for 1995, for each of the subsequent nine years, the new formula would be more expensive than the old formula and for the 10-year period going forward, the new formula would be slightly more expensive for Enron.[1440] In fact, a comparative analysis prepared by an outside consultant showed that Enron was expected to contribute more cash under the new formula than under the old formula until 2002.[1441]

Enron chose a five percent of pay cash balance formula to be competitive with other companies' retirement benefits.[1442]

<u>Plan provisions related to conversion</u>

As of January 1, 1996, participants in the Enron Cash Balance Plan were credited with accruals of five percent of their monthly compensation as well as interest accruals as of the last day of each calendar month starting January 1, 1997.[1443]

Under the Enron Cash Balance Plan, normal retirement benefits consist of the actuarial equivalent of a series of monthly payments for a participant's life commencing on the first day of the month coinciding with or next following the date of their retirement. Each monthly payment is equal to the sum of (1) the monthly amount of the participant's final average pay benefit (using the same formula as under the Enron Retirement Plan)[1444] and (2) the monthly payment

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[1439] *Id.*

[1440] *Id.* In a letter to the Department of Labor submitted in connection with its 1994 request for an advisory opinion, Enron's outside counsel explained that because the cash balance formula would have the effect of accelerating accruals into a participant's earlier years of employment with Enron, the effect, from a funding perspective, would be to increase the funding to the plan in the short run above that which would be required if its original formula were retained. Letter dated November 23, 1994, from Enron's outside counsel to the Department of Labor.

[1441] The comparative analysis of Enron's estimated funding obligations under the final average pay formula and the cash balance formula is included in Appendix D to this Report.

[1442] Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report.

[1443] Sec. 4 of Cash Balance Plan (effective Jan. 1, 1996).

[1444] The portion of a participant's final average pay benefit which is attributable to accruals under the plan during January 1, 1987, through December 31, 1994, are offset by their interest in their ESOP Retirement Subaccount. The offset does not apply to the benefit the participant would have received under the plan as of December 31, 1986, or to any benefit derived by converting the participant's cash balance accrual as of the annuity starting date into a single life annuity on an actuarially equivalent basis. Thus, under the terms of the converted plan, a participant's benefit generally is the sum of the participant's benefits accrued under the traditional defined benefit plan and the cash balance account.

Additionally, the Enron Cash Balance Plan includes special provisions for participants in the Enron Retirement Plan who:

(1) as of January 1, 1995, (a) were employed by Enron; (b) had attained age 50; and (c) completed five years of service under the Enron Retirement Plan ("Transition Participants"), and

(2) who retired from Enron on or before January 1, 2002.

The special provisions were intended to provide protection for such Transition Participants against adverse affects of the conversion to the cash balance formula.[1445] According to Enron, there were approximately 790 such Transition Participants but only about 140 would be adversely affected by the conversion.[1446]

Under the special provision, the retirement benefit for Transition Participants is the normal retirement benefit as described above, with the application of some special rules. The special rules are, in general, that Transition Participants who retired by January 1, 2002, are entitled to the better of the old or the new benefit formula through the participant's last day worked.[1447] That is, benefits for Transition Participants are increased by crediting additional

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accrued under the cash balance formula. Enron Cash Balance Plan section 5.1 (Jan. 1, 2001, restatement).

[1445] Letter dated October 25, 1994, from Vinson & Elkins to the Department of Labor in support of its application for an Advisory Opinion. *See* Department of Labor Adv. Op. 94-42A (Dec. 9, 1994). Enron represented that it would amend the Retirement Plan to provide that the benefits accrued by such adversely affected participants on an after January 1, 1995, will be equal to the greater of (1) benefits under the Cash Balance formula increased by certain allocations to the ESOP or (2) benefits under the Retirement Plan's formula as in effect on December 31, 1994.

[1446] Letter dated October 25, 1994, from Enron's outside counsel to the Department of Labor in support of its application for an advisory opinion.

[1447] The Plan provided (1) that a Transition Participant's accrual service will generally be increased for the period of employment January 1, 1995, to January 1, 2002, by crediting the participant with one month of accrual service for each calendar month of employment service with Enron and (2) that a Transition Participant's final average pay will be computed on the basis of a period consisting of the sixty consecutive months of employment within the last one hundred twenty months of employment with Enron prior to January 1, 2002, which yield the highest average compensation. Additionally, a Transition Participant who becomes disabled after January 1, 1995, will be credited with full and partial years of accrual service for each accrual service with Enron under the final average pay formula through January 1, 2002, and by considering compensation earned up to such date.[1448] The Enron Cash Balance Plan also includes a special provision for Transition Participants who terminate employment with Enron before attaining age 55.[1449]

The Enron Cash Balance Plan was amended effective November 1, 2001, to eliminate the requirement that the Transition Participant terminate employment prior to January 1, 2002, to qualify for the special provision.[1450]

Information provided to participants

The decision to convert the Enron Retirement Plan to the Enron Cash Balance Plan was communicated to participants in *EnSight*, Enron's "all-employee publication dedicated to benefits education". The November 1994 edition of *EnSight* described "the decision to change benefits [as] an effort to align Enron's retirement program with the company's approach to business." It explained that "[w]hile economics were considered, cost is not the driving factor. In fact, these enhancements will mean an increase in Enron's costs over the next decade. But as Enron continues to thrive in a culture built on change and built to respond positively to change, the company is committed to retirement benefits that are: Fair...Portable...Simple...and Valuable."[1451]

Enron also described the conversion to participants in the *Enron Retirement Program Guide*.[1452] The *Program Guide* includes an example that estimates a participant's benefit under the Enron Cash Balance Plan.[1453] Materials reviewed by Joint Committee staff do not contain an example provided to participants of the special provision for Transition Participants.

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period between January 1, 1995, and January 1, 2002, during which the participant was disabled. Enron Cash Balance Plan sec. 13.2 (effective Jan 1, 1996).

[1448] Exhibit V to the Enron Cash Balance Plan is an example of the calculation of regular and transition benefits under the Plan. The exhibit is included in Appendix D to this Report.

[1449] Enron Cash Balance Plan sec. 13.2(a) (Jan. 1, 2001, restatement).

[1450] Fifth Amendment to Enron Corp. Cash Balance Plan (effective Jan. 1, 1996).

[1451] *EnSight*, November 1994, EC000020206.

[1452] *Enron Retirement Program Guide,* included in Appendix D to this Report.

[1453] *Id.*

IRS technical advice pending

An IRS examination of the Enron Cash Balance Plan's 1996 year resulted in a request by IRS examiners for technical advice from the IRS National Office.[1454] The technical advice raised the concern that as a result of the floor-offset arrangement, in some instances, the final average pay benefit was completely offset so that participants are offered no qualified joint and survivor annuity, notwithstanding Code requirements that benefits accrued under the final average pay formula be offered in the form of a qualified joint and survivor annuity.[1455] IRS examiners also asked the IRS National Office to review the effect of the conversion of the Enron Retirement Plan to a cash balance formula, in accordance with the September 15, 1999, directive that all open cases involving conversions of defined benefit plans to cash balance plans be submitted for review by the National Office.[1456]

The request arrived in National Office of the IRS on March 17, 2000, and is currently under review. On April 12, 2000, Enron submitted to the IRS a request for a determination of the tax-qualified status of the Enron Cash Balance Plan.[1457] The IRS notified Enron that its request for a determination letter would be associated with the request for technical advice from IRS examiners. The request is currently pending.

Discussion of Issues

Changes in retirement plan design, including significant changes in benefit structure and formulas, are not uncommon. Plan design changes can occur for a variety of reasons, including employer cost considerations, employer views regarding appropriate retirement benefits, the popularity of an alternative plan design among employees, and mergers of plans with disparate provisions due to corporate transactions. The timing of any particular plan design changes may also depend on a variety of factors, including administrative convenience to the employer and others involved in the change.

During the 1990s, conversions of typical defined benefit plans to cash balance formulas were common among mid- to large-size employers. There was considerable media attention regarding such conversions, particularly in cases in which the plan contained a "wearaway" or in which older or longer-service employees close to retirement were denied the opportunity to

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[1454] The advice requested from the IRS National Office concerned a technical issue that arose with respect to the examination of the Enron Cash Balance Plan, as described in Part II.B.6.

[1455] At the time the technical advice was requested, the Enron Corp. ESOP did not offer benefits in the form of a joint and survivor annuity.

[1456] Announcement 2003-1, 2003-2 I.R.B. 281, http://www.irs.gov/pub/irs-drop/a-03-1.pdf

[1457] As described above at Part II.B.6., an application for determination of the tax-qualified status of the Enron Cash Balance Plan was also submitted on February 15, 2002.

continue to accrue benefits under the old plan formula.[1458] While perhaps complying with the law, such plan designs were viewed by many as unfair to certain participants. There was concern that some employers were adversely affecting participants in order to reduce costs. There was also concern that participants might not understand the effect of the conversion on their benefits (including future benefits the participant may have accrued under the old formula).[1459]

The conversion to a cash balance plan may be motivated by a variety of factors. From the employer's perspective, the change may result in reduced pension costs. Because the level of contributions and earnings under a cash balance plan are predetermined, a cash balance plan may also make it easier for employers to manage pension liabilities. Some employers are concerned about the level of contributions that may be required to fund typical defined benefit plans and cash balance plans can provide an attractive alternative.

Cash balance plans may also have advantages for employees. Unlike typical defined benefit plans, which tend to benefit long-service participants who remain with a company until retirement, cash balance plans often benefit shorter service, more mobile workers. Thus, cash balance plans may be popular in industries or markets in which workers are relatively mobile or among groups of workers who go in and out of the workforce. Cash balance plans also provide a more portable benefit than the typical defined benefit plan. Some participants also find cash balance plans easier to understand than a typical defined benefit plan--their benefit statement shows an account balance.

In Enron's case, the conversion to a cash balance formula appeared to be motivated primarily by a desire to provide a more attractive plan for most of its workers. Enron executives viewed the future of the Enron as consisting of a highly trained, mobile workforce. In many cases, such workers would find a cash balance plan more attractive that in a typical defined benefit plan. In addition, converting to a cash balance plan was consistent with Enron's image as an innovator; at the time, cash balance plans were viewed as an emerging, new type of benefit plan. While Enron benefit costs may be reduced due to the conversion over time, materials prepared by Enron indicate that, at least initially, the conversion would result in increased pension costs.

In effecting the conversion, Enron did not adopt the plan design features that garnered most of the media attention. Enron did not adopt a wearaway, but rather used a "sum of" approach in protecting accrued benefits. In addition, Enron took steps to protect the expectations of workers who were nearing retirement by providing that they would, in effect, receive benefits under whichever formula gave the greatest benefit.

[1458] *See, e.g.*, Albert B. Crenshaw, *Companies Embrace New Pension Plan*, THE WASHINGTON POST, Jan. 31, 1999, at H1; Richard A. Oppel, Jr., *Companies Cash in on New Pension Plan; But Older Workers Can Face Penalties*, N.Y. TIMES, Aug. 20, 1999, at C1; Ellen E. Schultz & Elizabeth MacDonald, *Retirement Wrinkle: Employers Win Big with a Pension Shift; Employees Often Lose*, WALL ST. J., Dec. 4, 1998, at A1.

[1459] As mentioned above, these concerns led to the enactment of the present-law notice requirements regarding future reductions in benefit accruals. Sec. 4980F.

Enron's cash balance plan is under review by the IRS National Office pursuant to the IRS directive regarding cash balance plan conversions. The Plan has been pending in the National Office since March 2000. The Enron Cash Balance Plan conversion does not appear to raise any issues other than those that generally arise with respect to such plans, particularly in the absence of definitive guidance with respect to such issues. As mentioned above, given the Enron plan design, the Enron conversion may raise fewer issues than many cash balance conversions.

Recommendations

Present law is not clear with respect to many issues that may be raised under cash balance plans. During the 1990s when conversions were receiving considerable attention, there was significant debate in Congress and elsewhere as to whether cash balance plans should be permitted as a plan design and, if so, what rules should apply (e.g., whether the wearaway approach should be permitted). While some thought that strict limits should be placed on such plans, others were concerned that strict limits would have a harmful effect on the voluntary retirement plan system. Under present law, employers are not required to adopt qualified plans for employees, and whenever new restrictions on plan design or other aspects of plan operation are considered, there is generally an issue of whether the changes will cause employers to reduce or eliminate qualified plan benefits. Thus, in the retirement plan area, there is often a tension between providing adequate safeguards for employees and allowing employers freedom to adopt the type of plan they deem appropriate.

Under the current state of the law with respect to cash balance plans, including the proposed Treasury regulations, cash balance plan conversions will be permitted, subject to certain requirements, unless statutory changes are made. While the proposed regulations answer certain questions regarding cash balance plans, there are other issues still outstanding.

The Joint Committee staff believes that both employers and employees would benefit from certainty in the law regarding cash balance plans and that the Congress or the Treasury Department should adopt appropriate rules. Thus, the Joint Committee staff recommends that specific rules be provided with respect to cash balance plan conversions and cash balance plans generally.

3. Enron ESOP Investment in Enron Stock

Present Law

ESOPs are defined contributions plans which are designed to invest primarily in qualifying employer securities. This generally refers to securities issued by the employer sponsoring the ESOP. Like other investments in securities, benefits under ESOPs are subject to the risks inherent in investing.

ERISA imposes broad duties governing all plan fiduciaries. Among them are the requirements that plan fiduciaries discharge their duties with respect to plans solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits and that such fiduciaries act with reasonable care, skill, prudence, and diligence under the circumstances. A fiduciary must also diversify plan investments so as to minimize the risk of large losses unless, under the circumstances, it is clearly not prudent to do so.[1460] Under ERISA, fiduciaries must also refrain from engaging in prohibited transactions.

Fiduciaries of ESOPs, like fiduciaries of other retirement plans subject to ERISA, are subject to ERISA's broad fiduciary duties.[1461] However, ESOP fiduciaries are generally not subject to the ERISA rule that plan investments must be diversified so as to minimize the risk of large losses.[1462] Specifically, under an ESOP, the diversification requirement and the prudence requirement (only to the extent that it requires diversification) is not violated by acquisition or holding of qualifying employer securities.[1463]

Notwithstanding, participants in ESOPs have challenged the actions of ESOP fiduciaries for failure to diversify ESOP investments. Courts have attempted to delineate the duties of ESOP fiduciaries under ERISA while remaining mindful of the purposes of ESOPs. In some instances, courts have acknowledged that ERISA's strict fiduciary standards could override plan provisions directing the investment of ESOPs in employer securities.[1464]

The difficulty of determining the ERISA responsibilities of ESOP fiduciaries has been acknowledged by courts facing this issue.[1465] In part, the difficulty arises, according to one court, because ESOPs are basically trusts created to invest in the stock of a single company.[1466]

[1460] ERISA sec. 404(a)(1)(C).

[1461] *See, e.g., Donovan v. Cunningham,* 716 F.2d 1455, 1467 (5th Cir. 1983); *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6th Cir. 1995); *Moench v. Robertson*, 62 F.3d 553, 566 (3d Cir. 1995); *Eaves v. Penn,* 587 F.2d 453, 459-60 (10th Cir. 1978).

[1462] *See* ERISA sec. 404(a)(2)

[1463] ERISA sec. 404(a)(2).

[1464] *See, e.g., Moench v. Robertson*, 62 F.3d 553, 556 (3d Cir. 1995) (The court said "[I]n limited circumstances, ESOP fiduciaries can [breach ERISA's fiduciary duty requirements] for continuing to invest in employer stock according to the plan's direction." In *Moench,* the court vacated the district court's grant of summary judgment in favor of defendant, ESOP fiduciaries, and remanded the case. The court concluded that in limited circumstances, ESOP fiduciaries could be liable under the ERISA for continuing to invest in employer securities according to the plan's direction. Ultimately, the parties reached a settlement agreement which was approved by the court.) *Moench v. Robertson,* 1996 U.S. Dist. LEXIS 21898 (D.N.J. 1996). *Also see Kuper v. Iovenko*, 66 F.3d 1447, 1458 (6th Cir. 1995).

[1465] *See Moench v. Roberston,* 62 F.3d at 569 (noting the difficulty in "delineating the responsibilities of ESOP trustees."); *Kuper v. Iovenko*, 66 F.3d at 1458.

[1466] *Id.* at 568-69.

Nonetheless, there may be a point at which investments in employer securities no longer are justified under the purposes of the trust.[1467]

In cases dealing with the ERISA-imposed duties of ESOP fiduciaries, courts have recognized that because ESOPs are generally designed to invest primarily in the stock of the employer, "an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision."[1468] That presumption does not, however, foreclose review of the actions of ESOP fiduciaries.[1469] While an ESOP fiduciary may be released from certain per se violations on investments in employer securities, ERISA requires that in making an investment decision of whether or not to invest a plan's assets in employer securities, an ESOP fiduciary is governed by ERISA's "solely in interest" and "prudence" tests.[1470]

Under ERISA, directed trustees may also have fiduciary responsibility for ESOP investments in certain limited circumstances.[1471] Generally, a directed trustee is a person who has custody of the plan assets but is not charged with discretionary authority over the disposition or management of those assets. Usually, a directed trustee follows instructions of a plan fiduciary with discretion over plan assets. A directed trustee's liability for a fiduciary breach generally is limited because the directed trustee lacks the requisite authority over the plan or its assets. Nonetheless, if a directed trustee has actual knowledge of the named fiduciary's breach

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[1467] *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6th Cir. 1995) (The court said that a plan provision that completely prohibits diversification of ESOP investments violates ERISA. Accordingly, fiduciaries who continue to invest in employer securities even when the plan sponsor's value is declining should not rely on ERISA's requirement that fiduciaries discharge their duties in accordance with plan provisions that are not inconsistent with ERISA for protection. ERISA exempts ESOPs from its diversification requirements but the purpose of an ESOP "cannot override ERISA's goal of ensuring the proper management and soundness of employee benefit plans" imposed by ERISA's prudence and loyalty standards).

[1468] *Moench v. Robertson*, 62 F.3d 553.

[1469] *See, e.g., Kuper v. Iovenko*, 66 F.3d 1447 (The court said that a proper balance between the purpose of ERISA and the nature of ESOPs requires review of an ESOP fiduciary's decision to invest in employer securities for an abuse of discretion.); *also see In re McKesson HBOC, Inc. ERISA Litigation*, 2002 U.S. Dist. LEXIS 19473 (N.D. Cal. 2002) (The court said that while fiduciaries of ESOPs "may not blindly follow an ESOP plan's directive to invest in company stock," the plaintiffs needed to establish that the fiduciaries of the ESOP abused their discretion in permitting a high level of investment in employer securities.)

[1470] *See Eaves v. Penn*, 587 F.2d 453, 459 (10th Cir. 1978).

[1471] *See FirstTier Bank v. Zeller*, 16 F.3d 907 (8th Cir. 1994). *See also* 29 CFR sec. 2509.75-8, FR-14.

of fiduciary duty, the directed trustee may have a duty to determine that the instructions it receives and carries out are proper.[1472]

Factual Background

The terms of the Enron ESOP provide that each year, Enron will contribute directly to the trustee for the Enron ESOP the amount, if any, authorized by Enron's Board of Directors. Enron's contributions to the Enron ESOP were payable in cash or in shares of Enron stock, as determined by the Board. To date, Enron has never made a direct contribution to the Enron ESOP.[1473]

Participants in the Enron ESOP were neither required nor permitted to make contributions to the Enron ESOP.

The Enron ESOP provides that plan assets are to be invested primarily in shares of Enron stock. For purposes of complying with the Code requirement that such assets are invested "primarily" in shares of such stock, the Enron ESOP provides that plan assets will be deemed to be so invested if 80 percent or more of the aggregate plan assets are invested in Enron stock. However, plan assets attributable to Enron stock which was purchased with the proceeds of the reversion transferred to the Enron ESOP when it was created in 1986 must be 100 percent invested in Enron stock to qualify for the exception to the excise tax on reversions.

The Enron ESOP provides that the duties, obligations, and responsibilities of the Enron ESOP trustee are governed by the trust agreement. The trust article entitled "Investment of Trust Fund" provides that the named fiduciary under the Enron ESOP has all discretionary authority for the management and control of the trust fund and is responsible for determining the diversification policy and for monitoring adherence by the investment manager to such policy. Under the trust agreement, the named fiduciary generally is the plan administrator, in this case, the Administrative Committee.

Materials presented by Enron's ERISA counsel to members of the Administrative Committee at the March 9, 2000, meeting generally describe the Administrative Committee's trustee duties. For example, the materials explain the general rules pertaining to appointment, removal and replacement of the plan trustee and the payment of plan expenses. In a section on the Enron ESOP's special provisions, the materials state that the trustee may invest up to 100 percent of the trust in Enron stock but that the Administrative Committee determines the extent to which the trust fund will be invested in Enron stock and determines the price at which the stock will be bought or sold.[1474]

[1472] *See FirstTier Bank v. Zeller*, 16 F.3d 907 (8th Cir. 1994), *Ershick v. United Missouri Bank of Kansas City*, 948 F.2d 660 (10th Cir. 1991), *Newton v. Van Otterloo*, 756 F. Supp. 1121 (N.D. Ind. 1991).

[1473] The assets of the ESOP are attributable to the stock purchased with the 1986 loan and 1987 reversion.

[1474] These materials are included in Appendix D to this Report.

As discussed above,[1475] the Administrative Committee generally did not evaluate Enron stock as an appropriate investment under the Enron ESOP. As described by one Administrative Committee member, the Enron ESOP plan terms provided for investment of plan assets in Enron stock, so there was no need to review that investment. The Administrative Committee questioned for the first time whether it should be examining Enron stock as an investment under any of the Enron qualified plans on November 1, 2001.[1476]

Documents provided by Enron indicate that, due to the volatility of Enron's stock and the fiduciary responsibility of the Administrative Committee, a special meeting of the Administrative Committee was held on November 1, 2001, to discuss the prudent steps that the Administrative Committee might need to consider with respect to the Enron Savings Plan, as well as other Enron qualified plans.

The Administrative Committee was presented with a snapshot of the current Enron stock holdings in the Enron Savings Plan and Enron ESOP as of October 26, September 30, and January 1, 2001. The Administrative Committee was advised that it had no duty to issue cautionary advice on the value or risk of holding Enron stock because the Administrative Committee does not act in the capacity of an investment advisor, but is charged with administering the plans in accordance with the terms of the plan documents and in compliance with ERISA. It was decided that the Administrative Committee should hire an independent investment advisor to monitor Enron stock, and a member of Enron's treasury department was directed to conduct the search.

With respect to the Enron ESOP, it was determined that the Administrative Committee had no duty to take action since adequate communication has been given to participants over the years. The Administrative Committee would review the recommendations of the investment advisor as to what, if any, action might be required.

Table 3 shows the number of active, retired, or separated participants with account balances and the number of beneficiaries of deceased participants entitled to benefits under the Enron ESOP during the period 1990 to 2000.[1477] Additionally, it shows how many shares were held by the Enron ESOP and the total value of the Enron ESOP assets during each year of the period. At the end of 2000, the total value of the ESOP assets exceeded $1 billion. As a result of the bankruptcy, the value of the ESOP assets was minimal.

[1475] Part II. B.3.

[1476] Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001847.

[1477] 1990 was the first year for which Joint Committee staff reviewed data.

Table 3.–The Enron ESOP–Number of Participants, and Shares Held and Total Value of Assets

Year	Number of Active, Retired, or Separated Participants with Account Balances or Beneficiaries of Deceased Participants Entitled to Benefits at End of Year	Shares of Enron Stock at End of Year (millions)	Total Value of ESOP Assets at End of Year (millions of dollars)
1990	9,396	17.2	469.2
1991	10,111	25.6	602.4
1992	10,664	33.8	788.0
1993	11,463	49.6	952.7
1994	11,262	32.5	827.6
1995	11,172	20.1*	797.1
1996	11,056	36.9*	689.9
1997	10,826	29.5	562.8
1998	10,585	**	624.6
1999	8,209	18.1	807.3
2000	6,920	12.8	1,062.9

Source: Forms 5500 for the Enron ESOP for the applicable years, unless otherwise indicated.
*Source: *Tittle v. Enron Corp.*, S.D. Texas, No. H-01-3913, First Consolidated and Amended Complaint (filed April 8, 2002), at paragraphs 173-174.
**No data available.

Discussion of Issues

The precipitous decline in the value of Enron stock raises the question of whether, at some point, plan fiduciaries have an obligation to question whether employer securities is an appropriate investment for a plan despite plan provisions directing such investment. As noted above, courts have sometimes found this issue to be difficult, because ERISA's general fiduciary standards and the policies underlying the present-law rules relating to employer securities have some inherent conflict. The questions raised in this regard in the case of the Enron ESOP are similar to those raised in other cases in which this issue has arisen.

These issues may include questions of law as well as fact, including: who are the relevant plan fiduciaries and what were their respective roles under the terms of the Enron ESOP and the related trust; the specific terms of the Enron ESOP and trust regarding investment authority and the types of investments that could be made; and at what point fiduciaries should have acted. These issues are being addressed in litigation. A discussion of the Enron ESOP and the relevant law has been provided here in order to provide a more complete picture of Enron qualified plans.

In addition to the issues raised specifically with respect to the Enron ESOP, the overall structure of Enron's qualified plans raises issues regarding appropriate levels of diversification in retirement plans, and ways to achieve such levels. These issues are addressed in Part II.C.5., below.

4. Change of recordkeepers under the Enron Savings Plan

Present Law

In general

The selection and change of third party service providers to qualified retirement plans are subject to ERISA's general fiduciary provisions.[1478] At the time of the Enron bankruptcy, there were no specific rules addressing blackout periods, so the general fiduciary rules were the only governing provisions. Advance notice of blackouts with respect to plans, i.e., periods during which participants are unable to engage in certain transactions due to a change in recordkeepers or other reasons, is now required under the Sarbanes-Oxley Act of 2002.[1479] These specific notice provisions now apply in addition to the general fiduciary rules. Even though the notice requirement did not apply at the time of the Enron blackout, a description is provided here for completeness.

In addition to the notice requirement, the Sarbanes-Oxley Act also included a provision prohibiting a director or executive officer of a publicly traded corporation from trading in the stock of the employer during a blackout period in certain circumstances.[1480]

Notice of blackout periods under the Sarbanes-Oxley Act

In general

The Sarbanes-Oxley Act amended ERISA to require the plan administrator of an individual account plan[1481] to provide advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.[1482] Generally, notice must be provided at least 30 days before the beginning of the blackout period. In the case of a blackout period that applies with respect to employer securities, the plan administrator must also provide timely notice of the blackout period to the employer (or the affiliate of the employer that issued the securities, if applicable).

Definition of blackout period

A blackout period means any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or

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[1478] These provisions are discussed in Part II.A.4., above.

[1479] Pub. L. No. 107-204, enacted July 30, 2002.

[1480] *Id.* at sec. 306(a).

[1481] An "individual account plan" is the term generally used under ERISA for a defined contribution plan. The notice requirement does not apply to one-participant plans.

[1482] ERISA sec. 101(i), as enacted by section 306(b) of the Sarbanes-Oxley Act of 2002.

diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary, under a qualified domestic relations order.

Timing of notice

Notice of a blackout period is generally required at least 30 days before the beginning of the period. The 30-day notice requirement does not apply if (1) deferral of the blackout period would violate the fiduciary duty requirements of ERISA and a plan fiduciary so determines in writing, or (2) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator and a plan fiduciary so determines in writing. In those cases, notice must be provided as soon as reasonably practicable under the circumstances unless notice in advance of the termination of the blackout period is impracticable.

Another exception to the 30-day period applies in the case of a blackout period that applies only to one or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or the employer and that occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of the merger, acquisition, divestiture, or similar transaction. Under the exception, the blackout notice requirement is treated as met if notice is provided to the participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.

The Secretary of Labor may provide additional exceptions to the notice requirement that the Secretary determines are in the interests of participants and beneficiaries.

Form and content of notice

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

Notices provided in connection with a blackout period (or changes thereto) must be provided in writing and may be delivered in electronic or other form to the extent that the form is reasonably accessible to the recipient. The Secretary of Labor is required to issue guidance regarding the notice requirement and a model blackout notice.

Penalty for failure to provide notice

In the case of a failure to provide notice of a blackout period, the Secretary of Labor may assess a civil penalty against a plan administrator of up to $100 per day for each failure to provide a blackout notice. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

Factual Background

In 2001, Enron Corp. changed recordkeepers under the Enron Savings Plan from Northern Trust Retirement Consulting ("Northern Trust") to Hewitt Associates ("Hewitt"). As part of this change, there was a period of approximately 2-½ weeks during which plan participants could not make investment changes (the "blackout"). During the blackout, the price of Enron stock fell.

Background--prior recordkeeper searches[1483]

During the period which was the subject of the Joint Committee staff review, Enron undertook a number of searches for new third party service providers for various benefit plans, including the Enron Retirement Plan, the Enron Savings Plan, and health and welfare benefit plans (i.e., plans other than retirement plans). In some, but not all cases, these searches resulted in a change of recordkeeper. Some of these searches related to efforts by Enron to outsource more of its benefit plan administration. For example, the Enron Retirement Plan had been administered in-house and was outsourced in 2000. Enron also looked for new third party service providers with respect to all its benefit plans, in 2000, including pension and welfare plans, but decided not to change recordkeepers for the Enron Savings Plan at that time.

With respect to the Enron Savings Plan specifically, a new recordkeeper search was begun in 1998 as a result of the acquisition by Enron of Portland General Electric ("PGE") in 1997. PGE also had a 401(k) plan, and Enron wanted to merge the two plans. While similar in many respects, the two plans had a number of differences. For example, the PGE match was at a higher level than the match in the Enron Savings Plan; the Enron Savings Plan had daily valuations, whereas PGE had monthly valuations. Many other plan features also varied.

The plans also had different recordkeepers. The Enron Savings Plan had Northern Trust Retirement Consulting ("Northern Trust") as recordkeeper, and the PGE plan recordkeeper was

[1483] Background information relating to prior searches for recordkeepers is based primarily on documents provided by Enron in response to the Joint Committee staff requests for information. Documents relating to prior recordkeepers encompasses almost an entire box of information. Relevant document numbers include a range of documents from EC000022700-23700. Information was also obtained from minutes of Administrative Committee meetings, interviews with Enron employees, and the Timeline Presented to the Administrative Committee (EC000001909-16), which is included in Appendix D to this Report.

Towers Perrin. While merging the two plans did not necessarily require hiring a new recordkeeper, in mid-1998, Enron engaged Watson Wyatt Worldwide ("Watson Wyatt") to assist in the search for a new recordkeeper. A letter to Enron from Watson Wyatt regarding the search process states the understanding that Enron was not at that time dissatisfied with the services being provided by Northern Trust, but would like to "test the waters" to see what other options might be available for the combined Enron/PGE plan.[1484] At that time, Enron records indicate the goal was to have the search completed by October 31, 1998, with a proposed implementation date of July 1, 1999.

According to documents provided by Enron, requests for information were sent out to 33 vendors in July 1998. The requests for information sought responses to a variety of questions relevant to the plans, such as the ability to perform daily valuations and administer self-directed accounts. Enron received responses from 17 vendors (10 of whom declined to provide service if assets did not change to their respective funds), seven vendors declined to participate, and nine vendors did not respond. Watson Wyatt compiled the responses and provided analysis and evaluations to Enron.

During the next few months, requests for proposals were sent to a number of vendors, with follow-up questions in some cases. Watson Wyatt again compiled and analyzed the responses in a number of areas. A weighted quantitative evaluation of the responses was provided. This process led to site visits by Enron to the top two candidates Fidelity Institutional Retirement Services Company ("Fidelity")--Fidelity and Northern Trust. Documents provided by Enron indicate that the decision to hire Fidelity was made at the end of October 1998. However, as described in more detail below, it was then decided to postpone any change in recordkeepers until after the merger of the two plans.

The merger of the plans went forward starting in June 1999. The merger resulted in a blackout period for PGE plan participants that was expect to last about 8-12 weeks, during the period from June 15 through September 3. Documents provided by Enron indicate there was a trust reconciliation issue that caused the blackout period to extend until September 15, 1999. Plan participants were apparently notified of the change in the blackout period by mail. Enron plan participants also had a blackout period that lasted from August 30, 1999, to September 3, 1999, even though they did not have a trustee or recordkeeper change. The blackout was said to be necessary in order to complete the merger of the approximately 3,400 PGE participants into the plan.

The involvement of the Enron Savings Plan Administrative Committee in the search for the new recordkeeper and the merger of the two plans is unclear. The first reference to the merger appears in the Administrative Committee meeting minutes of September 17, 1998, wherein it was reported that a member of the Enron Benefits Department updated the Administrative Committee on the work being done by the Enron and PGE Human Resources and Treasury Departments relating to the merger of the two plans. At that time, a joint meeting of

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[1484] Enron Corp. Service Provider Vendor Search RFI Teleconference notes prepared by Watson Wyatt, EC000022724-27.

the Administrative Committees of both plans on savings plan issues was scheduled for November 11, 1998.

According to Enron, there are no minutes of Enron Savings Plan Administrative Committee meetings from October 19, 1998, through October 26, 1999. However, a document prepared by Enron employees and provided to the Administrative Committee in connection with the recordkeeper search in 2001, indicates that the Administrative Committee was briefed on the transition on November 4, 1998. This document says that in November 1998, the "[d]ecision [to change recordkeepers] was reviewed for impact to Non-Qualified Deferral (NQ) Plans wherein it was determined that the recent vendor change for the NQ plans was to go live 3/99 at Northern Trust. A new recommendation was made to not move the 401(k) recordkeeping until after the PGE plan merger and [Enron's] Qualified and Non-Qualified plans were stabilized." The document also says that on November 4, 1998, "Presentations were given to both the PGE and [Enron's] administrative committees notifying both of the recommendation. In subsequent meetings, the recommendation to stay with Northern Trust was approved until the plans were stable. At this point, there was no more work on the move away from Northern Trust until after the PGE plan had been merged."[1485]

Documents provided by Enron to the Joint Committee staff include a document dated November 1998 titled: "Presentation to the Administrative Committees: The 1999 Enron/Portland General Savings Plan." This document includes a schedule of events, which indicates that in November 1998 there would be "presentation to the Committees for approval." The document also includes information relating to differences between the two plans, background on the recordkeeping search (including a list of possible service providers and their rankings based on responses to requests for information), the recommendation to hire Fidelity and background information regarding why, fee comparison information, discussion of adding a self-directed account, and implementation issues. It is unclear whether this document was presented to the Administrative Committee. Despite the fact that Administrative Committee minutes do not reflect discussion of this process, one committee member interviewed by the Joint Committee staff described the merger process as one of two major events that occurred during his tenure on the Administrative Committee.

2001 search process

Reasons for looking for new recordkeeper

Enron personnel and records indicate that the search for a new recordkeeper stemmed from customer service issues with respect to the prior recordkeeper (Northern Trust), such as difficulty dealing with the number of employees and transactions and data issues with respect to government filings. Enron personnel also felt that the level of technology services provided by Northern Trust in connection with the Savings Plan was not sufficient to satisfy the demands of Enron employees. Northern Trust personnel have testified regarding Enron comments on customer service issues and stated that Northern Trust had been working with Enron to correct

[1485] Timeline Prepared for Administrative Committee, EC000001869-EC000001875. This document is included on Appendix D to this Report.

identified problems, such as responses to telephone inquiries, and that progress in correcting problems had been made. Northern Trust personnel also testified to their understanding that Enron prided itself on its own technology and that Enron felt that the Northern Trust trading desk was not as advanced as the Hewitt operations.[1486] Enron personnel told the Joint Committee staff that although they had been working with Northern Trust to correct problems, they eventually determined that it would be appropriate to look for a change of recordkeepers.

<u>Selection process for new recordkeeper (Enron stock price: $78.79 on February 1, 2001; $68.68 on March 1, 2001; $56.57 on April 2, 2001; $63.41 on May 1, 2001)</u>

Enron employees told the Joint Committee staff that Enron had a task force consisting of four to five employees involved in the process of engaging a new recordkeeper for the Enron Savings Plan. While much of the detail work was handled by a single person, Enron personnel have stated that the decision-making process was a joint process. At the same time, Enron was also interested in a new recordkeeper with respect to the 1994 Deferral Plan and Expat Deferral Plan. According to Enron personnel, they had been experiencing customer service issues with respect to the 1994 Deferral Plan for some time. However, the volume of business generated by that plan was low so that most companies were not willing to bid for that plan alone, they would bid only in conjunction with a larger plan such as the Enron Savings Plan. When a decision was made to go forward with a change in recordkeepers for the Enron Savings Plan, personnel responsible for the 1994 Deferral Plan and Expat Plan were also involved and the search was a joint search.[1487]

As they had before, Enron engaged Watson Wyatt to assist in the search process and to update the work from the earlier searches. The search process began in early 2001.[1488] Watson Wyatt did a research screening of at least six companies, including Northern Trust and Hewitt. As part of this process, they sent a list of questions to companies that might be interested in bidding. They rated each of the companies in a variety of areas, such as administration, background, customer service, communication and education, implementation, investments, reporting, legal and compliance, and systems and technology. The rating was based on responses to questions in all of these areas.[1489] This process narrowed down the number of firms considered in the search process.

[1486] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 51 (Feb. 5, 2002).

[1487] The change in recordkeepers under the deferral plans is also discussed in Part III.C.1., below.

[1488] Letter from Watson Wyatt to Cynthia Barrow, dated January 26, 2001, EC000022055-58.

[1489] Pre Screen Vendors, EC00022066-78. Pre Screen Vendors, EC000022110-28.

A request for proposal was sent to four vendors in 2001, with an initial date for the response of March 9, 2001.[1490] The date was extended to March 13, 2001, due to adverse weather conditions in the Northwest United States.[1491] The 16-page request for proposal included a statement of objectives, requirements for the service provider, plan summary information, and questions to be answered with respect to a variety of administrative and investment issues. For example, the request for proposal indicates a need for daily valuation, interactive voice response systems, transactional and information web access, and a brokerage investment option. The request for proposal indicated July 1, 2001, as the date the conversion was to be completed and the system operational. The request for proposal asked respondents to describe the blackout period that was expected to occur during the conversion process.[1492]

The process was similar to the process for the 1998 recordkeeper search. Watson Wyatt evaluated responses and provided quantitative weighted ratings overall and in specific areas. Follow-up questions were provided in some cases. Specific questions were asked with respect to concerns Enron had identified with the current recordkeeper. After Watson Wyatt consolidated responses, an Enron task force met to evaluate the responses from a cost and service standpoint. This led to the selection of two finalists--Hewitt[1493] and another company.[1494] Enron employees made site visits to both potential recordkeepers. Among other things, they looked at the computer capabilities and customer service. They listened to customer service calls to monitor the quality of responses.

Enron personnel told the Joint Committee staff that, after making the site visits, the team working with the Enron Savings Plan met with the group working with the 1994 Deferral Plan and Expat Deferral Plan and a joint decision was made. Documents provided by Enron say that the last firm, other than Hewitt, was eliminated due to cost to the program for the nonqualified deferred compensation plans.

[1490] EC000022082. Other documents indicate requests for proposals were sent to six companies. Timeline prepared for Administrative Committee, EC000001872.

[1491] EC000022099.

[1492] Enron Corp. Savings Plan Request for Proposal, EC000022083-98.

[1493] Enron was seeking a service provider for both recordkeeping and trust services. Because Hewitt does not provide trustee services, Hewitt obtained a quote from Wilmington Trust Company, and Hewitt and Wilmington Trust Company made submissions in response to the Enron request for proposal. Wilmington Trust Company was chosen as the new trustee to replace Northern Trust Company. Committee on Governmental Affairs, United States Senate. *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 107 (Feb. 5, 2002).

[1494] *See* Summary of All Proposals Total Weighted Score Comparison, EC000022164-66.

The Administrative Committee was notified on May 3, 2001, of the decision to hire Hewitt as the new recordkeeper. Northern Trust was notified in July 2001 that Enron would transfer recordkeeping services for the Enron Savings Plan to Hewitt.[1495]

The response to the request for proposal submitted by Hewitt contains the following regarding the blackout period:

> There will be a blackout period while the final valuation is performed on the prior recordkeeping system, balances are reconciled, and accounts are established on the system. The duration of the blackout is dependent on the prior valuation cycle and the timeliness of final balances from the prior recordkeeper. Typically, Hewitt does not require a blackout period of longer than two weeks (this includes one week the prior recordkeeper needs to send us the conversion data and reports)[.][1496]

The 2001 transition process

Deciding on the blackout dates (Enron stock price: $53.04 on June 1, 2001; $48.30 on July 1, 2001; $45.61 on August 1, 2001; $29.15 on September 1, 2001)

According to testimony of Hewitt, Hewitt and Enron signed a letter of intent in June 2001. The letter of intent contemplated that Hewitt would begin work immediately, and would be compensated for the work it performed if a final contract was not agreed to. Pursuant to the letter of intent, during June 2001, Enron and Hewitt worked on what Hewitt refers to as the "Delivery Model," which describes the services Hewitt would normally expect to provide as a recordkeeper, additional services they would provide to Enron, and services that Hewitt would not provide.[1497]

During July 2001, Hewitt began what they refer to as the "Requirements Process." They describe this as a "detailed and comprehensive" process intended to identify precisely the services to be performed and how and when they would be provided. Transition issues with respect to the change of recordkeepers was addressed at this time as well. Hewitt stated that Enron had proposed a "live date" of October 23, 2001, and that Hewitt identified all work needed to effect the transition and target dates for completion in order to meet the proposed live date.[1498]

[1495] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 101 (Feb. 5, 2002).

[1496] Hewitt Associates, Request For Proposal - Savings Plan Enron Corporation (March 12, 2001). EC000022242-91, at EC000022246.

[1497] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 107-08 (Feb. 5, 2002).

[1498] *Id.* at 108.

During this time, there were discussions involving Enron and the old and new trustees and recordkeepers. After discussion, Enron decided on a blackout period that would begin on September 14, 2001, and end on the live date of October 23, 2001. The planned blackout period was two-tiered: (1) participants would be restricted from taking loans or withdrawals or making rollover contributions, and making similar transactions from the close of trading on September 14, 2001, to October 23, 2001; and (2) participants would be restricted from changing investments from the close of trading on September 26, 2001, through October 23, 2001. Under this schedule, the asset transfer from Northern Trust to Wilmington Trust Company was to take place on October 1.[1499]

According to Hewitt, transition issues were revisited in mid-August 2001. Hewitt says they were informed that Enron had decided to make some plan design changes that would affect recordkeeping requirements and of which Hewitt was not previously aware. These changes included (1) replacing three Vanguard investment funds with Fidelity funds, and (2) eliminating Enron Oil and Gas Stock Fund as an investment option.[1500]

Enron personnel told the Joint Committee staff that they wanted to eliminate the Enron Oil and Gas Stock Fund because Enron Oil and Gas ("EOG") had been sold and was no longer part of the Enron group. Since Enron had no further connection with EOG, it was not believed to be an appropriate fund. Enron benefits department personnel determined that plan amendments needed to be made to eliminate the fund, and did not want to proceed until the Administrative Committee had acted on the amendments. These issues were initially discussed at the May 3, 2001, meeting of the Administrative Committee,[1501] and were approved at the Administrative Committee meeting on August 15, 2001.[1502]

Hewitt indicated that they would need approximately two to three weeks of additional time to make the necessary adjustments to their systems to reflect these changes. Enron decided to provide more time, and moved the proposed target dates back by about one month. Under the revised timetable, the new live date was November 23, 2001. The asset transfer to the new trustee was scheduled for November 1, 2001. The blackout period was now as follows: (1) participants would be restricted from taking loans or withdrawals or making rollover contributions or making similar transactions from the close of trading on October 19, 2001, to

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[1499] *Id.* at 109-110.

[1500] *Id.*

[1501] At that meeting, the Administrative Committee requested additional information with respect to the change from Vanguard Funds to Fidelity funds, including further information regarding comparability of the funds.

[1502] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 110 (Feb. 5, 2002); interviews by Joint Committee staff of Enron employees.

November 19, 2001: and (2) participants would be restricted from changing investments from the close of trading on October 26, 2001, to November 19, 2001.[1503]

<u>October 4, 2001: initial notice of blackout periods mailed to plan participants (Enron stock price $33.10)</u>

Hewitt representatives testified that, at Enron's request, they prepared a draft communication to employees regarding the change in trustee, recordkeeper, and certain changes in investment options. This draft was reviewed by Enron and Hewitt incorporated changes from Enron into their draft. The communication was mailed to participants by Hewitt on October 4, 2001, using address lists provided by Enron and Northern Trust. Hewitt testified that at this point it had not received the data necessary to prepare mailing labels. Hewitt personnel have testified that Hewitt did not participate in the preparation of mailing of any other communications materials regarding the blackout, although they are aware that other communications were sent.[1504]

This initial communication, titled "Enron Corp. Savings Plan Changes, Money in Motion" a six-page document.[1505] It includes the following under "What's New?"

"In late November, Hewitt Associates will become our new administrator for the Enron Corp. Savings Plan, providing improved customer service and quicker processing of your requests." It states that on November 20, the Fidelity Freedom Funds will replace the Vanguard LifeStrategy Funds. The communication also states that all investment funds will now be listed by asset class in order of risk factor, from the least risky to the most risky. It shows the mapping of the Vanguard funds to the Fidelity funds, i.e., the comparable Vanguard funds to which assets in each of the Fidelity funds will be transferred.[1506]

Under "Transaction Action Items" the document includes the following. "During the transition period, you will NOT have access to your funds. Your fund balances will remain invested in the market based on your fund choices as of 3:00 PM October 26."[1507] The document states that all activity must be completed by the dates indicated and explains that the reason for this transition is that fund balances of approximately $1.4 billion for 24,000 participants will be moved and balanced and that each record must be correct. It explains that once the records are balanced, investment returns and November payroll contributions will be added.[1508]

[1503] *Id.*

[1504] *Id.* at 110.

[1505] This document is included in Appendix D. EC000021560-65.

[1506] *Id.*

[1507] EC000021564. (Emphasis in original.)

[1508] *Id.*

The document includes the following as blackout dates:

- October 19, 3:00 PM CST as the last date for loan requests, in-service withdrawals and distributions, hardship withdrawals, loan payoffs, rollovers into the plan and SDA Schwab Fund Liquidation;
- October 26 3:00 PM CST as the last date for investment fund balance transfers/allocation changes and contribution rate changes;
- November 20 8:00 AM CST as the date transition ends. Savings plan system opens with all the great new features.[1509]

The document also describes changes that will take place, including a new online investment education and advice tool that is described as helping to turn financial dreams into reality.[1510]

October 16, 2001: Enron reports a loss (Enron stock price $33.84)

On October 16, 2001, Enron reported that it had lost $618 million for the quarter ended September 30, 2001, after taking into account after-tax nonrecurring charges of $1.01 billion. Enron also announced it was making a $1.2 billion reduction to shareholders' equity.

October 16, 2001, 11:10 PM: electronic mail to employees (Enron stock price $33.84)

An electronic mail message was sent to "All Enron Employees United States Group @ Enron."[1511] stating that, for all Enron Savings Plan participants, Friday, October 19 at 3:00 p.m. will be the last day to request a loan or a loan payoff or requests an in-service or hardship withdrawal. For self-directed account participants, Friday, October 19, 3:00 p.m. is given as the last day to make trades in the brokerage account to move holdings in kind.

The message states that other transactions, such as contribution rate changes and investment fund transfers, will continue until 3:00 p.m. on October 26.

October 19, 2001: blackout period with respect to distributions begins (Enron stock price $26.05)

On October 19, 2001, the blackout period with respect to loans and distributions began as scheduled.[1512]

1509 *Id.*

1510 EC000021562.

1511 EC000021573. A copy of this message is included in Appendix D to this Report.

1512 Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 111 (Feb. 5, 2002). Timeline provided to

October 22, 2001, 10:28 pm: electronic mail message sent to employees (Enron stock price $20.65)

On October 22, 2001, an electronic mail message was sent to same group as the October 16 electronic mail message.[1513] The message cautioned that "October 26 is fast approaching," and reminded plan participants that Friday October 26 at 3:00 p.m. will be the last day to transfer investment fund balances and make contribution allocation changes, change the contribution rate for the November 15th payroll deductions, and enroll if the employee was hired before October 1.

The message contains a reminder regarding the change in investment funds from Vanguard to Fidelity, and states that funds will remain invested in the funds chosen as of 3:00 p.m. October 29 until 8:00 a.m. November 20, when the Enron Savings Plan reopens with "great new features."

The message provides contact information for those needing help during the transition.

October 25, 2001: Reconsideration of decision to move forward with blackout period for investment changes; electronic mail reminding employees of pending blackout (Enron stock price $16.35)

On the eve of the beginning of the blackout period for investment changes, there was concern in the benefits department about the timing of the blackout and the falling stock price. Mikie Rath, Benefits Manager, Enron Corp., testified that one employee had commented that the timing on the blackout was horrible, and that she tended to agree, but that the process had been well underway for some time.[1514] In addition, an employee had submitted an advance question for an all employee meeting to be asked Mr. Lay, "Now that I have lost all my retirement, what do I do? I have been here 20 years." Ms. Rath also indicated that there had been an all employee meeting in October and the facts had started to come out regarding problems of Enron.[1515]

In response to these concerns, Ms. Rath contacted Northern Trust on October 25, 2001, regarding the possibility of postponing the blackout date for investments until January 2002. Northern Trust personnel responded (on that date) that the date could be postponed, but that a January date could be problematic due to year-end demands on recordkeepers. They suggested as an alternative March 31, 2002.[1516]

Administrative Committee, EC000001913. This timeline is included in Appendix D to this Report.

1513 EC000021574. A copy of this message is included in Appendix D to this Report.

1514 Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 55-56 (Feb. 5, 2002).

1515 *Id.* at 50, 56-57.

1516 *Id.* at 101-102.

Ms. Rath also contacted Hewitt on October 25, 2001, regarding either postponing the blackout date or shortening the period of the blackout. Hewitt responded on the same day that accelerating the live date would present a number of risk issues, including adverse effects of plan participants of restarting plan activities in the event the shortened period resulted in accurate plan records and possible compromising of the services that Hewitt could provide. They also pointed out a number of factors that Enron should consider in determining whether to delay the blackout, including extra cost, staffing implications, and the inability to predict when Enron stock would be less volatile.[1517]

After discussions with Hewitt and Northern Trust, Ms. Rath consulted her superior, the Senior Director of Benefits, Cynthia Barrow. They consulted their superior, Cindy Olson, the Executive Vice President, Human Resources, Employee Relations and Building Services as to whether to go forward with the blackout. Ms. Olson consulted two other Human Resources Vice Presidents and another Enron employee, and also contacted Enron's ERISA counsel. Ms. Olson said that she consulted with the other Human Resources Vice Presidents because of their general experience and that she consulted with the other Enron employee because that person had made comments regarding the timing of the blackout. All of these persons thought that the blackout should go forward. The ERISA counsel advised that they should go forward with the blackout because of the difficulty of notifying all plan participants of the postponement, particularly the inactive employees who did not have access to electronic mail. One employee suggested that another electronic mail be sent reminding participants about the blackout.[1518]

The decision was made to go forward with the blackout as planned and Enron notified Hewitt and Northern Trust by telephone that a decision had been made to go forward with the blackout period as planned.[1519]

According to documents provided by Enron, on October 25, at 11:44 p.m. another electronic mail message was sent to the same group of active employees reminding them that the blackout was going to take place. Enron personnel indicated that no additional communication was sent to other plan participants at that time.

The electronic mail message contained the following notice: "If you are a participant in the Enron Corp. Savings Plan, please read this very important message." The message indicated that there had been concern about the timing of the move to a new administrator and the restricted access to funds during the transition period. The message stated "We have been working with Hewitt and Northern Trust since July. We understand your concerns and are

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[1517] *Id.* at 54-55, 111-112; interviews of Enron employees by Joint Committee staff.

[1518] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 55-58; interviews of Enron employees by Joint Committee staff.

[1519] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 102, 112. (Feb. 5, 2002).

committed to making this transition period as short as possible without jeopardizing the reconciliation of both the Plan in total or your account in particular."[1520]

The message also included "reminders" that "the Enron Corp. Savings Plan is an investment vehicle for your **long-term** financial goals" and that "the Enron plan will continue to offer a variety of investment opportunities with different levels of risk."[1521] The message reminds participants to review their overall investment strategy and weigh the potential earnings of each investment choice against its risks before making decisions.

The message concludes: "For that reason, it is critical that **ALL** trades among your investment funds be completed by **3:00 PM CST Friday, October 26 before the transition period begins.**"[1522]

<u>October 26, 2001: 11:58 AM; electronic mail message to Enron employees[1523] (Enron stock price $15.40)</u>

On the morning of October 26, 2001, an electronic mail message was sent to same group as the earlier electronic mail messages. The message contained a "final reminder" of the October 26 blackout date and said that investment funds would be frozen as of 3:00 p.m. on that date for the duration of the transition period.[1524]

<u>October 30, 2001: Hewitt requested to come to meeting of Administrative Committee (Enron stock price $11.16)</u>

A Hewitt representative testified that she was contacted by the Enron Benefits Department on October 30, 2001, and asked to come to a meeting of the Administrative Committee on November 1, 2001. She said Hewitt was asked to be prepared to discuss the feasibility of shortening the blackout period and accelerating the live date to November 13, 2001.[1525]

<u>November 1, 2001: Administrative Committee meeting (Enron stock price $11.99)</u>

Documents provided by Enron indicate that, due to the volatility of Enron's stock and the fiduciary responsibility of the Administrative Committee, a special meeting of the

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[1520] EC000021575. A copy of this message is included in Appendix D to this Report.

[1521] *Id.*

[1522] *Id.*

[1523] EC000023713.

[1524] EC000021576. A copy of this message is included in Appendix D to this Report.

[1525] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 113 (Feb. 5, 2002).

Administrative Committee was held on November 1, 2001, to discuss the prudent steps that the Administrative Committee might need to consider with respect to the Enron Savings Plan, as well as other Enron qualified plans. Minutes of the meeting indicate that it was attended by four of the Administrative Committee members, a newly engaged attorney representing the Administrative Committee,[1526] Benefits Department personnel, three representatives from Hewitt, and Enron's ERISA counsel.

The Administrative Committee was presented with a snapshot of the current Enron stock holdings in the Enron Savings Plan and Enron ESOP as of October 26, September 30, and January 1, 2001. The Administrative Committee was advised that it had no duty to issue cautionary advice on the value or risk of holding Enron stock because the Administrative Committee does not act in the capacity of an investment advisor, but is charged with administering the plans in accordance with the terms of the plan documents and in compliance with ERISA. It was decided that the Administrative Committee should hire an independent investment advisor to monitor Enron stock, and a member of the Enron Treasury Department was directed to conduct the search.[1527]

At the Administrative Committee meeting, Hewitt summarized the decision to move forward with the Enron Savings Plan transfer and discussed the implications of attempting to unwind the transaction, i.e., have Northern Trust return to their prior role and postpone the date of transferring recordkeeping to Hewitt. Hewitt indicated that the asset transfer from Northern Trust to the new trustee had already taken place, and the old trustee would have to be contacted if that were to be undone. Hewitt stated that unwinding would extend the blackout period beyond November 20.

Hewitt was asked if it were possible to speed up the process to grant limited access to accounts by all participants by November 13. Hewitt stated that it was to receive data from Northern Trust on November 7, and that it would take five days to review and that the ability to shorten the blackout period was dependent on the quality of data received.[1528]

Administrative Committee minutes state that the Administrative Committee agreed that it was most prudent to move forward with the transition and asked the Benefits Department to set up an external website and to mail a postcard to all participants informing them to check for updates on the transition. It was decided that this was the most prudent and reasonable action to take under the circumstances. The minutes also state that, with respect to the Enron ESOP, it was determined that the Administrative Committee had no duty to take action since adequate

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[1526] The previous legal counsel for the Administrative Committee had had to resign due to conflicts of interest that had developed. It was agreed that the November 1, 2001, Administrative Committee meeting that the new attorney would represent the Administrative Committee at this meeting and the next pending a further agreement regarding his services.

[1527] Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001).

[1528] *Id.* Committee on Governmental Affairs, United States Senate, *Retirement Insecurity; 401(k) Crisis at Enron*, S. Hrg. 107-378, at 113 (Feb. 5, 2002).

communication has been given to participants over the years. The Administrative Committee would review the recommendations of the Investment Advisor as to what, if any, action might be required.

The Administrative Committee also determined that weekly meetings should be held during the transition period, and the next meeting date was scheduled for November 6. At that time, candidates for investment advisor to the Administrative Committee would be presented.

November 6, 2001: Administrative Committee meeting[1529] (Enron stock price $9.67)

The November 6, 2001, meeting of the Administrative Committee was attended (by person or via phone) by five members of the Administrative Committee, Benefits Department personnel, Enron ERISA counsel, counsel for the Administrative Committee, and two representatives from Hewitt.

The Administrative Committee discussed retaining an investment advisor to give guidance to the Administrative Committee on Enron stock in relation to the blackout period as well as current market conditions surrounding Enron stock.

Benefits Department personnel provided an update of the status of participant communications and the transition process. It was reported that the website for participants to check for updates was operational as of the time of the Administrative Committee meeting, and that a notification postcard would be mailed to all participants on November 8. Hewitt informed the Administrative Committee that the transition was on target and that Hewitt would make every prudent effort possible to shorten the blackout period.

Pending lawsuits were also discussed.

November 7, 2001: data transfer from Northern Trust to Hewitt (Enron stock price $9.05)

On November 7, 2001, Hewitt received the data transfer from Northern Trust.[1530]

November 8, 2001: post card mailed to plan participants (Enron stock price $8.41)

At the request of Enron, Hewitt mailed a post card to plan participants on November 8, 2001. Hewitt says that they used participant address lists provided by Northern Trust and Enron in making the mailing.[1531] The post card stated that "Enron and Hewitt are committed to making this period as short as possible so we have established a phone number and a web address that

[1529] *See* Minutes of Administrative Committee Meeting (Nov. 6, 2001).

[1530] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity; 401(k) Crisis at Enron*, S. Hrg. 107-378, at 37 (Feb. 5, 2002).

[1531] *Id.* at 113-114.

enables you to get current information in a timely manner." The postcard also stated: "Stay connected to watch for an earlier access date."[1532]

November 13, 2001: blackout ends, Administrative Committee meeting (Enron stock price $9.98)

Enron and Hewitt report that the plan went "live" on November 13, 2001, at 8:00 am.

An Administrative Committee meeting was held on November 13, 2001, at which the Administrative Committee received an update of the status of the Enron Savings Plan transition. Benefits Department personnel reported that the Enron Savings Plan was "live" as of 8:00 am that morning and that the transition update website and phone line reflected this information. It was noted that the blackout had ended five days earlier than originally planned.

It was reported that on that day prior to the time of the Administrative Committee meeting, the plan website had experienced 200-250 hits and that the plan had not seen large movements in accounts.

The Administrative Committee chair requested that another electronic mail message be sent to employees to remind them that the transition period had ended.

An update on the investment advisor search was also provided at that time. It was reported that the selection process was expected to be finished by Friday, November 16, 2001.

Pending lawsuits were also discussed.

November 14, 2001, 9:07 PM:[1533] electronic mail to Enron employees notifying them that the blackout had ended on November 13 (Enron stock price $10.00)

An electronic mail message dated November 14, 2001, at 9:07 p.m. was sent to the same group of employees as previous electronic mail messages. The message announces an early end to the transition period and says that the internet site went live as of 8:00 a.m., November 13, the previous morning. It tells employees to log on to benefits.enron.com, to enjoy the new features.

This notice was sent 36 hours after the blackout had ended. Enron personnel interviewed by the Joint Committee staff were not able to specifically explain the delay. Joint Committee staff were told that the process for sending electronic mails to all employees was to send the message to a center for transmittal, and they were sent when they got around to them.

[1532] *Id.* at 122.

[1533] EC000023719.

Miscellaneous employee communications

Documents provided to the Joint Committee staff by Enron include additional employee communications that are not dated. These appear to be printouts from a website. They are as follows.

Undated web printout[1534]

This document tells people to stay connected to watch for an earlier access date.

Undated web printout[1535]

This document appears to be printout from a web page. Heading: "Welcome to your Enron Corp. Savings Plan Transition Update Site"--a website designed to bring you the most up-to-date news on the progress of the Savings Plan move to Hewitt Associates.

The document says: Update November 13, 2001, "The Savings Plan system is up and live as of 8:00 AM!" Provides wed address and telephone number to check on account, check out the new website or make changes.

The document also contains the following (historical) information:

- November 7: All participant information for approximately 24,000 participants will transfer.
- Activities for week ending 11/2/01:
  a. November 1: Savings Plan and ESOP balances transferred to new trust, remaining assets in the three Vanguard LifeStrategy funds mapped to the new Fidelity Freedom Funds;
  b. October 26: 187 investment transfers completed by the 3:00 PM deadline;
  c. October 22: The self-directed brokerage account began its migration from Schwab to CSFBdirect. With the exception of some mutual funds, no holdings were liquidated.

Involvement of the Administrative Committee

The first mention of a search for a new recordkeeper specifically for the Savings Plan appears in the Administrative Committee meeting on May 3, 2001. The minutes state that Ms. Rath reviewed the reasons for and status of the Enron Savings Plan recordkeeper and trustee vendor search.[1536] Ms. Rath presented the decision for the move to Hewitt Associates as

[1534] EC000023718.

[1535] EC000023721.

[1536] The minutes refer to an Attachment III for this agenda item. The documents supplied by Enron in response to Joint Committee staff request do not label Attachment III or describe either the reasons for or the status of the search. The Joint Committee staff has been unable to determine whether we have the complete documents provided to the Administrative recordkeeper and Wilmington Trust as trustee. She recommended that the Administrative Committee approve the elimination of the Enron Oil and Gas Stock Fund and the switch from Vanguard LifeStrategy Funds to Fidelity Freedom Funds. The Administrative Committee requested Ms. Rath to work with another Enron employee to determine whether the Fidelity Funds are a comparable class and optimal fee structure. It was decided that these matters would be brought back to the committee at the August 15th meeting for a vote.

The materials provided to the Administrative Committee in connection with this agenda item are:

(1) A one-page paper titled "Vendor Search" which says "Revised 1998 request for proposal and sent to": **Hewitt Associates, Fidelity**, Prudential, PaineWebber/Putnam, Merrill Lynch, Invesco, Citistreet, JP Morgan/American Century (emphasis in original).

(2) A one-page paper titled "Investment Offerings" which refers to the elimination of the Enron Oil and Gas Stock Fund and the recommended investment switch from Vanguard to Fidelity Funds. Also says "Increase rebate from Fidelity by $59,172.57/qtr."

(3) A one-page paper titled "Enron Corp. Savings Plan Fund Performance Average Annual Total Returns For The Period ended March 31, 2001," which compares certain Vanguard funds with Fidelity funds.

(4) Four pages of materials which describe the Fidelity Freedom Funds.

(5) Three pages of materials describing Vanguard LifeStrategy Funds.

While not clear, the first document referenced above appears to mean that, in making the search, the 1998 request for proposal was revised and sent to the listed service providers. The two bolded names were the two final providers considered in the process, with Hewitt being chosen.

As discussed above, the Administrative Committee discussed the status of the blackout at the November 6, 2001, meeting.

<u>Subsequent Administrative Committee meetings</u>

Issues relating to the change of recordkeeper were discussed at some subsequent Administrative Committee meetings. At the Administrative Committee meeting on November

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Committee on this matter. The materials described here were included with the minutes and relate to this item, so it is assumed they were provided for this item.

20, 2001, a timeline of the events leading to the change of recordkeepers was discussed.[1537]

At the Committee meeting on December 11, 2001, copies of the following were provided to the Committee: employee communications and an updated timeline documenting the sequence of events relating to the blackout; a copy of the prior presentation by in-house counsel regarding the roles and responsibilities of the Administrative Committee; and a copy of a draft analysis by of the history of the stock price and the transition period.

<u>Enron Savings Plan holdings of Enron stock and transactions in Enron stock</u>

According to information provided by Ms. Rath to the Senate Committee on Governmental Affairs, at the time the blackout of investments began under the Enron Savings Plan on October 26, 2001, approximately 26 percent of the assets of the Enron Savings Plan were invested in Enron stock. At this time, approximately 58 percent of the Enron Savings Plan investment in Enron stock was due to participant investment elections with respect to participant contributions and 42 percent was due to Enron matching contributions. Approximately 22 percent of plan participants at that time were eligible to reinvest the matching contributions in something other than Enron stock.[1538]

For the two weeks preceding October 26, 2001, Enron Savings Plan participants were net buyers of Enron stock. During this period, Enron Savings Plan participants purchased $15.770 million of Enron stock and sold $11.553 worth of Enron stock. Also during this period, the number of Enron Savings Plan participants who bought Enron stock (501 participants) outnumbered plan participants who sold Enron stock (224 participants) by more than a two to one margin.[1539]

In contrast, for the two week period after the blackout period ended on November 13, 2001, Enron Savings Plan participants were net sellers of Enron stock.[1540]

<u>Enron Savings Plan provisions relating to third party service providers</u>

[1537] EC000001909-16. An updated copy of this timeline was presented at the December 11, 2001, Administrative Committee Meeting. A copy of this document is included in Appendix D to this Report.

[1538] Responses to questions for the record submitted on behalf of Mikie Rath by Swidler Berlin Shereff Friedman, LLP, *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 188-89 (Feb. 5, 2002).

[1539] Responses to questions for the record submitted by Northern Trust Retirement Consulting, LLC, *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 191 (Feb. 5, 2002).

[1540] Responses to questions for the record submitted by Hewitt Associates, *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 200 (Feb. 5, 2002).

Section XV.6 of the Enron Savings Plan (as amended and restated effective July 1, 1999) provides as follows:

> Notwithstanding any provision of the Plan or the Trust Agreement to the contrary, the Company may, in its sole discretion, engage any service provider which is not an employee or a subsidiary of the company to perform identified administrative serves with respect to the Plan ("Third-Party Administrative Services"). In the event that the Company so engages any such service provider to perform Third-Party Administrative Service, then notwithstanding any provision of the Plan to the contrary, the Company shall be fully responsible and accountable for selecting, credentialing, overseeing, and monitoring such service provider, including without limitation, evaluating the quality of performance, determining whether the fees charged are reasonable, and removing or replacing such service provider, as the Company deems to be necessary or appropriate in its discretion. Upon engaging a service provider to perform Third-Party Administrative Services, the Company shall advice the Committee in writing regarding such engagement identifying the service provider and the Third-Party Administrative Services which are to be performed by such service provider. Thereafter the Committee shall have not power, duty, or responsibility with respect to such Third-Party Administrative Services and shall have no power, duty or responsibility to monitor the performance of such service provider.

Discussion of Issues

Changes in third party service providers, including plan recordkeepers, are a normal part of qualified plan operation. Changes in recordkeepers may be made for a variety of reasons, including mergers of plans due to corporate transactions, problems with a current recordkeeper, fee differences between comparable providers, and investment or other plan changes. A change in recordkeepers generally will involve some interruption or blackout of normal plan operations; the extent and duration of the interruption will depend on a variety of factors, including the nature of services provided, plan features (e.g., whether loans are permitted and how often investment changes can be made), the number of plan participants and accounts, and the accuracy of the information being transferred. Some recordkeepers have commented that the latter feature is often a key element determining the length of any blackout period, because if the transferred data is not accurate, then the reconciliation process will take longer.

The decision of when to implement a change, i.e., when to impose a plan blackout, may also depend on a variety of factors, including when a change is likely to have the least effect on plan operations and administrative convenience for the new and old recordkeeper and others involved in plan administration. Once chosen, blackout dates may be changed due to necessity or convenience. For example, as described above, the blackout for the Enron Savings Plan was originally scheduled to begin on September 14, 2001. The date was deferred (prior to the time participants were notified of the change) because of a perceived need to make additional plan amendments. In some cases, unanticipated problems discovered either before a blackout has begun or during a blackout may result in a delay in implementing the blackout or a delay in restarting full normal plan operations.

Actions relating to a change in plan recordkeepers are subject to ERISA's general fiduciary provisions. Thus, if ERISA's fiduciary standards are not met in connection with a change in recordkeepers, including implementation of any blackout period, fiduciary liability for losses may be imposed.

The blackout associated with the Enron Savings Plan in November 2001 has received considerable attention due to the timing of the blackout and the decline in the value of Enron stock during this period. At the beginning of the blackout, Enron stock was $15.40 per share, compared to $9.98 per share at the end of the blackout. This is a 35 percent loss in value during the blackout period. However, Enron's stock price was falling before the blackout, and participants who wished to could have sold stock previously. For example, on February 1, 2001, Enron stock price was $78.79, and on October 25, 2001, the day before the blackout began, Enron stock price was $15.35. During this period, the price of the stock fell 81 percent. Until the blackout, there is some indication that Enron employees viewed Enron stock as a good investment. As described above, Enron Savings Plan participants were net buyers of Enron stock just before the blackout. During the blackout, attitudes regarding the future of the company may have changed; Enron Savings Plan participants were net sellers of Enron stock.

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, thereby possibly allowing plan participants to reduce their losses. In hindsight, the blackout was ill-timed. However, the actions of plan fiduciaries should be evaluated based on what was known (or should have been known) at the time.

One issue is whether the Administrative Committee (or other plan fiduciaries) should have acted to postpone the blackout. The Administrative Committee, although informed about matters related to the change in recordkeepers, did not become actively involved until the blackout was underway. At that point, the Administrative Committee became concerned with the possibility of accelerating the end of the blackout period.

On the eve of the blackout, the possibility of postponing the blackout due to volatility of Enron stock was considered by Enron personnel. Although the Administrative Committee was not formally involved in this decision, Cindy Olson, a member of the Administrative Committee and also, at the time, Executive Vice President, Human Resources and Community Relations, Enron Corp., was involved. In deciding to go forward with the blackout, she consulted with two other human resources vice presidents and Enron's ERISA counsel.[1541]

[1541] Committee on Governmental Affairs, United States Senate. *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 57. (Feb. 5, 2002); interview of Cindy Olson by Joint Committee staff.

According to Ms. Olson, the blackout was not postponed due to the difficulty of providing notice of the postponement to all plan participants.[1542] Part of this reasoning appears to be a concern that different groups of participants not be treated differently, and part of this appears to be due to the thought that if not all participants could be notified, the blackout would go into effect as a practical manner in any case for some participants. The first concern is undermined somewhat by the fact that during the transition process to the new recordkeeper, Enron routinely provided different notices to different groups of plan participants.

Issues involving possible fiduciary liability relating to the blackout are being addressed in litigation.

Another issue that arises with respect to the blackout is 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 notices to plan participants regarding the blackout. The Joint Committee staff did not undertake to determine whether all plan participants received notice of the blackout; however, the Joint Committee staff determined that various groups of plan participants received different notices regarding the blackout. In particular, active plan participants (i.e., those currently employed by Enron) were sent numerous electronic mail messages regarding the blackout. Inactive plan participants (i.e., those not currently employed by Enron) were not sent such electronic messages, nor comparable messages regarding the blackout. Thus, active employees received more reminders of the blackout than other plan participants. The exact group of employees to whom the messages were sent is unclear, as Enron did not respond to the Joint Committee staff request to explain the group electronic mail address.

Even active employees did not all receive the same notices. In particular, it appears that PGE employees did not receive all the electronic mail messages addressed to Enron employees generally.[1543] Enron employees indicated to the Joint Committee staff that this was due to technical error, and that it was not uncommon for electronic mail links to break down between Enron and its related companies.

5. Investments under the Enron Savings Plan

Present Law

ERISA

As discussed above,[1544] ERISA generally provides that a person is a plan fiduciary to the extent the fiduciary exercises any discretionary authority or control over management of the plan or exercises authority or control over management or disposition of its assets, renders investment

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[1542] *Id.*

[1543] A note from a PGE employee to Ms. Rath states that PGE employees did not receive the electronic mail messages of October 16, October 22, and October 26, 2001. EC000021566.

[1544] *See* Part II.A.3., above.

advice for a fee or other compensation, or has any discretionary authority or responsibility in the administration of the plan. Under ERISA, the person deciding how to invest the assets of a pension plan or selecting an investment manager generally is a fiduciary by virtue of those actions. ERISA imposes a number of specific fiduciary obligations on that person or entity, including the duty to diversify plan investments. Limited exceptions permit certain defined contribution plans to hold an unlimited amount of plan assets in employer securities.[1545]

Additionally, ERISA requires that plan assets be held in trust and that the trustee (or the named fiduciary that directs the trustee) have "exclusive authority and discretion to manage and control the assets of the plan."[1546]

Under a so-called safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants if plan participants control the investment of their individual accounts.[1547] Many employers design plans to meet the safe harbor in order to minimize fiduciary responsibilities. If the safe harbor applies, a plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions made by participants. This includes investments in employer securities made at the direction of a participant. Failure to satisfy the safe harbor rule means that plan fiduciaries may be held liable for the investment decisions of participants.

In order for the safe harbor to apply:

- the plan must provide at least three different investment options, each of which is diversified and has materially different risk and return characteristics;
- the plan must allow participants to give investment instructions with respect to each investment option under the plan with a frequency that is appropriate in light of the reasonably expected market volatility of the investment option;
- at a minimum, participants must be allowed to give investment instructions at least every three months with respect to at least three of the investment options, and those investment options must constitute a broad range of options (the three-month minimum rule);
- participants must be provided with detailed information about the investment options, information regarding fees, investment instructions and limitations, and copies of financial data and prospectuses; and
- specific requirements must be satisfied with respect to investments in employer securities to ensure that employees' buying, selling, and voting decisions are confidential and free from employer influence.[1548]

[1545] *See* Part II.A.4., above.

[1546] ERISA sec. 403(a).

[1547] ERISA sec. 404(c).

[1548] Additional limitations on the safe harbor include that it generally does not apply to any investment instruction of a participant which, if implemented, would result in an acquisition or sale of any employer security except to the extent that the securities are publicly traded and

In addition, the safe harbor applies only with respect to a transaction if a participant exercises independent control in fact with respect to the assets in his or her account. Whether a participant has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case. However, a participant's exercise of control is not independent in fact if:

- the participant is subjected to improper influence by a plan fiduciary or the employer
- with respect to the transaction;
- a plan fiduciary has concealed material nonpublic facts regarding the investment from
- the participant, unless the disclosure of the information by the plan fiduciary to the
- participant would violate other law not preempted by ERISA; or
- the participant is legally incompetent and the responsible plan fiduciary accepts the participant's instructions knowing this.

If the safe harbor is being relied upon, then participants must be permitted to change investment decisions in a manner consistent with that safe harbor or the safe harbor will not apply. Unless the safe harbor is being relied upon, there are no specific rules regarding how often a plan must permit participants to change investments.

Rules relating to investments in employer securities[1549]

In general, the assets of either a defined contribution plan or a defined benefit plan may be invested in employer securities. The rules relating to such investments differ for defined benefit plans and defined contribution plans. ERISA rules applicable to defined benefit plans prohibit such plans from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities. Most defined contribution plans, such as profit-sharing plans, stock bonus plans, pre-ERISA money purchase plans, 401(k) plans and ESOPs, generally are not subject to this limitation. In general, there is no limit on the amount that an employee can choose voluntarily to invest in employer securities in a defined contribution plan.

A defined contribution plan can generally require that some or all plan contributions must be invested in employer securities, with no opportunity to change investments. It is common for 401(k) plans to require that the employer match be invested in employer securities.

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are traded with sufficient frequency and in sufficient volume to assure that participant and beneficiary directions to buy or sell the security may be acted upon promptly and efficiently. ERISA reg. sec. 2550.404c-1(d)(2)(ii). In connection with such an acquisition or sale, the regulations also include requirements pertaining to the provision of information about such securities to participants and beneficiaries as well as voting, tender, and similar rights with respect to such securities. *Id.*

[1549] For a more detailed discussion of these rules, *see* Part II.A.4., above.

Factual Background

In general

Under the Enron Savings Plan, participants generally may contribute from one to 15 percent[1550] of their base pay in any combination of elective deferrals[1551] or after-tax contributions, subject to the limits prescribed by the Code. Materials reviewed by Joint Committee staff showed that participants generally could change the amount of their contributions monthly and could stop their contributions at any time.[1552] Such changes generally would be effective within one month.[1553]

Participants may also roll over amounts from other plans to the Enron Savings Plan in certain circumstances ("rollover contributions").

Enron contributed as matching contributions amounts equal to a percentage of participants' contributions to the Enron Savings Plan to participants' company contribution accounts.[1554] Enron's matching contributions under the Enron Savings Plan historically were invested "primarily" in Enron Corp. common stock and could not be reinvested by employees in another investment until they turned age 50.[1555]

The amount of Enron's matching contribution varied over time. Under the 1994 version of the Enron Savings Plan, Enron contributed 100 percent of participants' elective deferrals and after-tax contributions, up to six percent of their base pay, depending on the participant's years

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1550 At one point, 14 percent was the maximum permitted contribution. Summary of Enron Savings Plan (undated), at 118. The Enron Savings Plan provides that the contribution amount must be an integral percentage. Sec. 3.2, Enron Savings Plan (July, 1, 1999, restatement).

1551 For a description of elective deferrals, *see* Part II.A.2., above.

1552 *See The Enron Retirement Program Guide,* included in Appendix D to this Report.

1553 Changes made to the amount of a participant's contribution before the 15th of any month would be effective within one to two payroll periods following the change. Changes made after the 15th would be effective the following month. *Money in Motion - 401(k) Plan Details,* DOL020522.

1554 Additionally, in November 1996, Enron announced a special $300 contribution to the Enron Savings Plan on behalf of regular full-time Enron employees. Participants would automatically be 100 percent vested in the contribution, which would be made in mid-January 1997 and would be invested in Enron stock. *EnSight* (Nov. 1996), EC000020134-EC000020137.

1555 The Enron Savings Plan provides that matching contributions to the accounts of participants who are Enron Oil & Gas employees are to be invested primarily in shares of Enron Oil & Gas stock. Sec. 5.1(a) of Enron Savings Plan (July 1, 1999, restatement).

of service.[1556] Effective January 1, 1998, the Enron Savings Plan was amended to provide that notwithstanding participants' years of service, for 1998, Enron would contribute a matching contribution equal to 50 percent of a participant's elective deferrals, up to two percent of base pay. The January 1, 1999, version of the Enron Savings Plan provides that Enron's matching contribution for 1999 was equal to 50 percent of participants' elective deferrals up to four percent of base pay. For 2000 and 2001, the limit was six percent of compensation. These contributions were discontinued effective November 28, 2001.[1557]

Role of the Administrative Committee

The Enron Savings Plan Administrative Committee is the plan administrator and named fiduciary for purposes of ERISA,[1558] except with respect to the investment of assets of the trust fund, for which the plan trustee is the named fiduciary.[1559] The trust agreement under the Enron Savings Plan provides that the named fiduciary thereunder is the organization, entity, or other person responsible for benefit administration under the Enron Savings Plan.[1560] Further, it provides that the named fiduciary is responsible for management and control of the Enron Savings Plan trust fund and is responsible for determining the "diversification policy."[1561] The trust agreement also provides that the named fiduciary may delegate discretionary authority for the management and control of all or any portion of the trust to investment managers.[1562]

As discussed above in Part II.B.3., above, the Administrative Committee generally did not evaluate Enron stock as an appropriate investment under the Enron Savings Plan. The Administrative Committee questioned for the first time whether it should be examining Enron stock as an investment under the Enron qualified plans at a special meeting of the Administrative

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[1556] Sec 3.4. Enron Corp. Savings Plan (Jan. 1, 1994, restatement).

[1557] Third Amendment to Enron Corp. Savings Plan (July 1, 1999, restatement), DOL020351-DOL020354.

[1558] Sec. 13.1 of Enron Savings Plan (July 1, 1999, restatement).

[1559] Sec. 14.1(a) of Enron Savings Plan (July 1, 1999, restatement).

[1560] Sec. 1.1 of the Trust Agreement between Enron Corp. and the Wilmington Trust Company, as Trustee (effective Nov. 1, 2001) ("Trust Agreement"). The Trust Agreement between Enron and Wilmington Trust was effective November 1, 2001. Documents reviewed by Joint Committee staff indicate that The Northern Trust Company previously served as trustee to the Enron Savings Plan. The trust agreement also allocates the authority of the named fiduciary to the organization, entity, committee or other person who has authority to perform the functions allocated to it under the trust agreement. *Id.*

[1561] *Id.*

[1562] *Id.* at sec. 4.1.

Committee on November 1, 2001.[1563] Documents provided by Enron indicate that, due to the volatility of Enron's stock and the fiduciary responsibility of the Administrative Committee, the special meeting was called to discuss the prudent steps that the Administrative Committee might need to consider with respect to the Enron Savings Plan, as well as other Enron qualified plans. Minutes of the meeting indicate that it was attended by four of the Administrative Committee members, a newly engaged attorney representing the Administrative Committee,[1564] Benefits Department personnel, three representatives from Hewitt, and Enron's ERISA counsel.

The Administrative Committee was presented with a snapshot of the current Enron stock holdings in the Enron Savings Plan on January 1, September 30, and October 26, 2001. The Administrative Committee was advised that it had no duty to issue cautionary advice on the value or risk of holding Enron stock because the Administrative Committee does not act in the capacity of an investment advisor, but is charged with administering the plans in accordance with the terms of the plan documents and in compliance with ERISA. It was decided that the Administrative Committee should hire an independent investment advisor to monitor Enron stock.

At a November 6, 2001, meeting, the Administrative Committee discussed retaining an investment advisor to give guidance to the Administrative Committee on Enron stock in relation to the Administrative Committee's operation of the plans.[1565] Minutes of the meeting indicate that the Administrative Committee agreed that the role of the advisor would be to give advice on Enron stock and to assist the Administrative Committee in operating the plans in the best interests of its participants.[1566] Additionally, it was decided that the Administrative Committee should select an independent investment advisor to monitor Enron stock, and an Enron Treasury Department employee was directed to conduct the search.[1567]

Investment authority and investment decisions under the Enron Savings Plan

Upon enrolling in the Enron Savings Plan, participants select the fund or funds in which they want to invest their contributions. The Plan provides that participants' elective deferrals and after-tax contributions may be invested into any combination of funds offered by the

[1563] Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001847-EC000001855.

[1564] The previous legal counsel for the Administrative Committee had had to resign due to conflicts of interest that had developed. It was agreed that the November 1, 2001, Administrative Committee meeting that the new attorney would represent the Administrative Committee at this meeting and the next pending a further agreement regarding his services.

[1565] Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001858-EC000001860.

[1566] *Id.*

[1567] *Id.*

Plan.[1568] Participants' rollover contributions may also be invested in any combination of investments available under the Plan.[1569]

The Enron Savings Plan provides that participants may change their investment selections prospectively as well as with respect to amounts already invested under the Plan.[1570] The Plan provides that the manner and frequency of such changes are subject to procedures established by the Enron Savings Plan Administrative Committee.[1571]

Participants generally can make changes in investment choices for future contributions and transfer current balances from one fund to another on any business day.[1572] Participants wishing to make a change from one fund to another could call a phone line for the Enron Savings Plan or make the change electronically, through a website for the Plan.[1573] Participants would receive written confirmations of transactions.[1574]

With respect to Enron's matching contributions, the Enron Savings Plan generally provided that upon turning 50, participants may elect to reallocate their company contribution account balances among other investment options offered under the Enron Savings Plan. For this purpose, participants could designate one investment fund for all the amounts allocated or may split the investment of such amounts between investment funds. However, effective November 28, 2001, the Enron Savings Plan was amended to provide that notwithstanding their age, participants could reinvest the amounts in their company contribution accounts in the investment funds offered under the Plan.

Effective February 15, 2002, the Plan was amended to provide that the portion of a rollover contribution including Enron stock or other "employer securities" will continue to be so invested until the participant elects to convert it into another investment under the Plan.[1575] Effective March 15, 2002, the Plan was amended to provide that participants may not elect to

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[1568] Participants can invest in any or all funds offered under the Plan as long as the investment allocations are made in one percent increments and total 100 percent. *See The Enron Retirement Program Guide.*

[1569] Sec. 5.3 Enron Savings Plan (July 1, 1999, restatement); *Money in Motion,* DOL 020252.

[1570] Sec. 5.2 Enron Savings Plan (July 1, 1999, restatement); *Money in Motion,* DOL 020252.

[1571] *Id.*

[1572] *Money in Motion,* DOL020252.

[1573] *Id.*

[1574] *Id.*

[1575] Sixth Amendment to Enron Corp. Savings Plan (July 1, 1999, restatement).

convert any investment of any portion of their accounts under the Plan into an investment in Enron stock or any other "employer security."[1576]

Plan investment options available to participants

During the period reviewed by Joint Committee staff, participants could invest their contributions to the Enron Savings Plan in up to 20 investment options[1577] as long as the whole percentages chosen totaled 100 percent.[1578] The options included several mutual funds, Enron stock, and beginning in 1999, a Schwab account that functioned like a self-directed brokerage account,[1579] through which participants could invest in almost any individual stock or mutual fund.

The particular funds available under the Enron Savings Plan varied over time. During the period covered by the Joint Committee review, they included Enron stock as well as funds sponsored by a variety of financial institutions.[1580]

Information provided to participants

Enron produced a variety of employee benefit education materials for Enron Savings Plan participants. These included periodic newsletters, occasional special newsletters, electronic communications, and materials designed to meet legal requirements, such as summary plan descriptions.[1581] Materials provided to the Joint Committee staff show that Enron also periodically produced publications for participants which describe the investment options under the Enron Savings Plan. Examples of prospectuses for the funds available under the Enron Savings Plan were provided to Joint Committee staff.

1576 *Id.*

1577 The number of investment options varied over time.

1578 *See generally* "Enron Savings Plan summary description."

1579 SEC 1999 Form 11-K. Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 33 (Feb. 5, 2002).

1580 See Table 4 through Table 9, below, for the identity of the various investment options under the Enron Savings Plan for 1996 through 2000.

1581 *Money in Motion - 401(k) Plan Details*, a summary plan description for the Savings Plan, describes for participants the Plan features and details, as well as their rights under the Plan. DOL020532. In a section called "ERISA Rights," *Money in Motion* tells participants that ERISA requires the individuals responsible for managing the plan to act prudently and in their best interests. *Id.*

For example, Enron produced *Only You - Enron Retirement Planning - Tools and Information for Your Future.*[1582] *Only You* includes information to assist employees with determining how much to contribute to the Enron Savings Plan and how to invest their contributions.[1583] Additionally, an accompanying *Resource Guide*[1584] identifies resources through which employees could learn about investing. The *Resource Guide* lists the following types of assistance as provided by Enron:

- Information about Enron retirement benefits so that employees know what to expect when they retire;
- The "Wealthy Barber" video which provides advice about saving and investing;
- *Future$aver*, interactive retirement planning software, customized for Enron's benefit plans; and
- "Investing in Your Future" workbooks, emphasizing the importance of saving for retirement and focusing on the fundamentals of investing and the relationship between risk and return, the importance of diversification and the impact of time on investment results.

Employee meetings and company culture

Enron held periodic "all-employee" meetings. Depending on the location of the meetings, employees could attend the meetings in person. In addition, the meetings were typically broadcast to all employee locations. While the purpose of these meetings generally was not to discuss investment options under the Enron Savings Plan, the future of Enron and projected prices of Enron Corp. common stock were discussed.

The Joint Committee staff reviewed videotapes of nine employee meetings for the period February 1, 1999, to October 23, 2001. The meetings had a common format. Information regarding the most recent financial information, the future of the company, and any current changes or planned changes were addressed. The discussion was typically led by the Chairman (either Mr. Lay or Mr. Skilling, depending on the time frame) and two or three other high-ranking Enron officials, such as Mr. Skilling, Joseph Sutton and Mark Frevert. A question and answer session followed the presentations by such individuals. In many cases, the questions had been submitted in advance of the meeting.

[1582] *Only You - Enron Retirement Planning - Tools and Information for Your Future,* EC000020214-EC000020237.

[1583] For example, the *Only You Resource Guide* states that there is "no better way to save money than on a before-tax basis through payroll deduction. Thanks to the plans' tax advantages and wide variety of investment options, it simply can't be beat...Make the most of your investment options. Most of us are long-term investors and can take advantage of the more aggressive investment funds. Enron has also recently introduced three new "Lifestyle" investment funds designed to fit a variety of investor profiles," EC000020241.

[1584] *Only You Resource Guide*, EC000020238-EC000020257.

With two exceptions, described below, Enron stock was not discussed in the employee meetings specifically in the context of the Enron Savings Plan. However, the future of Enron and the projected value of Enron stock was always addressed. A positive picture of the future was generally presented. The view that all employees should be owners of Enron was also frequently addressed.

For example, at the employee meeting on July 13, 1999, Mr. Lay told employees that "[w]e think it's critical that every body has an ownership position in the company" and that it is "very possible before year end" that the stock price would reach $100 per share and that "there is a fairly good chance we could see the stock price double again in the next year to 18 months…Do that math on your Enron stock."[1585] On August 16, 2001, Mr. Lay explained to employees, "we think we're at the bottom of the cycle and want you [the employees] to enjoy the ride back up. And more importantly, we want you to work hard so we get that ride back up."[1586] The previous day, Enron stock closed at $40.25. Mr. Lay added, "we are a deep value stock" and "the company is doing extremely well." Also on August 16, 2001, Mr. Lay told Enron employees that "the next several months, the next few years are going to be great for Enron, great for Enron's employees…And that's all starting now." Enron stock closed at $36.85 that day.

As mentioned above, Enron stock was addressed in the context of the Enron Savings Plan at two employee meetings. At the February 1, 1999, meeting, Cindy Olson, Enron's Executive Vice President for Human Resources and Community Relations was asked to join Mr. Lay, and respond to the question "Should we invest all of our 401(k) in Enron stock?," submitted by an employee. She replied, "Absolutely!"[1587]

According to Ms. Olson, the question was impromptu and her reply, which was intended to be humorous, was "greeted with laughter by those running the meeting and by the audience."[1588] In her view, when taken in the context of the meeting, it is clear that this was not

[1585] July 13, 1999, employee meeting.

[1586] Mr. Lay was explaining to Enron employees that an additional issuance of stock options would be made to them. The options would vest in one year, instead of over five years as under previous similar programs.

[1587] In an interview with Joint Committee staff, Ms. Olson said she had no "on-the-ground detailed knowledge" of the Savings Plan despite the fact that she served on the Administrative Committee from January 2001 to March 2002. According to Ms. Olson, her responsibilities were more in the nature of customer service: to ensure that the Savings Plan was administered properly "in accordance with the culture" and that participants "got the services they needed." She said that she was not involved with the Savings Plan from a technical standpoint.

[1588] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 182-183 (Feb. 5, 2002).

intended as a serious statement. She also stated that she generally stressed diversification of investments.[1589]

At an employee meeting on October 23, 2001, Mr. Lay directly answered employee questions. To the question "I'm showing little in my 401(k). Any speculation on whether there will be any guarantee of pensions for those with 10 or 20 years of service?", Mr. Lay included as part of his answer, "Enron stock--we'll bring it back. We're gonna bring it back."

A few weeks following the meeting, on November 8, 2001, Enron announced its intention to file restated financial statements for the years December 31, 1997, through 2000, and for the first and second quarters of 2001.[1590]

Current and former employees interviewed by the Joint Committee staff indicated that there was a general culture encouraging employee ownership of Enron stock and that it was part of the Enron philosophy that all employees should also be owners of the company. Employees interviewed by the Joint Committee staff generally expressed continued loyalty to Enron, despite their own financial losses. One former employee of an Enron subsidiary gave the following testimony at a Congressional hearing:

> Throughout my time with Enron, the top management of the company constantly encouraged us to invest our savings in Enron stock. I took the fact that the company matched our savings only with Enron stock as a further endorsement of the stock as a safe retirement investment. More recent statements made by Enron's top management, including e-mails from Ken Lay, about the company's stock also caused me to keep investing my savings into the stock. I remember, in the Fall of 2000, Enron's top executives telling us at an employee meeting and by company e-mail that Enron's stock price was going to increase to at least $120 per share. When Mr. Skilling resigned last

[1589] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 40, 44 (Feb. 5, 2002). Additionally, Ms. Olson provided Joint Committee staff with examples of her responses to questions e-mailed to her by Enron employees about their benefits. In answering one such question, Ms. Olson wrote: "We encourage employees to discuss these questions with a financial advisor or tax expert. Because everyone's situation, risk tolerance and diversification goals are different, there is no one solution that works for everyone." Printout of *Enron Options, Featuring Cindy Olson, executive vice president, Human Resources & Community Affairs* (Nov. 2, 2000). Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron,* S. Hrg. 107-378, at 177-78 (Feb. 5, 2002).

[1590] SEC Form 8-K, filed with the Securities and Exchange Commission on November 8, 2001.

August, Mr. Lay told us that the company was stronger than it had ever been....Our stock ownership was encouraged by Enron's top management.[1591]

The Joint Committee staff was told that Enron employees were constantly aware of the price of Enron stock, and that, until the bankruptcy filing, the current stock price was displayed on a monitor in the lobby of the Enron building.

Historical information regarding distribution of plan investments by type of investment

Table 4 through Table 9, below, show the general distribution of investments under the Enron Savings Plan by type of investment for the years 1996 to 2000 and as of October 26, 2001. The source of the data for 1996 to 2000 is the Forms 11-K[1592] as filed with the SEC for those years. The source of the data for 2001 is an attachment to minutes of the November 1, 2001, meeting of the Administrative Committee.[1593]

[1591] Committee on Education and the Workforce, United States House of Representatives, *The Enron Collapse and Its Implications for Worker Retirement Security,* H. Hrg. 107-42, at 100-101 (Feb. 7, 2002).

[1592] The Form 11-K is an annual report for employee stock purchase, savings, and similar plans, interests in which constitute securities registered under the Securities Act of 1933. The Form 11-K is required to be filed pursuant to section 15(d) of the Securities Act of 1933 even though the issuer of the securities offered to employees under the plan also files annual reports in accordance with the Securities Exchange Act of 1934. The Form 11-K is generally due to the Securities Exchange Commission within 180 days after the end of an ERISA plan's fiscal year. See 17 CFR 249.311.

[1593] *Enron Corp. Savings Plan Fund Information,* attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001854.

Table 4.–Distribution of Enron Savings Plan Investments by Type of Investment for 1996

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
Short-Term Investments:		
Northern Trust Collective Stock Index Fund	7.8	
SEI Stable Asset Fund	0.0	
Total		7.8
Stock:		
Enron Corp. Common Stock	308.1	
Enron Corp. Cumulative Second Preferred Convertible Stock	41.2	
Enron Oil & Gas Company Common Stock	24.0	
Total		373.3
Investment Funds:		
Fidelity Investments Equity Income Stock	27.6	
Fidelity Investments OTC Fund	9.2	
Fidelity Investments Balanced Fund	3.7	
Fidelity Investments Growth & Income Fund	19.6	
Fidelity Investments Magellan Fund	15.9	
Fidelity Investments Growth Company Fund	16.3	
Fidelity Investments Overseas Fund	6.1	
Vanguard Growth Portfolio	2.4	
Vanguard Moderate Growth Portfolio	0.9	
Vanguard Conservative Growth Portfolio	1.4	
Total		103.1
Fixed Income Deposit Contracts:		
Allstate #GA-5826	4.4	
Canada Life Contracts #P-45770	12.3	
J.P. Morgan Enron-02	3.7	
John Hancock Mutual Life Insurance Co. #GAC 7374	7.1	
Lincoln National #GA-9597	7.2	
New York Life #GA-30282	4.9	
Peoples Security BDA00149TR-1	8.0	
Peoples Security BDA00149TR-2	3.9	
Peoples Security BDA00149TR-5	3.8	
Peoples Security BDA00437FR	8.3	
Principal Mutual #4-20383	4.3	
Protective Life #GA-1206	4.2	
Provident Life and Accident Insurance #627-5578	5.0	
Sun Life of Canada Insurance #S-0885-G	10.0	
Transamerica Occidental Life #51362	0.0	
Transamerica Occidental #51313-00	3.3	
Total		90.6

Note: Items may not sum to total due to rounding.

Source: 2000 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, *available at* www.sec.gov.

Table 5.–Distribution of Enron Savings Plan Investments by Type of Investment for 1997

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
Short-Term Investments:		
Northern Trust Collective Stock Index Fund	9.6	
SEI Stable Asset Fund	5.2	
Total		14.8
Stock:		
Enron Corp. Common Stock	276.9	
Enron Corp. Cumulative Second Preferred Convertible Stock	39.7	
Enron Oil & Gas Company Common Stock	28.4	
Total		345.0
Investment Funds:		
Fidelity Investments Equity Income Stock	39.7	
Fidelity Investments OTC Fund	10.7	
Fidelity Investments Balanced Fund	5.4	
Fidelity Investments Growth & Income Fund	31.8	
Fidelity Investments Magellan Fund	20.8	
Fidelity Investments Growth Company Fund	20.1	
Fidelity Investments Overseas Fund	8.3	
Vanguard Growth Portfolio	4.8	
Vanguard Conservative Growth Portfolio	1.5	
Vanguard Moderate Growth Portfolio	2.0	
Total		145.1
Fixed Income Deposit Contracts:		
Allstate #GA - 5826	4.7	
J.P. Morgan Enron-#02	3.8	
John Hancock Mutual Life Insurance Co. GAC # 7374	7.6	
New York Life #GA-30282	5.2	
Peoples Security BDA00149TR-1	8.0	
Peoples Security BDA00149TR-2	3.9	
Peoples Security BDA00149TR-5	3.8	
Peoples Security BDA00437FR	4.5	
Principal Mutual #4-20383	4.6	
Protective Life GA-#1206	4.2	
Provident Life and Accident Insurance #627-5578	5.2	
State Street Bank #97053	8.0	
Sun Life of Canada Insurance #S-0885-G	10.6	
Transamerica Occidental Life #51362	0.0	
Transamerica Occidental #51313-00	1.7	
Total		75.8

Note: Items may not sum to total due to rounding.

Source: 1997 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, *available at* www.sec.gov.

Table 6.–Distribution of Enron Savings Plan Investments by Type of Investment for 1998

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
Short-Term Investments:		
Morgan Stanley Stable Value II	6.2	
Northern Trust Collective Stock Index Fund	14.0	
SEI Stable Asset Fund	21.2	
Total		41.4
Stock:		
Enron Corp. Common Stock	311.1	
Enron Corp. Cumulative Second Preferred Convertible Stock	54.5	
Enron Oil & Gas Company Common Stock	38.9	
Total		404.5
Investment Funds:		
Fidelity Investments Equity Income Fund	45.1	
Fidelity Investments OTC Fund	17.0	
Fidelity Investments Balanced Fund	10.1	
Fidelity Investments Growth & Income Fund	55.9	
Fidelity Investments Magellan Fund	33.2	
Fidelity Investments Growth Company Fund	26.2	
Fidelity Investments Overseas Fund	9.4	
The Vanguard Group Growth Portfolio	9.6	
The Vanguard Group Conservative Growth Portfolio	3.1	
The Vanguard Group Moderate Growth Portfolio	3.4	
Total		213.0
Fixed Income Deposit Contracts:		
John Hancock Mutual Life Insurance Co. #GAC 7374	8.1	
John Hancock Mutual Life Insurance Co. #14447	6.0	
Peoples Security BDA00149TR-1	9.7	
Peoples Security BDA00149TR-8	3.9	
Peoples Security BDA00149TR-6	3.6	
Peoples Security BDA00437FR	4.8	
Peoples Security BDA00149TR-11	3.4	
Principal Mutual #4-20383	4.9	
Provident Life and Accident Insurance #627-5578	5.5	
State Street Bank 97-053B	7.8	
Sun Life of Canada Insurance #S-0885-G	11.1	
Transamerica Occidental Life #51362-00	0.0	
Transamerica Occidental Life #51313-00	1.9	
Total		70.7

Note: Items may not sum to total due to rounding.

Source: 1998 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, *available at* www.sec.gov.

Table 7.–Distribution of Enron Savings Plan Investments by Type of Investment for 1999

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
Short-Term Investments:		
Northern Trust Company Short-Term Investment Fund	8.8	
SEI Trust Company Stable Asset Fund	23.1	
Morgan Stanley Dean Witter Stable Value II	12.5	
Total		44.4
Stock:		
Enron Corp. common stock	662.1	
Enron Corp. Cumulative Second Preferred Convertible Stock	84.8	
Enron Oil & Gas Resources, Inc. Common Stock	25.2	
Charles Schwab Self-Directed Brokerage Account	16.1	
Total		788.2
Investment Funds:		
Fidelity Investments Equity Income Fund	43.2	
Fidelity Investments OTC Funds	43.4	
Fidelity Investments Balanced Fund	13.8	
Fidelity Investments Growth & Income Fund	55.0	
Fidelity Investments Magellan Fund	52.1	
Fidelity Investments Growth Company Fund	66.1	
Fidelity Investments Overseas Fund	15.5	
Morgan Stanley Dean Witter International Equity Portfolio	12.9	
Morgan Stanley Dean Witter Institutional Fund	69.1	
The Vanguard Group Growth Portfolio	59.5	
The Vanguard Group Conservation Growth Portfolio	15.1	
The Vanguard Group Moderate Growth Portfolio	56.5	
The Vanguard Group Index Trust 500 Portfolio	17.4	
The Vanguard Group Windsor II Fund	39.3	
T. Rowe Price Small Cap Fund	20.9	
PIMCO Total Return Fund	12.0	
PIMCO Low Duration Fund	10.2	
PIMCO Total	6.3	
UAM Trust Company Dwight Target 2 Fund	24.8	
UAM Trust Company Dwight Target 5 Fund	44.0	
Total		677.1
Fixed Income Deposit Contracts:		
John Hancock Mutual Life Insurance Co. GAC #7374	4.3	
John Hancock Mutual Life Insurance Co. #14447	6.4	
Principal Mutual Life Insurance Co. #4-20383	5.2	
Sun Life of Canada Insurance #S-0885-G, 5.42 percent	11.7	
Transamerica Occidental Life #51362-00, 6.10 percent	0.0	
Allstate Insurance Co. #5926P	4.3	
Allstate Insurance Co. #6229	6.0	
GE Life & Annuity Assurance Co. #3322	5.1	
John Hancock Mutual Life Insurance Co. #3322	5.0	
Monumental Insurance Co. #ADA00757FRP	6.6	
New York Life Insurance Co. #30505P	5.2	

Table 7.–Distribution of Enron Savings Plan Investments by Type of Investment for 1999

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
New York Life Insurance Co. #31036	32.7	
CDC Financial Synthetic #1032-01-P	0.7	
Transamerica Life Insurance Co. #76644-P	1.0	
Total		94.2

Note: Items may not sum to total due to rounding.

Source: 1999 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, *available at* www.sec.gov.

Table 8.–Distribution of Enron Savings Plan Investments by Type of Investment for 2000

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
Short-Term Investments:		
Northern Trust Company Short-Term Investment Fund	17.8	
SEI Trust Company Stable Asset Fund	18.3	
Morgan Stanley Dean Witter Stable Value II	13.4	
Total		49.5
Stock:		
Enron Corp. Common Stock	1,157.5	
Enron Corp. Cumulative Second Preferred Convertible Stock	158.9	
Enron Oil & Gas Resources, Inc. common stock	26.4	
Charles Schwab Self-Directed Brokerage Account	30.8	
Total		1,373.6
Investment Funds:		
Fidelity Investments Equity Income Fund	34.9	
Fidelity Investments OTC Funds	37.6	
Fidelity Investments Balanced Fund	12.2	
Fidelity Investments Growth & Income Fund	43.3	
Fidelity Investments Magellan Fund	46.5	
Fidelity Investments Growth Company Fund	84.0	
Fidelity Investments Overseas Fund	14.8	
Morgan Stanley Dean Witter International Equity Portfolio	11.7	
Morgan Stanley Dean Witter Institutional Fund	45.9	
The Vanguard Group Life Strategy Growth	44.9	
The Vanguard Group Conservation Growth Portfolio	12.6	
The Vanguard Group Moderate Growth Portfolio	41.1	
The Vanguard Group Index Trust 500 Portfolio	23.2	
The Vanguard Group Windsor II Fund	28.0	
T. Rowe Price Small Cap Fund	25.5	
PIMCO Total Return Fund II Institutional	8.0	
PIMCO Low Duration Fund	11.0	
PIMCO Total Return Fund	7.0	
UAM Trust Company Dwight Target 2 Fund	27.1	
UAM Trust Company Dwight Target 5 Fund	49.6	
Total		608.9
Fixed Income Deposit Contracts:		
John Hancock Mutual Life Insurance Co. #14447	6.8	
Canada Life Investment #P46067	12.5	
Canada Life Investment #P46058	13.8	
People's (Aegon) Life Co. #NDA0017SFR	10.2	
People's Benefit Life Investment #173FR	10.4	
Allstate Insurance Co. #5926P	4.6	
Allstate Insurance Co. #6229	6.5	
GE Life & Annuity Assurance Co. #3322	5.5	
John Hancock Mutual Life Insurance Co. #9600P	5.0	
New York Life Insurance Co. #31036	5.9	
CDC Financial Synthetic #1032-01-P	0.2	

Table 8.–Distribution of Enron Savings Plan Investments by Type of Investment for 2000

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
Transamerica Occidental Life Insurance Co. #76644-P	(0.4)	
State Street Bank Synthetic #97053	0.3	
Monumental Insurance Co. #BDA00390TR	(0.1)	
Total		81.2

Note: Items may not sum to total due to rounding.

Source: 2000 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, *available at* www.sec.gov.

Table 9.–Enron Savings Plan Fund Information at October 26, 2001, as Reported at the November 1, 2001, Meeting of the Administrative Committee

Investment	Value (millions of dollars)	Total Value (millions of dollars)
Enron Corp. Stock	246.7	
EOG Resources	16.3	
Self-Directed Account	26.5	
SEI Trust Company Stable Asset Fund	223.5	
Fidelity Investments Equity Income Fund	31.4	
Fidelity Investments OTC Funds	22.8	
Fidelity Investments Balanced Fund	15.1	
Fidelity Investments Growth & Income Fund	36.7	
Fidelity Investments Magellan Fund	37.1	
Fidelity Investments Growth Company Fund	49.9	
Fidelity Investments Overseas Fund	10.4	
Morgan Stanley Dean Witter International Equity Portfolio	10.6	
Morgan Stanley Dean Witter Equity Growth	34.2	
The Vanguard Group Life Strategy Growth	36.3	
The Vanguard Group Conservation Growth Portfolio	9.9	
The Vanguard Group Moderate Growth Portfolio	36.2	
The Vanguard Group Index Trust 500 Portfolio	26.7	
The Vanguard Group Windsor II Fund	31.1	
T. Rowe Price Small Cap Fund	27.7	
PIMCO Total Return Fund II Institutional	17.0	
Total		946.1

Note: Items may not sum to total due to rounding.

Source: *Enron Corp. Savings Plan Fund Information,* attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001854.

Based on the data reported on the SEC Forms 11-K for the Enron Savings Plan for 1996 to 2000, as shown in Table 4 through Table 8, the portion of the assets under the Enron Savings Plan that was invested in Enron stock was 65 percent in 1996, 59 percent in 1997, 55 percent in 1998, 48 percent in 1999, and 62 percent in 2000.[1594] In 2000, these securities were valued at over $1.3 billion.[1595]

According to an attachment to the minutes of the November 1, 2001, meeting of the Administrative Committee, as of October 26, 2001, as shown in Table 9, 28 percent, or $246.7 million, of the assets under Enron Savings Plan were invested in Enron stock. Of this amount, $102 million was attributable to Enron's matching contribution and $144.7 million was attributable to participants' contributions.[1596]

Discussion of Issues

Enron stock was a significant portion of the assets held under the Enron Savings Plan in the period before Enron's bankruptcy. As a result, many Enron Savings Plan participants lost considerable amounts of retirement savings when Enron's stock price plummeted.[1597] There are a variety of factors which may have contributed to such significant investment in Enron stock, including plan design, a company culture that may have induced participants to invest in (and keep assets invested in) Enron stock, statements by high ranking Enron officials even as the Enron stock price fell regarding the bright future for Enron, a lack of understanding of the importance of diversification, and the actions (or inactions) of plan fiduciaries, including the Administrative Committee.

The design of the Enron Savings Plan is not atypical. Many defined contribution plans allow participants to direct the investment of their account balances, particularly elective deferrals under a 401(k) plan. Participants' varying tolerances for investment risk can be accommodated if plans offer a variety of investment options. It is not uncommon for stock of the employer sponsoring a plan to be offered as an investment option under a defined contribution plan.

[1594] For purposes of these calculations, because Enron Oil & Gas ("EOG") was established as a public company independent of Enron in 1999, investment in EOG is not considered in determining the overall amount of assets invested in Enron stock beginning in 2000. *See* Part II of Part Two of this Report; *also see* Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 45 (Feb. 5, 2002). Notwithstanding, EOG was retained as an investment option under the Enron Savings Plan. *Id.*

[1595] 2000 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes.

[1596] *Enron Corp. Savings Plan Fund Information,* attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001854.

[1597] Many participants also lost their jobs. *Tittle v. Enron Corp.*, S.D. Texas, No. H-01-3913, First Consolidated and Amended Complaint (filed Apr. 8, 2002), at paragraph 20.

Some employers make all or part of their contributions to defined contribution plans in employer securities.[1598] Many employers favor contributing their stock to their defined contribution plans because newly-issued stock and treasury stock generally do not reduce the employer's cash flow. Many employers also believe that contributing company stock to a retirement plan places the stock in the hands of persons who are more likely to retain their shares through the company's downcycles and vote with current management. However, employees whose defined contribution account balances are heavily invested in employer securities are vulnerable to losing both their job and their retirement security if the company's fortunes decline. Employees often like the opportunity to have an ownership interest the company they work for, having the opportunity to share directly in profits of the company.

When an employee chooses to allocate a large percentage of his or her defined contribution plan assets to a single investment such as employer securities, that employee is generally assuming more risk than under a diversified asset allocation. The level of employee investment in Enron stock under the Enron Savings Plans and the losses in retirement savings resulting from the decline in Enron's stock price emphasizes the importance of prudent investment principles such as diversification. Diversification helps to mitigate investment risk by reducing excessive exposure to any one source.

The high concentration of Enron Savings Plan investments in Enron stock resulted from both employee investment choice and Enron's matching contributions being made in the form of Enron stock.[1599] Enron Savings Plan participants clearly did not invest their elective deferrals in Enron stock due to a lack of other alternatives. The Enron Savings Plan offered approximately 20 investment options other than Enron stock, consisting of a broad range of alternatives offering various risk and return characteristics, including a self-directed brokerage account. Overall losses experienced by Enron employees may have been limited if employees had diversified their elective deferral and after-tax contribution accounts and if the plan permitted them to diversify their company contribution accounts earlier than age 50. However, even if Enron Savings Plan participants had had this opportunity, it is not clear that many participants would have taken advantage of it, given the overall level of voluntary Enron Savings Plan investment in Enron stock. Current and former Enron employees interviewed by the Joint Committee staff demonstrated a tremendous loyalty to Enron, despite the bankruptcy and their own personal financial losses and experiences. While this loyalty certainly may not be universal, the degree to which many of the individuals interviewed by the Joint Committee staff still had faith in Enron was striking.

[1598] Many plans require that at least some portion of any employer contribution be in stock.

[1599] However, the high level of investment in Enron stock under the Enron Savings Plan was not altogether anomalous. One study of 401(k) plans with company stock showed that 25 out of 219 plans had more than 60 percent of their assets invested in company stock. *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).

Investment in Enron stock by employees was generally encouraged by Enron, both through plan design and statements by management. During the period reviewed by the Joint Committee staff, Enron employees could acquire Enron stock through several company-sponsored arrangements, including the Enron Savings Plan, the Enron ESOP, and stock options. This variety of opportunities to purchase company stock is not uncommon among large employers.

In addition, Enron officials and Enron's "company culture" actively encouraged employee ownership of Enron stock, both through the Enron Savings Plan and in general. A central premise of Enron's philosophy seemed to be that all employees should be company owners.

Even as the price of Enron stock declined during 2001, management told employees of a bright future for Enron. For example, Mr. Lay was optimistic in his predictions for the future of Enron stock, even when an employee specifically asked about Enron stock in the context of the Enron Savings Plan. Similarly, Enron's Executive Vice President for Human Resources and Community Relations, Cindy Olson, said that employees should "Absolutely!" invest their contributions to the Enron Savings Plan in Enron stock. Even if management's positive predictions to employees about the future of Enron stock were not intended to be anything more than inspirational company pep talks, statements regarding Enron stock--especially in the context of the Enron Savings Plan--could have been understood by some employees to be an endorsement that a significant portion of their assets should be invested in Enron stock.

Additionally, the Administrative Committee may have played a role in the ultimate losses sustained by participants under the Enron Savings Plan. The Administrative Committee was the named fiduciary under the plan with responsibility for plan assets and had the power to direct the trustee, which held the plan assets.[1600] Under the Enron Savings Plan and the accompanying trust agreement, the Administrative Committee was responsible for selecting the investment alternatives available to participants in the Enron Savings Plan.[1601] While the trust agreement included Enron stock as an investment fund alternative, it also stated that the Administrative Committee had the authority to terminate any existing investment alternatives at any time.[1602] Notwithstanding, the Administrative Committee did not seem to view its role as including the obligation to review the suitability of Enron stock as an investment under the Enron Savings Plan. Minutes of Administrative Committee meetings show that the first time the Administrative Committee undertook such a review was at their meeting on November 1, 2001.

[1600] Sec. 15.2 of the Enron Savings Plan (July 1, 1999, restatement).

[1601] *Id.; see* Trust Agreement, Art. 4.

[1602] Trust Agreement, Art. 4; Under the Trust Agreement, the Committee has discretion to eliminate an investment option at any time. Additionally, the Committee is authorized to direct the Trustee as to the level of investment in Enron stock "as the Committee may deem appropriate." Enron Savings Plan, Article VIII, 7(j) (July 1, 1999, restatement).

If the Administrative Committee had acted sooner, losses under the Enron Savings Plan may have been limited. Provisions of the plan could be interpreted to give them the authority to act in this regard. These issues are currently the subject of litigation.[1603]

Recommendations

The Joint Committee staff believes that the main principle that can be drawn from the Enron experience is that the importance of diversification of retirement savings assets cannot be overemphasized. The Joint Committee staff recommends that that a variety of legislative changes should be made to reduce the likelihood that plan participants in plans that allow participant directed investments will have high concentrations of assets in a single investment.

The Joint Committee staff also recommends that plans should provide participants with investment education in a manner consistent with fiduciary standards. This should include. notices describing sound investment practices, with a focus on the importance of diversification. The notice might include, for example: (1) information regarding diversification of investments; (2) information on the essential differences, in terms of risk and return, of available investments, including stocks, bonds, mutual funds and money market investments; (3) information on how investment fees may affect the return on an investment; and (4) a description of the factors that may be relevant to determining the appropriate investment allocations under the plan, such as an individual's age and years to retirement.

The Joint Committee staff also recommends that plan participants should be notified when plan assets are over concentrated in a single asset. The notification could include a statement that the participant should review their plan investments to make sure they are properly diversified.

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. In adopting specific rules, the Congress should consider the scope of any new diversification requirement as applied to employer contributions, for example, whether it should be limited to contributions related to elective deferrals (such as matching and nonelective employer contributions used to satisfy applicable nondiscrimination requirements) or whether it should have a broader application.

Finally, the Joint Committee staff recommends certain changes with respect to ERISA fiduciary rules. The experience at Enron pointed out the difficulties that may arise when plan

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[1603] Some participants in the Enron Savings Plan have alleged that the plan's administrators violated their fiduciary duties by allowing participants to continue investing in Enron stock and continuing to make matching contributions in Enron stock even after they knew or should have known that Enron faced difficult financial straits. As discussed above, several Enron Savings Plan participants have filed suit against Enron in federal court seeking relief for losses sustained to their balances under the Plan. *See* Part II.B.2., above.

fiduciaries play more than one role, particularly a role as a fiduciary and a role as an employee or executive of the employer. These two roles may conflict and cause confusion among plan participants. In addition, fiduciaries may not fully understand their dual roles.

In Enron's case, senior management, including Mr. Lay, made numerous statements in employee meetings and in electronic mail messages to employees regarding the future of Enron and the price of Enron stock. Most of these statements were not made specifically in the context of the Enron qualified plans; however, in at least two instances statements were made in the context of the Enron Savings Plan as to the appropriateness of Enron stock as an investment. In one case, Cindy Olson replied to the question "Should we invest all of our 401(k) in Enron stock?" by saying "Absolutely." In the other case in response to a question regarding the Enron Savings Plan and whether Enron would act to replace lost retirement benefits, Mr. Lay said "Enron stock, we'll bring it back."

There are legal and factual questions as to whether Ms. Olson and Mr. Lay were plan fiduciaries at the time of these statements and, if they were, whether they were acting in a fiduciary capacity. These issues are the subject of litigation.

Regardless of the outcome of this litigation, the statements were at best ill advised and certainly may have created the impression on the part of Enron Savings Plan participants that Enron stock was a safe investment. Corporate executives may generally be expected to present a positive view of the company, and should be free to do so. However, in the context of qualified retirement plans, the Joint Committee staff believes that senior executives, whether or not they are otherwise plan fiduciaries, should not make statements regarding the plan or plan investments, particularly employer securities, that are not in accord with generally accepted investment principles or general fiduciary standards. Thus, the Joint Committee staff recommends that fiduciary rules should apply to such statements.

Enron also demonstrates that plan fiduciaries may have difficulty determining what actions are consistent with their dual roles. The Congress should direct the Department of Labor to assist in this effort, including for example, making additional efforts to educate plan fiduciaries who are also employees regarding their duties, particularly in the context of real life situations. The materials could include, for example, a description of actions that might make a company executive a plan fiduciary, even if the individual is not named a fiduciary under plan documents.

While these recommendations may help prevent future losses such as those experienced by Enron employees, given the factors in Enron's case, particularly the culture that encouraged Enron stock ownership, it is not clear that the situation would have been any different if these measures had been in place prior to the bankruptcy. Further, Enron is not alone it the 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.[1604]

[1604] *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).

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.

Enron also illustrates a general shift away from defined benefit plans toward defined contribution plans, particularly defined contribution plans that provide for participant directed investments. This shift can reduce retirement income security for plan participants, both because participants bear the risk of investment loss in defined contribution plans and because plan participants may not make appropriate investment decisions, regardless of the level of investment education they receive. Thus, the Congress may wish to consider broader approaches to addressing retirement income security under defined contribution plans. A range of options are possible; some suggestions that have been proposed by commentators include providing a Federal government guarantee of a minimum rate of return on defined contribution plan assets and placing some restrictions on the ability of plans to require that participants direct investments.

6. Allegations of misuse of benefit funds

Present Law

A number of present-law rules may be relevant with respect to misuse of pension plan assets by an employer or plan fiduciary.

Under the Code, a qualified retirement plan must be maintained for the exclusive benefit of the employees (the "exclusive benefit rule").[1605] In particular, the trust established in connection with the plan must prohibit the diversion of assets for purposes other than exclusive benefit of employees and their beneficiaries.[1606]

Through similar provisions of ERISA, the exclusive benefit rule applies to all employee benefit plans subject to ERISA without regard to their tax-qualified status. ERISA prescribes that plan fiduciaries shall discharge their duties with respect to a plan solely in the interest of the beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries.[1607]

ERISA also contains a "noninurement" rule which requires that, subject to certain exceptions, the assets of a plan shall never inure to the benefit of any employer and shall be held in a trust for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries.[1608] For this purpose, the assets of the plan include contributions that are withheld

[1605] Sec. 401(a).

[1606] Sec. 401(a)(2).

[1607] ERISA sec. 404(a)(1).

[1608] ERISA sec. 403(c)(1).

from a participant's wages, which must be contributed to the plan as soon as they can reasonably be segregated from the employer's general assets.[1609] Employers who fail to promptly transmit participant contributions, and plan fiduciaries who fail to make diligent efforts to collect those amounts in a timely manner, may violate the requirement that plan assets be held in trust and may be engaging in prohibited transactions.[1610]

Under criminal law provisions of the U.S. Code, embezzlement, conversion, abstraction, or stealing of "any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or any fund connected therewith" is a criminal offense punishable by fine, imprisonment, or both.[1611]

Factual Background[1612]

In early 2002, Robin Hosea, a former Enron contract employee and full-time employee, publicly alleged that payments were made from Enron's employee benefit funds for purposes unrelated to employee benefits. Specifically, Ms. Hosea alleged that, during 2000, approximately $15 million was improperly paid out of Enron Benefits Department accounts for purposes unrelated to employee benefits. She also claimed that her superiors at Enron told her that the payments were made to friends of executives and that she should not pursue the issue. Ms. Hosea's claims were reported in the national media, including in an interview on the television program, the *CBS Evening News*, which aired on February 4, 2002.

Because Ms. Hosea's allegations are under investigation by Federal government enforcement agencies, the Joint Committee staff has not attempted to independently investigate their veracity.

Ms. Hosea was hired by Enron in August 2000 on a contract basis to work in the Enron Benefits Department. Jobs she previously held with other employers included human resource, payroll, and accounting positions. In November 2000, Ms. Hosea was hired for the full-time position of Senior Benefits Specialist in the Enron Benefits Department. This was her only position while at Enron. While working for Enron, Ms. Hosea assisted with benefit compliance and budgeting work. Her specific responsibilities included accounting for employee benefit plans and the Benefits Department compliance and budgeting work.

Ms. Hosea reported to Enron's Senior Director of Benefits and one other manager at different times during her employment at Enron. Ms. Hosea took medical leave from Enron beginning May 24, 2001. She did not return to Enron and was laid off on December 5, 2001, as part of a general layoff following Enron's bankruptcy filing.

[1609] 29 C.F.R. 2510.3-102.

[1610] *See* Preamble to regulations at 29 C.F.R. 2510.3-102.

[1611] 18 U.S.C. sec. 664.

[1612] Unless otherwise indicated, the background information described herein is based on an interview of Ms. Robin Hosea conducted by Joint Committee staff on September 20, 2002.

According to Ms. Hosea, a general ledger account for the Enron Benefits Department was composed of several subaccounts, including subaccounts for medical benefits, dental benefits, life insurance, the Savings Plan, and vision benefits. Each month, Ms. Hosea would receive a statement of the account (including subaccounts) from Enron's Finance Department. The statement included a line for unallocated or unrecognized payments. These were payments that came out of the general account but were not assigned to a subaccount. According to Ms. Hosea, the unallocated payments were not initiated by the Benefits Department.

Sometime before taking medical leave, Ms. Hosea started to review the unallocated payments. She tracked two to three items that appeared in the accounts each month for three or four months running and determined that the payments had been made over a period of a few years. She obtained copies of the check requests but was unable to determine the purpose of the requisition. She showed them to her supervisor as well as the Benefit Department's administrative assistant, who did not recognize them. She also showed them to the Senior Director of Benefits, who did not recognize them. On instructions from the Senior Director of Benefits, Ms. Hosea contacted the person who approved the payments and learned that the payments originated in the Legal Department. According to Ms. Hosea, the Senior Director of Benefits told Ms. Hosea that she vaguely remembered the payments, and instructed Ms. Hosea to disregard the issue.

Additionally, in May 2001, Ms. Hosea identified a payment that originated with the Benefits Department and had the approval of the Department. A check in the amount of approximately $1,000 to $5,000 payable to an individual as a "consulting fee" was paid out of the medical or dental subaccount. Ms. Hosea's supervisor and the Benefits Department administrative assistant told Ms. Hosea that the fee was not unusual and that the payee was a friend of a highly-placed Enron executive. Ms. Hosea stated that she was again instructed to disregard the issue.

Former Enron Executive Vice President for Human Resources and Community Relations Cindy Olson, and former Enron Benefits Manager Mikie Rath were asked about Ms. Hosea's claims in hearings before the Senate Governmental Affairs Committee and the House Education and the Workforce Committee which were held in February 2002.[1613] Ms. Olson testified that she did not have first hand knowledge of Ms. Hosea's claims. Ms. Rath, who handled day-to-day administration of Enron's retirement plans, testified that no funds were diverted from the Savings Plan. Further, Ms. Rath explained that any payment from the Savings Plan trust would be reported in the plan's annual filing with the Department of Labor, the Form 5500, which requires a listing of payments from the plan. According to Ms. Rath, those audited financial statements appended to the Form 5500 showed no payments to individuals.

Ms. Hosea contacted the Department of Labor about these issues at the end of November or the beginning of December 2001. After contacting the Department of Labor, Ms. Hosea

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[1613] Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 59 (Feb. 5, 2002); Committee on Education and the Workforce, United States House of Representatives, *The Enron Collapse and Its Implications for Worker Retirement Security,* H. Hrg. 107-42, at 121-22 (Feb. 7, 2002).

claimed that she began to receive threats "almost daily" in the form of "threatening" phone calls and "hang up calls." Although she could not remember the callers' exact words, she perceived the threats to be physical. Ms. Hosea's stated that her husband answered a call to their home in which the caller admonished Ms. Hosea to "be quiet." Ms. Hosea also stated that she was being followed but did not report it to the police because she perceived "no real physical threat" or destruction of property.

Ms. Hosea feels that the threats she alleges she received were connected to her actions in relation to Enron. She claims that, at the time she received the calls, she had contacted the Department of Labor, but that contact had not been made public. Because of this timing, she believes that the threats could only have originated with Enron. She contacted the press about one month later.

Mr. Mark Lindsey, Enron's Vice President for Corporate Accounting and Planning told Joint Committee staff that he first learned of Ms. Hosea's allegations from a television program.[1614] He said that he recognized a schedule displayed during the program. The Corporate Accounting and Planning staff approached Mr. Lindsey about Ms. Hosea's allegations. They discussed her allegations and looked into them. According to the Mr. Lindsey, the allegations related to monthly reconciliations of benefits liabilities accounts for welfare benefits as well as for Enron's qualified plans. The staff, together with the Benefits Department, assembled an analysis of 14 to 15 subaccounts as part of their review.

In looking into her allegations, the Corporate Accounting and Planning staff did not speak directly with Ms. Hosea or attempt to contact her. Mr. Lindsey said there was "no reason" to contact her. He also said that the facts did not warrant speaking with anyone else about Ms. Hosea's claims. In the wake of Enron's bankruptcy filing, he explained, numerous allegations surfaced, many of which were sensationalized. Against this backdrop, he said, Ms. Hosea's claims were not compelling. Mr. Lindsey stated that he does not believe Ms. Hosea's claims that amounts allocated to other departments were diverted. He also said that there was no evidence that benefits funds were misused or that consulting fees were paid to friends of Enron executives but noted that consultants were occasionally retained by Enron in connection with special hiring initiatives.

Enron's Accounting Department responded to a subpoena issued by the Department of Labor in February 2002 in its investigation of Ms. Hosea's claims. According to Mr. Lindsey, the Department of Labor sent three or four investigators to audit Enron's employee benefits accounts during March or April of 2002. Mr. Lindsey and his staff spoke with the auditors and reviewed a reconciliation of employee benefits accounts with them.

Ms. Hosea's allegations were reported to the Administrative Committee of the Enron Qualified Plans by Enron's Director of Benefits at a February 12, 2002, meeting of the Committee. The Director of Benefits told the Committee that Ms. Hosea's allegations appeared to relate to accounting reserves for welfare benefit plans maintained by Enron, rather than assets

[1614] Joint Committee staff interviewed Mr. Mark Lindsey, Enron's Vice President for Corporate Accounting and Planning, on January 23, 2002.

of any of the plans. He reported that the Department of Labor recently concluded a review of certain plans maintained by Enron and found no irregularities.

The Department of Labor is investigating Ms. Hosea's allegations.

Discussion of Issues

The allegations made by Ms. Hosea, if established as true, might have serious legal consequences for Enron officials, Enron itself, and certain Enron employee benefit plans. Specifically, violations of the exclusive benefit rule of the Code and ERISA could lead to plan disqualification or the imposition of prohibited transaction penalties. However, the allegations, even if true, do not necessarily represent an illegal or improper diversion of funds. Payments from unallocated subaccounts do not, taken alone, constitute improper or illegal payments.

Further, any violations of ERISA fiduciary responsibility provisions could result in the imposition of penalties by the Department of Labor. Criminal sanctions could be imposed. Additionally, participants, beneficiaries, or cofiduciaries could make legal claims against responsible persons for which they would be personally liable for plan losses or other court-ordered relief including punitive and extracontractual damages.[1615]

Based on interviews conducted by Joint Committee staff as well as the staff review of the media reports regarding Ms. Hosea's claims, there appear to be a variety of interpretations of what may have happened with respect to accounting practices of the Enron Benefits Department. The unallocated or unrecognized payments from the general ledger account identified by Ms. Hosea may have been legitimate entries consistent with the Benefits Department's bookkeeping practices. When she made the allegations in early 2001, Ms. Hosea was barely six months into her employment with Enron. It is possible that she was not yet familiar with the legitimate accounting practices of her employer.

When asked about her claims during an interview with Joint Committee staff, Ms. Hosea's answers to questions about the specifics of her allegations were vague. She stated that she could not recall the specific accounts from which the alleged improper payments were made nor could she recall the amounts involved. When asked about the threats she alleged were made against her, she could not provide any specific details.

Because there is an ongoing Federal investigation into Ms. Hosea's claims, the Joint Committee staff did not pursue Ms. Hosea's allegations issues further.

[1615] *See Mass. Mut. Life Ins. Co. v. Russell,* 473 U.S. 134 (1985).

III. OTHER COMPENSATION-RELATED ISSUES

A. General Overview of Compensation

In general

Enron had a pay for performance compensation philosophy. Employees who performed well were compensated well. The amount of compensation that Enron paid to employees, especially executives, increased significantly over the years immediately preceding the bankruptcy. The amounts of compensation paid in 2000, the year immediately preceding the bankruptcy, are extraordinary.

Tax return data for Enron Corp. and its subsidiaries shows how compensation of officers, salaries and wages, and employee benefit program expenses increased. Table 10, below, shows the deduction taken by Enron Corp. and its subsidiaries for such expenses on its Federal income tax returns for 1998, 1999, and 2000.[1616] Enron's total compensation deduction dramatically increased from 1998 to 2000. The increase in compensation expense was, in part, due to the substantial increase in Enron's deduction attributable to stock options.[1617]

The deduction for compensation of officers increased exponentially. The compensation of officers doubled from 1998 to 1999 and tripled from 1999 to 2000. As shown in Table 10, in 2000 the deduction for compensation of officers was almost twice the deduction for salaries and wages.[1618]

[1616] The deductions for 1998 and 2000 are from the originally-filed returns. The deduction from 1999 is from Enron's amended return. The Joint Committee staff is not aware of amended returns for 1998 or 2000.

[1617] Upon exercise of a nonqualified stock option, the difference between the fair market value of the stock and the option price is generally includible in the gross income of the employee. This amount is also deductible as a business expense by the employer.

[1618] It is unclear how many employees were considered officers for purposes of the compensation deduction.

Table 10.–Enron Compensation Deductions for 1998, 1999, and 2000[1619]

	1998	1999, as amended	2000
Compensation of officers[1620]	$149,901,000	$313,312,000	$952,492,000
Salaries and wages[1621]	$499,746,000	$702,725,000	$557,550,000
Pension, profit-sharing, etc., plans[1622]	$628,000	$834,000	$20,000
Employee benefit program[1623]	$344,676,000	$569,278,000	$1,456,796,000
Total[1624]	$994,951,000	$1,586,149,000	$2,966,858,000

As discussed below in further detail, executives of Enron were extremely highly compensated. Table 11, below, shows information compiled by the IRS, which is based on information provided by Enron, on compensation of the top-200 highly compensated employees for 1998 through 2000.[1625] Compensation for the top-200 increased over recent years, particularly in the area of stock options.

Appendix D includes a list of compensation paid to the top-200 highly compensated employees for 1998 through 2001, which was provided by Enron. As in many instances, the data provided by Enron to the IRS and to the Joint Committee staff does not reconcile.

[1619] Amounts are rounded.

[1620] Includes deductible officers' compensation. Instructions for Forms 1120 (U.S. Corporation Income Tax Return) and 1120-A (U.S. Corporation Short Form Income Tax Return).

[1621] Includes salaries and wages paid for the tax year, reduced by certain employment credits. *Id.*

[1622] Includes deduction for contributions to qualified pension, profit-sharing, or other funded deferred compensation plans. *Id.*

[1623] Includes contributions to employee benefit programs not claimed elsewhere on the return (e.g., insurance, health and welfare programs) that are not an incidental part of a pension, profit-sharing, etc., plan deducted in the previous line. *Id.*

[1624] This is not a line item on the tax return, but was computed for purposes of this table.

[1625] The compensation of the top-200 does not reconcile with the deduction for the officers as shown in Table 10, as the group of employees included in each category is different. For example, an employee could be one of the top-200 highly compensated employees, but not be an officer for purposes of the compensation deduction. Additionally, the compensation of the top-200 also includes nondeductible compensation.

Table 11.–Compensation Paid to the Top-200 Highly Compensated Employees for 1998-2000[1626]

Year	Bonus	Stock options	Restricted stock	Wages	Total
1998	$41,193,000	$61,978,000	$23,966,000	$66,143,000	$193,281,000
1999	$51,195,000	$244,579,000	$21,943,000	$84,145,000	$401,863,000
2000	$56,606,000	$1,063,537,000	$131,701,000	$172,597,000	$1,424,442,000

Enron used a market pricing approach to compensation. Enron frequently used outside consultants, principally Towers Perrin, to determine compensation practices in the market place. The role of outside consultants is discussed below. Total compensation was determined based on job level, job type, individual performance, and company performance. Total compensation targets were established using external benchmarking practices. The components of compensation generally included base pay, bonus, special programs, and long-term incentive compensation. These components are discussed below in further detail.

Enron used a variety of forms of compensation in recent years, including cash, stock, stock options, restricted stock, phantom stock, performance units, and participation interests. Enron also offered employees standard benefits such as participation in retirement plans (as previously discussed) and health and life insurance. Executives were also offered special compensation arrangements, including nonqualified deferred compensation, employee loans, and split-dollar life insurance.

Enron used stock-based compensation as a principle form of compensation. As discussed below in further detail, Enron compensated executives through stock options, restricted stock and phantom stock. All-employee stock option grants were also periodically made. Enron did not grant qualified stock options (i.e., incentive stock options or options under employee stock purchase plans). Stock appreciation rights were granted in the past, but were not granted in recent years.

As shown in Table 12, below, tax return information demonstrates that Enron's stock option deduction dramatically increased over recent years.[1627] The deduction in 2000 was more than 1,000 percent greater than the deduction taken just two years prior.

[1626] The information provided by the IRS includes some inconsistencies. In reproducing the summary data, the Joint Committee staff attempted to reconcile inconsistencies and include the data that appears to be accurate. Amounts are approximates.

[1627] Information from Schedule M1. See Table 11, below, for summary information from the IRS stating that stock option income resulting from the exercises of nonstatutory stock options for the top-200 most highly compensated employees was $62 million for 1998, $244.6 million for 1999, and $1,063.5 million for 2000.

Table 12.--Enron Stock Option Deductions for 1998, 1999, and 2000[1628]

1998	1999	2000
$125,343,000	$585,000 (as filed) $367,798,000 (as amended)	$1,549,748,000

Enron's revised compensation system

Enron's compensation system was revised in the late 1990's.[1629] Prior to 1999, each operating company had its own base pay, annual incentive, long-term incentive, and employment contract arrangements. It was seen as beneficial for Enron for there to be more fungibility between the various operating companies and business units. The new structure was implemented to create one centralized compensation structure for all business units so that employees could move easily between the business units. The new compensation structure was designed with the intention to decrease competition within the various business units for employees resulting from differing compensation structures and plans.

The new compensation structure consisted of standardized base salary, bonus, and long-term incentive. Suggested compensation ranges for each executive by job type and performance rating were developed. In connection with the new structure, Enron developed standardized performance measures and ratings of individual executive performance across business units. The new compensation structure also included buyouts of certain business units' equity plans. Buyouts generally were done in order to move executives out of the older business unit plans and into centralized Enron plans and programs.

Enron had an incentive structure in place for middle and upper management. The revised compensation structure brought a long-term incentive plan that was used throughout the entire company. Before implementation of the new process, business units had their own version of long-term incentives. For example, the international group used the Project Participation Plan, while Enron Capital & Trade Corp. and Enron Energy Services, LLC, each used their own phantom equity plans.

In connection with the new compensation structure, the Compensation Committee also approved the creation and delegation of authority to an administrative committee consisting of

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[1628] Amounts are rounded.

[1629] The possibility of changing Enron's compensation structure was first presented at the May 3, 1999, meeting of the Compensation Committee. The changes were again presented by Mr. Skilling at the June 28, 1999, Compensation Committee meeting and were approved by the Compensation Committee on August 9, 1999. The status of the program was reviewed by the Compensation Committee throughout 1999. The Compensation Committee minutes show that the status of the program was reviewed at the October 11, 1999, and November 16, 1999, Compensation Committee meetings.

Mr. Skilling and Mr. Lay,[1630] to make grants under the long-term incentive program, except for grants to Section 16 officers.[1631]

The new compensation structure was intended to result in uniform compensation packages.[1632] Nevertheless, after the implementation of the new compensation structure, individualized compensation arrangements for executives did exist. For example, the minutes to the Compensation Committee meeting of February 14, 2000, show that an officer of recently reorganized Enron Broadband Services was to receive short-term stock options as compensation in lieu of salary and bonus. As discussed below, one executive was compensated with a fractional interest in an airplane. Despite these individualized arrangements, the new compensation structure did result in a more uniform compensation system.

The new compensation system introduced the new performance evaluation process (referred to as "PEP") for employees, which was a web-based performance evaluation system.[1633] The new performance evaluation process introduced the performance review committee ("PRC") process throughout Enron. Before it was implemented on a company-wide basis, the performance review committee process was used by Enron Capital & Trade Resources. Subject to a few exceptions, the performance review committee process was generally used for all Enron employees.[1634]

At the initial stage of the performance review process, employees were able to choose individuals who were familiar with their work to be reviewers of their performance, subject to the approval of their supervisors. Feedback forms would be completed on-line by the selected reviewers. Performance criteria included business skills, innovation/entrepreneurship, communication/vision and values, team work/interpersonal, leadership, analytical/technical, and

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[1630] In August 2001, the Compensation Committee approved changing the administrative committee to be composed of Mr. Lay and one member of the Compensation Committee.

[1631] Throughout this document, "Section 16 officers" refers to individuals subject to the requirements of section 16 of the Securities Exchange Act of 1934. These requirements include disclosure requirements and restrictions on short-swing profits.

[1632] *See* Attachments to the February 9, 1998, Compensation Committee meeting which outline the executive compensation structures used by the various operating companies.

[1633] Joint Committee staff discussed the performance review process in an interview with Mr. Skilling, who was responsible for establishing the process on a company-wide basis.

[1634] In an interview with Joint Committee staff, Mr. Skilling said that the performance review committee process was not used for non-executives of the pipeline organization. Enron documents state that the following job groups were not required to participate in a formal performance review committee meeting, but would be reviewed at the business unit's discretion. This included junior specialists, specialists, senior specialists, and non-exempt positions. PEP Performance Management HR Guide Year End 2001. ECu000077031. Documents for the 2001 Midyear review state that all active exempt employees are rated in a performance review committee meeting. ECu000077115.

professional and career development.[1635] Performance would be rated in one of the following categories: highly effective, effective, acceptable, and ineffective.[1636] It appears that before 2001, the performance ratings were superior, excellent, strong, satisfactory, needs improvement, and issues.[1637] Supervisors would develop a preliminary rating for their employees based on the reviewers' feedback, which would be used by the performance review committee. Employees were allowed to submit self-assessments to be considered in a performance review committee meeting.[1638]

After the preliminary review was complete, a performance review committee would meet to evaluate individual employee performance. According to Mr. Skilling, there were approximately 30 performance review committees throughout Enron.[1639] Each employee was ranked from one to five, with a ranking of five being the lowest.[1640] According to Mr. Skilling, there was a target distribution of how many employees should fall within each category. Enron documents for the 2001 review state that there was no preferred distribution for performance review committee meetings, but that each unit was required to submit their top 10 percent and bottom 10 percent of employees.[1641] Earlier dated documents state that there was a preferred distribution.[1642]

According to Enron documents, the purpose of the performance review committee meeting was to identify the top 10 percent and bottom 10 percent of performers of each job level based on the intrinsic skills, competencies and potential of employees relative to their peers.[1643] According to documents provided by Enron, the placement of each employee would provide a guide for compensation decisions for year-end bonuses, but the purpose was not to determine compensation, but to determine employee performance and potential.[1644]

[1635] PEP Process Guide 2001. ECu000077160.

[1636] PEP Performance Management HR Guide, Year End 2001. ECu000077031.

[1637] ECu000077017; ECu000077063.

[1638] PEP Performance Management HR Guide, Year End 2001. ECu000077031.

[1639] Enron documents show that there would be no more than 30 meetings in total. ECu000077162.

[1640] PEP Performance Management Midyear 2001 HR Guide. ECu000077129.

[1641] PEP Performance Management Midyear 2001 HR Guide. ECu000077031.

[1642] PEP Performance Management Midyear 2001 HR Guide. ECu000077130.

[1643] PEP Performance Management HR Guide, Year End 2001. ECu000077032.

[1644] PEP Performance Management HR Guide, Year End 2001. ECu000077032.

According to Mr. Skilling, after employees were ranked into the five categories, matrixes were developed. The theory was that all employees in a certain category at a particular job level should be compensated similarly, subject to some modification. According to Mr. Skilling, employees with a ranking of category five were encouraged to "look elsewhere."[1645] Enron documents state that there was no prescribed action for employees in the bottom 10 percent, but that managers would identify which employees need to be part of a performance improvement plan.[1646] According to Mr. Skilling, this group was the only group of Enron employees who did not receive annual bonuses. As part of the revised compensation structure, all other employees received annual bonuses. According to Enron documents, typically promotion candidates typically would come from the top 10 percent, but discretion was given to promote candidates outside of the top 10 percent.

The performance review committees met twice per year, once in June or July and once in January. The January review determined compensation. According to Mr. Skilling, the mid-year review allowed employees to know how they were ranked so that they would have time to improve before the January review. After the completion of the performance review committee process, employees would receive one-to-one feedback from their supervisors. There have been media reports that some employees viewed the performance review committee process as harsh or unfair. One former Enron executive interviewed by the Joint Committee staff indicated that the process may have created tension among employees.

Enron's Compensation Committee

In general

The Compensation Committee of the Board of Directors[1647] (the "Compensation Committee") was responsible for developing the Enron executive compensation philosophy.[1648] The Compensation Committee's focus was stated to be on ensuring that there is a strong link between the success of the shareholder and the rewards of the executive.[1649] According to interviews with Compensation Committee members, the charge of the Committee was to make sure that the executive officers of Enron were adequately compensated in a way to increase shareholder wealth. The Compensation Committee believed in "pay for performance." The

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1645 The media has reported that employees in the lowest ranking group were fired. Enron executives interviewed by Joint Committee staff stated that employees in category five were not fired, but were advised of the ranking they received and may have been encouraged to leave.

1646 PEP Performance Management HR Guide, Year End 2001. Ecu000077032.

1647 In some years, the Committee was named the Compensation and Management Development Committee.

1648 2001 Enron Corp. Proxy Statement.

1649 2001 Enron Corp. Proxy Statement.

Compensation Committee also believed that a great deal of executive compensation should be at risk; if shareholders did not profit, executives would not profit.

As stated in the 2001 proxy, the responsibility of the Compensation Committee "is to establish Enron's compensation strategy and ensure that the senior executives of Enron and its wholly-owned subsidiaries are compensated effectively in a manner consistent with the stated compensation strategy of Enron, internal equity considerations, competitive practice and the requirements of appropriate regulatory bodies."[1650] In the proxies, the Compensation Committee stated its mission as follows:

> The basic philosophy behind executive compensation at Enron is to reward executive performance that creates long-term shareholder value. This pay-for-performance tenet is embedded in each aspect of an executive's total compensation value. Additionally, the philosophy is designed to promote teamwork by tying a significant portion of compensation to business unit and Enron performance. Base salaries, annual incentive awards and long-term incentive awards are reviewed periodically to ensure consistency with Enron's total compensation philosophy.[1651]

Compensation Committee charter

The Board of Directors established the Compensation Committee with authority, responsibility, and specific duties as described in the Compensation Committee charter.[1652] The charter provided that the Committee is to consist of directors who are independent of management and free from any relationship that, in the opinion of the Board of Directors, as evidenced by its election of the Committee members, would interfere with the exercise of independent judgment as a Committee member. Under the charter, the Compensation Committee's basic responsibility is "to assure that the senior executives of Enron and its wholly-owned affiliates are compensated effectively in a manner consistent with the stated compensation strategy of Enron, internal equity considerations, competitive practice, and the requirements of the appropriate regulatory bodies. The charter provided that the Committee is to communicate to shareholders Enron's policies and the reasoning behind such policies as required by the Securities and Exchange Commission."[1653]

The charter dated 1998 provides that the Committee was also responsible, in connection with the Chief Executive Officer, for management development and succession planning for key

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[1650] 2001 Enron Corp. Proxy Statement.

[1651] 2000 Enron Corp. Proxy Statement; 2001 Enron Corp. Proxy Statement.

[1652] On February 9, 1998, the charter was approved to the Board by the Compensation Committee. In response to Joint Committee staff requests for the most recent Compensation Committee charter, Enron provided a copy of the Compensation Committee charter from October 4, 1994. The 1994 and 1998 charters are almost identical.

[1653] Enron Corp. Compensation Committee Charter. EC 002634700 - EC 002634702.

top level management positions. The charter lists other responsibilities of the Compensation Committee, including reviewing Enron's stated compensation strategy, reviewing and determining Chief Executive Officer and senior management compensation, and assuring that Enron's executive incentive compensation program is administered consistent with Enron's compensation strategy. Under the charter, the Compensation Committee was also responsible for approving all new equity-related incentive plans for senior management, approving annual retainer, meeting fees and stock compensation for the Board of Directors, approving executive salary range structures, reviewing Enron's employee benefit programs and approving all changes, hiring executive compensation experts to assist the Committee with its reviews, and such other duties and responsibilities as may be assigned to the Committee from time to time.

The charter provided that the Committee would meet as often as necessary to carry out its responsibilities. Meetings could be called by the Chairman of the Committee and/or management of Enron. All meetings of the Committee were required to be held pursuant to the bylaws of Enron with regard to notice and waiver, and written minutes of each meeting were required to be filed with Enron records. According to the charter, reports of the meetings of the Compensation Committee were required to be made to the Board of Directors at its next regularly scheduled meeting following the Committee meeting accompanied by any recommendation to the Board of Directors approved by the Committee.

Activities of the Compensation Committee

The Compensation Committee made decisions on a wide variety of compensation issues. While the Compensation Committee was principally involved with executive compensation, the duties of the Compensation Committee were not limited to executive compensation. The Compensation Committee approved all qualified retirement plan documents and amendments. They also approved medical and dental plans, severance pay plans, and flexible compensation plans. The Compensation Committee also approved all stock plans, bonus plans, and deferral plans and approved grants of stock options and other equity compensation. The Compensation Committee was also responsible for authorizing bonus pools and often approved accelerated vesting of options and other equity-based compensation. Selected employment agreements were approved by the Compensation Committee.

While the Compensation Committee had responsibility for a wide range of issues, they were not deeply involved in most issues. Members of the Compensation Committee interviewed by Joint Committee staff were not fully aware of all of the issues for which they were responsible and often made decisions. For example, even though changes to the nonqualified deferred compensation plans were approved by the Compensation Committee, one former member of the Compensation Committee interviewed by Joint Committee staff did not know whether Enron offered nonqualified deferred compensation. Even though reflected in the minutes, one former member of the Compensation Committee interviewed by Joint Committee staff could not recall whether the Committee approved qualified retirement plans issues, while another Committee member did not know what a qualified retirement plan was. The Compensation Committee did not scrutinize proposed arrangements, but basically approved whatever compensation arrangements were presented to them by management.

According to interviews with former Compensation Committee members, the Compensation Committee reviewed the compensation of the 30 to 45 senior positions annually. There was special concentration on the Chief Executive Officer and Chief Operating Officer and any other position in the Office of the Chairman. Most meetings of the Compensation Committee included an executive session in which the salaries of the top executives were discussed. Generally, the executive sessions were not recorded in the meeting minutes. The attachments to the minutes show that during the executive sessions, the Committee periodically reviewed executive committee compensation summary charts.[1654] These charts summarized the compensation of the top executives and included information on employment end date, years of service, age, base salary, cash bonus, stock owned, long-term value realized, vested and unvested options, restricted stock, performance units, outstanding long-term value, and five-year projection of outstanding long-term values.

In each annual proxy, the Compensation Committee issued a report regarding executive compensation. The report outlined the responsibility of the Committee and its basic philosophy. The report did not change much, if at all, from one year to the next.

In recent years, the Compensation Committee was composed of a Chairman and three or four members of the Board. According to the Chairman of the Committee during the period reviewed by the Joint Committee staff, the members of the Committee were selected by a nominating committee as the members who were most independent; and then members would be elected by the full Board.[1655] The Compensation Committee met at least once before each Board meeting and also held telephone meetings when issues arose. The Committee formally met ten times in 2000. Until the restructuring following the bankruptcy filing, the members of the Committee were Charles A. LeMaistre, Norman Blake, Jr., John H. Duncan, Robert K. Jaedicke and Frank Savage.[1656] The Board members have been replaced in connection with reorganization of Enron.

Role of outside consultants

The Compensation Committee relied on outside consultants in making a variety of decisions. The annual proxy statements described the Compensation Committee's reliance on outside consultants. According to the 2001 proxy, all decisions regarding executive compensation were made based upon performance, measured against preestablished objectives and competitive practice, as determined by utilizing multiple public and private compensation surveys. The proxy stated that Enron utilized the services of Towers Perrin to conduct an

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[1654] In older years, the charts were labeled "Executive Compensation Value."

[1655] Interview with Dr. LeMaistre.

[1656] Messrs. Blake and Jaedicke were appointed to the Compensation Committee in 1996, replacing Robert A. Belfer and Joe E. Foy. *See* Enron Corp. 1996 and 1997 Proxy Statements. Mr. Savage is first listed as being on the Compensation Committee in the 2000 proxy statement.

executive compensation study covering executives in the top corporate and business unit positions.[1657] Additional studies performed by Towers Perrin are discussed below.

The 2001 proxy states that competitive compensation rates are developed using published and private compensation survey sources for companies of comparable size and, as appropriate, in comparable industries. According to the proxy, data from the sources represent similar positions in general industry and industry specific companies as appropriate.

Towers Perrin advised the Compensation Committee that "under most circumstances, Compensation Committee actions are governed by the Business Judgment Rule. Under this rule, Compensation Committee (and full Board) decisions are not to be second-guessed if good processes have been used in making decisions, even if the impact of the decisions turn out to be unfavorable. A helpful condition for demonstrating sound business judgment is the use of reputable professional experts (such as compensation consultants in the case of making compensation decisions)."[1658]

The minutes of the Compensation Committee meeting on April 30, 2001, discuss the consulting services provided to Enron and the Compensation Committee by Towers Perrin. The services included: (1) providing analysis and recommendation with respect to base, bonus, and long-term compensation for the Office of the Chairman and the Board of Directors; (2) providing updates and opinions relative to trends in executive compensation; (3) reviewing, validating, and recommending executive compensation program design alternatives; (4) providing consultation with respect to governmental regulations and shareholder perspectives on certain issues; (5) reviewing and validating management's executive job pricing analysis and pay target recommendations; (6) providing Black-Scholes stock option valuations on request; and (7) conducting consultations and special studies as requested by management and/or the Compensation Committee.[1659]

Enron frequently obtained analysis from consultants, particularly Towers Perrin, to ensure that the executive compensation program was within its stated philosophy and goals. Towers Perrin periodically issued opinion letters to Enron regarding their compensation programs in general and on specific compensation issues. For example, in December 2001, the Compensation Committee received an opinion letter from Towers Perrin regarding the

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[1657] The compensation studies were said to evaluate total direct compensation, defined as base salary plus most recent actual annual incentive earned plus the estimated annualized present value of long-term incentive grants.

[1658] Letter from Towers Perrin to Dr. Charles LeMaistre dated November 14, 2001. EC2 000028647. This letter is included in Appendix D. Towers Perrin also advised that once a company is in a merger or other similar situation, a higher standard of decision-making could apply.

[1659] Minutes of the meeting of the Compensation Committee, at 4 (April 30, 2001). EC 000102176.

competitiveness of the executive compensation programs at Enron.[1660] Additionally, Towers Perrin issued a letter to Enron dated November 14, 2001, addressing potential strategies Enron might want to consider in dealing with 2001 bonus allocations and possible ways to retain key employees during the period before the anticipated merger with Dynegy was expected to be completed.[1661] The letter outlined how Enron's Compensation Committee was impacted by the announced merger and provided suggested compensation decision parameters.

General compensation studies were frequently performed. For example, a comparative analysis of Enron's executive compensation levels was conducted in November 2000.[1662] In January 2001, the Compensation Committee approved the performance of a study by Towers Perrin to analyze the relationship between pay and performance.[1663] Towers Perrin presented to the Compensation Committee that they concluded that the basic structure of the program was consistent with Enron's stated philosophy and that the program was appropriately tied to performance. Towers Perrin recommended that Enron not make any broad-based programmatic changes to its executive pay programs since pay-for-performance systems work when pay rises and falls according to the gains realized by shareholders.

While Towers Perrin concluded that the basic structure of the program was consistent with Enron's philosophy, the findings of the study show that pay elements were higher than the stated philosophy.[1664] The study looked at the specific compensation of approximately 60 executives. The results of the study showed that the base compensation, base plus bonus, long-term incentives, and total compensation for many executives were considerably above the stated target. The finding showed that for base salaries, Enron was 91 percent of market median.[1665] For total cash, Enron was 140 percent of market 75th percentile.[1666] For long-term incentives, Enron was 97 percent of market 75th percentile,[1667] and for total direct pay was 113 percent of

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1660 The letter provided an overview of Enron's executive compensation programs and is included in Appendix D. EC2 00028641 - EC2 000028645.

1661 Letter from Towers Perrin to Dr. Charles LeMaistre dated November 14, 2001. EC2 000028647. This letter is included in Appendix D.

1662 The results indicated Enron's 2000 actual total direct compensation to be at the 75th percentile of the market, which met Enron's stated philosophy relative to pay and performance.

1663 The findings of the study, dated April 20, 2001, were presented to the Compensation Committee on May 1, 2001. EC 002634703 - EC 002634756. The findings of the study, as presented to the Compensation Committee, are included in Appendix D.

1664 *Id.* at EC 002634712.

1665 *Id.*

1666 *Id.*

1667 *Id.*

market 75th percentile.[1668] Still, Towers Perrin concluded that the program was consistent with Enron's philosophy.

Towers Perrin also provided opinions on individual compensation arrangements. At the request of Enron, Towers Perrin prepared a letter to document the results of marketplace compensation analysis for the top two executives at Enron (Mr. Lay and Mr. Skilling) dated November 16, 2000.[1669] On January 18, 2001, Towers Perrin prepared a letter for Enron providing alternative compensation arrangements for Mr. Lay, given his shift in responsibilities to Executive Chairman of the Board, with Mr. Skilling becoming CEO of Enron.[1670]

From Joint Committee staff interviews with many former members of the Compensation Committee, it appears that many members made decisions relying on the opinions of consultants without fully understanding the underlying issue. For example, former Compensation Committee members interviewed by Joint Committee staff could not explain why Enron purchased two annuities from Mr. Lay and his wife in 2001, but knew that Towers Perrin issued an opinion providing justification for the transaction.

Employment agreements

Several employees had employment agreements with Enron. There were no set rules for determining which employees entered into employment agreements, but generally agreements were executed for top executives and traders. Employment agreements were often used in the commercial areas, or other areas in which skills were in high demand. In many of these cases Enron wanted to have a contract with noncompetition clauses. Employment agreements were generally used for members of the management committee, managing directors and some vice presidents. Documents provided by Enron show that as of February 9, 1998, there were 425 employment contracts in place throughout the various business units and affiliated companies. Enron documents show that as of April 30, 2001, 225 executives, not including traders, below the Vice President level had employment agreements with Enron.[1671]

Employment agreements were individually negotiated, but generally included certain standard terms. Agreements generally included an appendix listing the employee's base salary, bonus and long-term incentive and generally included a signing bonus. Employment agreements were often renegotiated before expiration. Terms were typically two to three years. Some contacts included noncompete provisions. Selected employment agreements were approved by the Compensation Committee. The Compensation Committee generally approved the agreements for the top executives only.

[1668] *Id.*

[1669] Letter from Towers Perrin to Pam Butler dated November 16, 2000. EC 000102297 - EC 000102306. The letter is included in Appendix D.

[1670] Letter from Towers Perrin to Dr. Charles LeMaistre dated January 18, 2001. EC 000102234 - EC 000102238. The letter is included in Appendix D.

[1671] EC 000102476.

B. Overview of Executive Compensation Arrangements

1. In general

Overview

Enron's stated executive compensation philosophy was to provide executives with rewards that reflect their impact on Enron's total shareholder returns and creation of long-term shareholder value.[1672] As previously discussed, each year, the Compensation Committee established total compensation targets based on an assessment of external trends and market data. According to Enron employee materials, the key tenets of the executive compensation program were: (1) to tie executive compensation to the creation of shareholder value; (2) to deliver a significant portion of total compensation in a combination of short-term and long-term incentives so that executives have the opportunity to earn at the 75th percentile of the external marketplace or higher, subject to the achievement of Enron financial and nonfinancial goals and individual performance objectives; and (3) to promote teamwork and support movement of key talent to opportunities as they arise throughout the organization.[1673]

Executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Executives had the opportunity to earn at the 75th percentile or higher level, subject to obtaining performance at the 75th percentile or higher.[1674] In addition to the three principal components of executive compensation (base salary, annual incentive and long-term incentive), certain executives also participated in special compensation arrangements, such as nonqualified deferred compensation programs, split-dollar insurance arrangements, and employee loans. Individualized compensation arrangements were also used for certain executives. For example, as discussed below, as a form of compensation, Enron purchased two annuities from Kenneth L. Lay and his wife. Another executive, Mr. Lou Pai, received a fractional interest in an airplane as part of his compensation.

Base salary

Base salary levels were targeted at the 50th percentile of the external marketplace. An annual salary increase budget was set to maintain Enron's position relative to the market. Base pay was reviewed and adjusted at Enron's discretion and in relation to market conditions, but was also reflective of individual performance. Base pay was generally reviewed and adjusted on February 1 of each year, if appropriate. Base salary increases were typically approximately four percent per year.[1675]

[1672] Enron Compensation Program 2001 (employee brochure). EC2 000019710.

[1673] Enron Compensation Program 2001 (employee brochure). EC2 000019710.

[1674] Report from Compensation Committee, 2001 Enron Corp. Proxy Statement.

[1675] The minutes of the May 3, 1999, meeting of the Compensation Committee show that Messrs. Lay and Skilling requested that the Committee not increase their respective salaries for

Annual incentive awards

Annual bonuses were a major component of Enron's executive compensation structure. Annual bonuses were targeted at the 75^{th} percentile level compared to the market and could often be larger than base salary for some employees.

According to the 2001 proxy, the primary objective of the annual incentive plan was to promote outstanding performance by Enron in absolute terms, as well as in comparison to its peer companies. The plan was funded as a percent of recurring after-tax net income as approved by the Compensation Committee each year.

Competitive annual incentive targets were established by the Compensation Committee each year based on external trends and market data.[1676] Payments were based upon Enron's performance against preestablished goals, as well as business unit and individual performance. According to the 2001 proxy, annual bonus payments were based upon Enron's performance measured against Enron's operating plan as approved by the Board of Directors. Key performance criteria such as funds flow, return on equity, debt reduction, earnings per share improvements, and other relevant factors could be considered at the option of the Committee. Proxy statements from recent years state that a Performance Review Report was presented to the Compensation Committee in January, which summarized management's view regarding whether and to what extent the key performance criteria were attained. The Performance Review Report also discussed any other significant, but unforeseen factors that positively or negatively affect Enron's performance. The Compensation Committee verified Enron's actual recurring after-tax net income, reviewed management's funding level recommendation, and approved the resulting award fund.

The Performance Review Committee process and resulting employee ranking significantly influenced the actual incentive awards paid. The Annual Incentive Plan was used for bonuses for Section 16 officers. The Annual Incentive Plan for Section 16 officers was funded as a percentage of after-tax net income, not to exceed five percent. Officers other than Section 16 officers were paid annual bonuses, but not through the Annual Incentive Plan.

Annual incentives are discussed in detail in Part III.B.2., below.

Long-term incentives

According to the 2001 proxy, Enron's long-term incentive program was designed to tie executive performance directly to the creation of shareholder wealth. The long-term incentive

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1999. The Committee reluctantly agreed to honor the request on the condition that the minutes reflect the Committee's judgment that during 1998 Messrs. Lay and Skilling had performed their respective duties superbly, that Enron's shareholders had benefited significantly from such performance, and that, in the absence of the specific request they had made, each would have received a salary increase for 1999.[1675] Joint Committee staff asked several interviewees about this and no one, including Mr. Skilling, could recall the reason for the request.

[1676] 2001 Enron Corp. Proxy Statement.

program provided for awards of nonqualified stock options and restricted stock. Awards were one-half stock options and one-half restricted stock. In the past, the Compensation Committee utilized other long-term compensation vehicles. Option grants generally vested over a five-year term. The number of options to be awarded was determined based on the approved Black-Scholes value as determined by the Compensation Committee. Restricted stock grants generally vested over four years, but could be accelerated based on Enron's performance relative to the S&P 500 index.

Participation in the long-term incentive plan was available to employees in the vice president job group and above.[1677] Long-term incentive target values were to be established by the Compensation Committee each year based on assessment of external trends and market data.[1678] Actual grants were determined each January based on the year-end performance review committee assessments and were subject to the approval by the Office of the Chairman. Award agreements providing the terms and provisions of the awards were typically presented to recipients during the first quarter of the year. Grants for section 16(b) officers required Compensation Committee approval.

Before the changes to Enron's compensation structure in 1999, some business units had their own long-term incentive programs. For example, Enron Capital & Trade Resources had its own long-term compensation program for stock options and phantom stock units, which were granted under the Enron Capital & Trade Resources Corp. Phantom Stock Unit Plan.

Long-term incentives are discussed in detail in Part III.C.2., below.

<u>Nonqualified deferred compensation</u>

Certain executives were given the opportunity to participate in nonqualified deferred compensation arrangements. Participants were eligible to defer all or a portion of salary, bonus and long-term compensation into Enron-sponsored deferral plans. The plans provided an opportunity to delay payment of Federal and State income taxes and earn tax-deferred return on deferrals. Many executives took advantage of the opportunity to defer amounts that would otherwise be included in income currently. The specific nonqualified deferred compensation plans and programs offered by Enron are discussed below in more detail.

<u>Miscellaneous</u>

Enron maintained a FlexPerq program for Managing Directors and above. Under the program, certain expenses were covered by an allowance rather than required to be submitted for reimbursement on an expense report. These included income tax preparation, investment counseling/estate planning, legal counseling, country club and health club membership, luncheon club membership, airline VIP club membership, car/cell phone, in-home long-distance service, and "premium" credit cards. In materials provided to executives, Enron explained that all FlexPerq allowance amounts would be reported as compensation on the participant's Form W-2.

[1677] Enron Corp. Executive Compensation Program brochure. EC 002634797.

[1678] Enron Corp. Executive Compensation Program brochure. EC 002634797.

Eligible participants would be given an annual FlexPerq allowance equal to three percent of their salary.

Top-200 most highly compensated

Appendix D shows the compensation paid to each of the top-200 highest paid employees for the years 1998, 1999, 2000, and 2001.[1679] Compensation attributable to bonus, stock options, restricted stock, deferred payout, and other compensation is separately stated. As shown in Appendix D, the top executives were extremely highly compensated, especially in the years immediately preceding Enron's bankruptcy. The range of total compensation paid to the top-200, as provided by Enron, is shown in Table 13, below.

Table 13.–Range of Total Compensation Paid to the Top-200 Most Highly Compensated Employees for 1998-2001[1680]

Year	Range of Total Compensation Paid to the Top-200
1998	$152,000 to $20,621,000
1999	$325,000 to $56,541,000
2000	$1,270,000 to $168,741,000
2001	$1,104,000 to $56,274,000[1681]

In 2000 and 2001, each one of the top-200 employees was paid over $1 million. In 2001, the year of Enron's bankruptcy, at least 15 executives were paid over $10 million. One executive was paid over $56 million.[1682] In 2000, three executives were paid over $100 million, with the top-paid executive receiving $169 million. In 2000, at least 26 executives were paid over $10 million.

Table 14, below, shows information obtained from the IRS, which is based on information provided by Enron, on the total compensation for the top-200 employees for 1998 through 2000.

1679 This information was provided to the Joint Committee staff by Enron.

1680 Amounts are rounded.

1681 For 2001, $56.274 million is the highest compensation which is separately listed. There are eight separate listings for Chairman and CEO, but because names are not provided it is unclear whether compensation to some individuals is separately stated in more than one line entry.

1682 As mentioned above, there are eight separate listings for Chairman and CEO, but because names are not provided it is unclear whether compensation paid to the most highly compensated individual is included in more than one line entry, which is likely the case.

Table 14.–Total Compensation Paid to the Top-200 Highly Compensated Employee for 1998-2000[1683]

Year	Total Compensation paid to the Top-200
1998	$193,281,000
1999	$401,863,000
2000	$1,424,442,000

As in many other cases, the information provided by the Company to the IRS does not reconcile with the information provided by Enron to the Joint Committee staff.

Executive compensation White Papers

In general

During 1986, the Compensation Committee, with the assistance of Hewitt Associates, developed the compensation philosophy, objectives, and comprehensive executive compensation program for senior Enron executives to be implemented January 1, 1987.[1684] With the merger of HNG and InterNorth, Enron needed to reconcile the different executive compensation philosophies and programs. With the help of Board members and management, Hewitt Associates developed a suggested philosophy and objectives for the compensation program. Based on these suggestions, the Management Committee developed a comprehensive executive compensation program based upon the agreed-to philosophy and objectives. The Compensation Committee approved the program (with modification), as did the full Board of Directors on December 8, 1986, subject to ongoing review and change. Approximately 60 Enron executives (less than 1 percent of the total Enron employee population) participated in the original program, including management committee members, operating company presidents, corporate officers, and selected key line and staff officers in the operating companies.

The Enron Executive Compensation Program "White Paper" provides a summary of Enron's executive compensation polices. The White Paper was periodically revised to incorporate changes agreed to by the Compensation Committee. The White Paper was distributed by management to the executives who were participants in the program. The original White Paper was dated August 1987, and was revised August 1990, May 1993, January 1996, January 1997, and January 1998. The changes between the various versions are relatively minor. In most cases, the only changes from one version to the next are the peer companies used for performance comparison and the number of executives participating in the program. The following discussion summarizes the executive compensation White Paper.

[1683] The information provided by the IRS includes some inconsistencies. In reproducing the summary data, the Joint Committee staff attempted to reconcile inconsistencies and include the data that appears to be accurate. Amounts are rounded.

[1684] EC 001934641 - EC 001934656.

Compensation philosophy and objectives

Throughout the various versions of the White Paper, Enron's stated compensation philosophy for its senior management remained the same and included the following:

- Total compensation will consist of base pay, annual bonus, long-term incentive pay, benefits, and perquisites.

- Individuals will have an opportunity to earn at the 75th percentile or higher level relative to peer companies, subject to obtaining performance at the 75th percentile or higher. Higher achievement provides higher payouts, while lesser achievement decreases total compensation. In order to assure that individual compensation is tied to performance, more dollars of total compensation will be placed at risk, tied to Enron absolute performance, and performance relative to its peers.

- Program design will promote teamwork by tying a significant portion of compensation to subsidiary and Enron Corp. performance.

White Paper Updated, January 1998

The most recent version of the White Paper appears to be January 1998,[1685] which is almost identical to all other older versions, as Enron's compensation philosophy has generally been the same since 1986. The January 1998 White Paper is included in Appendix D. The major components of the most recent White Paper, January 1998, are summarized below. Joint Committee staff asked Enron whether the White Paper had been revised since the January 1998 version. In response to this request, Enron provided an undated Enron Corp. Executive Compensation Program brochure.[1686] The brochure is summarized below and is included in Appendix D. It is unclear whether the brochure replaced the White Paper.

According to the White Paper, the executive compensation program would be reviewed biannually for market competitiveness and was reviewed periodically to determine if changes in philosophy, targets or compensation vehicles were necessary. The White Paper lists the companies that would be considered the "market" in making compensation comparisons.

Compensation Objectives.–The compensation objectives were stated as shown in Table 15 below.[1687]

[1685] EC 001934688.

[1686] EC 002634796 - EC 002634799.

[1687] This table lists the compensation objectives exactly as stated in the January 1998 White Paper. EC 001934689.

Table 15.–Enron "White Paper" Compensation Objectives

Component	Enron Target
Base Salary	50th Percentile
Target Annual Bonus for Outstanding Performance	"Gap" between Total Direct Target and Base Salary
Total Direct Compensation	Commensurate with Enron Performance - Target of 75th Percentile
Long-Term Incentive Pay	Grants at 75th Percentile - Payouts Commensurate with Enron Performance
Benefits	Same as All-Employee Benefits Target
Perquisites	50th Percentile

Participation.–According to the 1998 White Paper, approximately 78 Enron executives participated in the program. These 78 executives included management committee members, operating company presidents, corporate officers, and selected key line and staff officers in the operating companies. These 78 executives represent approximately one percent of the total Enron employee population. The participation is an increase from 60 in 1987, which at that time was less than one percent of the employee population.

Base salary.–The target for base salary was the 50th percentile of the market. The salary midpoints were set at the 50th percentile for the executive positions. The annual merit increase budget was set to maintain Enron's market position.

Annual Incentive Plan.–The primary objective of the annual incentive plan was to promote outstanding performance by Enron in absolute terms, as well as in comparison to its peer companies. The plan was funded as part of a percent of after-tax net income as approved by the Compensation Committee each year. Payouts under the program would be made in the year following the year of performance. The payout would be based upon Enron's performance against preestablished goals, as well as subsidiary and individual performances.

Long-term incentives.–Enron's long-term incentive program was designed to tie executive performance directly to the creation of stockholder wealth over a four-year period. Payout was based upon how well Enron's stock price performed absolutely and how well it performed against the stock process of its peer companies.

Each participant would be assigned a "Targeted Grant Value" coincident with selection for participation in the program and in December each year thereafter. The "Targeted Grant Value" would be determined by the results of the Hewitt Compensation Survey.

Grants were targeted at the 75th percentile. One half of the grants would be paid in nonqualified stock options to foster shareholder return. The remaining one half would be granted in the form of performance units to be paid within six weeks after the close of books for the fourth year. The Compensation Committee had the option to substitute any other long-term compensation vehicles that they deemed appropriate (e.g., restricted stock).

Enron Corp. Executive Compensation Program brochure

In general.–As discussed above, the Joint Committee staff asked Enron whether the White Paper had been revised since the January 1998 version. In response to this request, Enron provided an undated Enron Corp. Executive Compensation Program brochure.[1688] It is unclear whether the brochure replaced the White Paper. The brochure is included in Appendix D. According to the brochure, the "central philosophy of Enron's executive compensation program is to provide executives with rewards which reflect their impact on Enron's total shareholder returns and creation of long-term shareholder value. The Program is targeted at Enron's senior management team, which is approved each year by the Compensation and Management Development Committee . . . of the Enron Board of Directors."[1689] The key tenets of the program, as stated in the brochure, are:

- To deliver market competitive total compensation targets as determined through comprehensive market studies.

- To deliver a significant portion of total compensation in a combination of short-term and long-term incentives so that executives have the opportunity to earn at the 75th percentile of the external marketplace or higher, subject to the achievement of company financial and nonfinancial goals and individual performance objectives.

- To tie executive compensation to the creation of shareholder value.

- To promote teamwork and support Enron's desire for a transferable workforce.

The brochure states that the Enron Corp. Executive Compensation Program is "designed to promote excellence in both team and individual performance and to attract and retain key talent." The program is revised annually for market competitiveness. It is also reviewed periodically to determine if changes in philosophy, targets or compensation vehicles are necessary to help attract, motivate and retain executive talent."[1690]

The various components of the executive compensation program are discussed in the brochure and include base salary, annual incentives, long-term incentives, executive deferral plans, and benefits. The components of the program as explained in the brochure are discussed below. These are essentially the same as described in the White Paper for prior years.

[1688] EC 002634796 - EC 002634799.

[1689] Enron Corp. Executive Compensation Program brochure. EC 002634796.

[1690] Enron Corp. Executive Compensation Program brochure. EC 002634799.

Base salary.–Base salary was targeted at the 50th percentile of the external marketplace. An annual salary increase budget was set to maintain Enron's market position. Base pay was reviewed and adjusted on February 1 of each year.

Annual incentives.–Competitive annual incentive targets were established by the Committee each year based on an assessment of external trends and market data. Cash awards were determined each January based on company and business unit performance as determined by the Committee. Individual performance, as determined trough year-end performance review committee process had a significant influence on actual incentive awards paid.

Long-term incentives.–Long-term incentives were composed of stock options and restricted stock. Options grants provided time-based vesting. Restricted stock grants were made with a future vesting date, which could be accelerated based on Enron's performance relative to the S&P 500. The brochure describes how restricted stock vesting could be accelerated based on Enron's annual cumulative shareholder return relative to the S&P 500. Participation in the long-term incentive program was available to employees in the vice present job group and above. Actual grants were determined each January based on the year end performance review committee assessments and were subject to approval by the Enron Corp. Office of the Chairman. Awards are presented to each recipient during the first quarter of the year. Grants to Section 16 officers required Compensation Committee approval.

Executive deferral plans.–Long-term incentive plan participants were eligible to defer all of a portion of salary, bonus and long-term compensation into Enron-sponsored deferral plans.

Benefits.–Executives typically had the same benefit plans as other Enron employees.

2. Bonuses

In general

As discussed above, the components of executive compensation at Enron included base salary, annual incentive awards (cash bonus) and long-term incentive. Bonuses were targeted at the 75 percent level. There has been much media attention on the magnitude of bonuses paid to Enron executives. In many cases, bonuses were the principal compensation component. Appendix D shows the bonuses received by each of the top-200 highest paid employees for the years 1998, 1999, 2000, and 2001.[1691] Bonuses paid in 2001, the year of Enron's bankruptcy, were as high as $5 and $8 million dollars in some cases. In 2001, at least 48 executives received bonuses of $1 million or greater. Table 16, below, shows bonuses for the top-200 employees according to information obtained from the IRS.[1692] Enron's bankruptcy filing Exhibit 3b.2 shows that bonuses to 144 insiders (managing directors and above) paid during the year preceding the bankruptcy totaled approximately $97 million.

[1691] This information was provided to the Joint Committee staff by Enron.

[1692] The data is based on information provided by Enron to the IRS. As in other cases, information regarding bonuses provided by Enron to the Joint Committee staff does not reconcile with similar information provided by Enron to the Joint Committee staff and to the IRS.

Table 16.–Total bonuses for the top-200 highly compensated employees[1693]

Year	Total bonuses for the top-200
1998	$41,193,000
1999	$51,195,000
2000	$56,606,000

The Joint Committee staff asked Enron to provide the average employee bonus for employees other than the top-paid 200, for each of the years 1999 - 2001. Enron provided information on managers and above only.[1694] For such group, the average bonus paid in 2000 (earned in 1999) was $37,396, which was an average of 43.6 percent of base salary and 19.5 percent of total compensation. The average bonus paid in 2001 (earned in 2000) was $61,543, which was an average of 70.7 percent of base salary and 27.4 percent of total compensation.

According to materials provided to employees, the primary objectives of Enron's annual incentive plan were to provide cash awards aligned with Enron's achievement of preestablished financial and nonfinancial operating goals and to reward individual contributions to Enron's success.[1695] In recent years, the Annual Incentive Plan was used for bonuses for certain executives.[1696] Prior to 1999, the Annual Incentive Plan was also used for bonuses to non-executives. According to Enron, generally all employees were eligible for incentive/variable pay consideration unless excluded due to union contracts, local labor laws, etc.[1697] Payment of bonus, however, was continent on company an individual performance; therefore, less than 100 percent of employees actually received bonuses.[1698] Employees interviewed by Joint Committee staff stated that all employees, other than those receiving a performance review committee ranking of category five, received annual bonuses.

Prior to the modification of Enron's compensation structure in 1999, some business units maintained their own bonus plans. For example, the Enron International, Inc. Project Participation Plan was used for international developers. The Project Participation Plan has received a considerable amount of attention because of the large bonuses that were paid from the plan and because of the way that bonus amounts were determined. For a discussion of the Project Participation Plan, see Part III.B.3., below.

1693 Amounts are rounded.

1694 EC 002690459. Because Enron did not provide the specific data requested, the averages are not true indicators of typical employee bonuses.

1695 Executive Compensation Program brochure. EC2 00019710.

1696 Enron's bonus program is generally referred to as its "annual incentive plan," which includes the Enron Corp. Annual Incentive Plan, as approved in 1999.

1697 EC 002679698.

1698 EC 002679698.

Annual Incentive Awards

Annual Incentive Plan

The most recent version of the Enron Corp. Annual Incentive Plan (the "Annual Incentive Plan") was executed as of May 4, 1999, and was effective as of January 1, 1999. The Plan was "designed to recognize, motivate, and reward exceptional accomplishment toward annual corporation objectives; to attract and retain quality employees; and to be market competitive."[1699]

The Annual Incentive Plan was approved by the shareholders at the May 1999 Annual Meeting. Before the approval of the plan in 1999, an older version of the Annual Incentive Plan had been approved by the shareholders in 1994. The older version of the plan was somewhat different from the plan approved in 1999, as eligibility under the 1994 plan included all full-time and part-time employees, while eligibility under the more recent version is limited to Section 16 officers. With the change in class of eligible employees under the Plan, employees other than Section 16 officers still received annual bonuses, but not through the Annual Incentive Plan.

The Annual Incentive Plan was administered by the Compensation Committee of the Board of Directors, who had the sole discretion to interpret the plan, approve preestablished, objective, annual performance measures, certify the level to which the performance measures were attained prior to any payment under the Plan, approve the amount of awards made under the Plan, and determine who is to receive payments under the Plan.[1700]

The Annual Incentive Plan has an annual award fund of five percent of recurring after-tax net income of Enron. "Recurring after-tax net income" is after-tax net income subject to downward adjustment by the Compensation Committee in its discretion for what the Committee considered extraordinary or nonrecurring items of after-tax net income and other items or events, including, but not limited to financial impact on Enron resulting from changes in law or regulation pertaining to Federal corporate taxes. The maximum individual target award level that may be established under the Plan is one percent of the recurring after-tax net income of Enron. This is an increase from the Annual Incentive Plan in effect prior to 1999, which had a maximum individual award level of .5 percent.

According to the Plan document, at the end of each plan year, the Compensation Committee would verify the actual recurring after-tax net income of Enron, if any, and the resulting award fund (taking into consideration any downward adjustments made by the Committee). The Committee would then determine which participants would receive payments under the Plan and the amounts of the payments. Payments made under the Plan could be made in cash or other property having equivalent value, including shares of Enron Corp. common stock. Cash payments under the Plan could be deferred according to the terms of Enron's deferral plans. Eligible recipients of an Annual Incentive Plan bonus payment could defer up to 100 percent of bonus into one or more of the Enron Corp. 1994 Deferral Plan, the Enron Corp. Bonus Stock Option Program and/or the Enron Corp Bonus Phantom Stock Program.

[1699] Enron Corp. Annual Incentive Plan.

[1700] Enron Corp. Annual Incentive Plan.

Bonus determinations

Bonuses for individuals would be determined after the approval of bonus pools. Preliminary bonus pools were generally approved at the close of the current year as were preliminary funding for the following year. Exact bonus amounts would be determined and approved in the beginning of the following year. The year-end Performance Review Committee process significantly influenced the annual incentive paid to an employee.[1701]

According to the 2001 Proxy, annual bonus payments were based upon Enron's performance measured against the Enron Operating Plan as approved by the Board of Directors. Key performance criteria such as funds flow, return on equity, debt reduction, earnings per share improvements, and other relevant factors were considered at the option of the Compensation Committee.[1702] A Performance Review Report, which summarized management's view regarding whether and to what extent the key performance criteria were attained, would be presented to the Compensation Committee in January.[1703] The report also discussed other significant, but unforeseen factors that positively or negatively affected Enron's performance. The Compensation Committee would verify Enron's actual recurring after-tax net income, review management's funding level recommendation and then approve the resulting award fund.[1704]

After the Board of Directors determined the overall funding level, the Office of the Chairman determined the allocations for each operating group based on performance. Individual payouts were based on business unit performance (or corporate financial performance for corporate executives) and the employee's individual performance as determined through the Performance Review Committee process. The Compensation Committee would review the individual recommendations for key executives and the Office of the Chairman would approve the recommendations for all other participants.[1705] In an interview with Joint Committee staff, the former chairman of the Compensation Committee stated that bonuses for executives were generally proposed by management and then recommended to Compensation Committee, who would basically approve what management had proposed. According to interviews with current and former Enron employees, bonuses for nonexecutive level employees were generally determined by market data and then ultimately approved by management.

Funding

Before 2000, Enron's bonuses were funded as a percentage of each specific business unit's net income. Maintaining separate bonus funding created problems for business units,

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[1701] Executive Compensation Program brochure. EC2 00019710.

[1702] 2001 Enron Corp. Proxy Statement.

[1703] *Id.*

[1704] *Id.*

[1705] *Id.*

especially new business units, that had little or no net income, but significant total shareholder value. As discussed below, to help ensure continued employee fungibility, a single corporate-wide funding pool was established.

Before the 1999 restatement of the Annual Incentive Plan, a bonus pool for all Enron Corp. Section 16 officers and corporate staff would be determined annually. The Annual Incentive Plan as adopted in 1994 did not have a specific bonus target, but allowed the Compensation Committee to set a target based on after-tax net income. For 1996, the Annual Incentive Plan fund for Enron Corp. was 11 percent of after-tax net income. For 1997 and 1998, the Annual Incentive Plan fund for bonuses was 15 percent of after-tax net income.

At Enron's request, Towers Perrin prepared a letter, dated July 27, 1998, providing information about the percentage of after-tax net income allocated to management annual incentives.[1706] Towers Perrin commented that Enron's annual bonus spending cap of 15 percent of after-tax net income for Section 16 officers and corporate staff was relatively high.[1707] However, Towers Perrin noted that most companies are well advised to set high bonus caps because the limits exist only to preserve the tax deductibility of compensation paid to the top-five highest paid officers.[1708] Beginning in 1999, with the effectiveness of the restated Annual Incentive Plan, which limited eligibility for payments under the Plan, there was a five-percent bonus pool for Section 16 officers. Bonuses of corporate staff were not paid from the five-percent pool.

As discussed above, until 2000, Enron funded bonus pools for each business unit and for corporate staff based on market levels of incentive funding by business line.[1709] In 2000, senior management expressed concern that this bonus funding structure discouraged key commercial employees from leaving profitable units to take critical positions in less profitable units (since funding was based on a percentage of net income for each unit).[1710]

To address that concern, at the recommendation of Towers Perrin, the Compensation Committee adopted a new bonus funding scheme under which bonuses throughout Enron would be funded with one pool. At its December 11, 2000, meeting, the Compensation Committee approved a change in the compensation scheme to utilize a single corporate-wide bonus funding pool for 2000 which would be set at up to 27 percent of after-tax income. Individual employee

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[1706] EC 000104381.

[1707] The Towers Perrin survey showed that most companies pay management annual incentives from two percent to 10 percent of net income. EC 000104381.

[1708] See the discussion of the $1 million limit on deductibility of executive compensation in Part III.C.6, below.

[1709] Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641. This letter is included in Appendix D.

[1710] *Id.*

bonus allocations from the pool would be made using discretion, but considering the value of the individual's position using market data and individual performance.

At the January 22, 2001, Compensation Committee meeting, the 2000 bonus pool as a percentage of after-tax net income up to 27 percent was adopted.[1711] This pool included Enron Corp. and all business units. The pool as a percentage of earnings before interest and taxes was up to 15 percent. Pursuant to the Annual Incentive Plan, the pool allocated under the Plan (for Section 16 officers) was five percent of recurring after-tax net income. Towers Perrin advised Enron that its annual incentive plan design was consistent with market 75th percentile practices for energy trading and marketing entities.[1712]

Annual bonuses for employees other than executives

As of January 1, 1999, even though payments under the Annual Inventive Plan were limited to Section 16 officers, other employees were paid annual bonuses under the general bonus pool of Enron. The bonuses were determined similar to the determination of executive bonuses and were market driven. Consulting firms, such as Towers Perrin, would be involved in determining bonuses for both executives and nonexecutives.

Bonus deferral programs

In general

Enron had two bonus deferral programs, the Bonus Stock Option Program and the Bonus Phantom Stock Deferral Program. The bonus deferral programs gave participants an opportunity to receive stock options and/or phantom stock in lieu of cash bonus payments.[1713] It appears that these programs were open to all employees receiving a cash bonus, with the exception of certain employees working outside of the United States. These programs were considered deferral programs because Federal and State income taxes associated with bonus deferrals, plus appreciation on such amounts, were not incurred until stock options were exercised or phantom shares were released. Participants were required to enroll in the programs in the year prior to the scheduled bonus payment. Participation in the programs did not guarantee that a participant would receive a bonus. The minutes of meetings of the Compensation Committee show that the Committee approved the issuance of stock options and phantom stock that Section 16 officers elected to receive pursuant to the bonus deferral programs.[1714]

[1711] The letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001, states that the bonus pool approved was 24.5 percent of recurring net income. The Compensation Committee minutes reflect approval of a bonus pool of 27 percent.

[1712] Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641.

[1713] EC2 0000018944.

[1714] *See, e.g.*, Minutes of Compensation Committee meetings held January 24, 2000, and January 22, 2001.

Bonus Stock Option Program

The Bonus Stock Option Program provided employees with an opportunity to purchase stock at a fixed price, over a specified period of time. Under the Bonus Stock Option Program, participants could elect to defer up to 50 percent of bonus (in 5 percent increments) to purchase stock options.[1715] For every dollar deferred into the program, the participant would receive $1.50 in expected value (employees would receive a 50 percent premium). The size of the grant was determined using a Black-Scholes ratio. Before 2001, a fixed dollar value was used. Bonus stock options were fully vested immediately upon grant. Beginning with 2001 deferrals, options had a five-year term.[1716] Before 2001, options had a seven-year term. The change was meant to be in sync with an overall trend in moving toward shorter stock option grants.[1717] Company documents show that when the options were exercised, all taxes (Federal and state income taxes and FICA and Medicare) were due.

Employee materials emphasized that there is risk in choosing to receive a portion of bonus in stock options.[1718] Employees were informed that if the stock price did not appreciate to the break-even point before exercise, the participant would receive less than the amount deferred and could lose the entire deferred bonus amount if the stock price did not increase above the grant price. According to documents provided by Enron to the IRS, in 2000, approximately 1,121 employees participated in the Bonus Stock Option Program, deferring amounts ranging from $75 to $300,000.

Bonus Phantom Stock Program

The Bonus Phantom Stock Program was established in 1997 to allow Enron employees the opportunity to take a one for one exchange of cash for phantom stock for up to 50 percent of any cash bonus received.[1719] A participant electing to defer a percentage of bonus could select a holding period from one to five years and would receive a premium of five percent for each year holding the shares.[1720] Phantom stock mirrored the performance of Enron Corp. common stock and was used so that employees would not be considered to be in receipt of actual shares at the time of grant, thereby allowing deferral of taxes until the shares were released. Dividend equivalents accrued during the holding period.

[1715] Bonus Stock Option Program employee materials. EC2 000019129.

[1716] EC2 000018959.

[1717] Letter from Kim Bolton describing deferral programs dated October 12, 2000. EC2 000018424.

[1718] EC2 000018968.

[1719] EC 000104582.

[1720] Employee election form. EC2 000018971.

Beginning in 2001, Company documents show that FICA and Medicare taxes were due on the bonus shares (deferred amounts) on the bonus payment date, and would be deducted from the remaining bonus or from subsequent paychecks until fully collected.[1721] It appears that prior to 2001, FICA and Medicare taxes on the deferred bonus would be paid when the shares were released. FICA and Medicare on premium shares would be paid when the phantom shares were released. Federal and State income taxes were imposed when phantom shares are released.[1722] At the end of the holding period, shares would be sold to cover the tax liability and remaining shares would be released into the employee's brokerage account.[1723] An employee could also choose to pay withholding taxes in cash.

Information provided by Enron states that in the initial year of the Bonus Phantom Stock Program, 1998, there were approximately 620 participants.[1724] Information provided by Enron also shows that there were approximately 610 participants in 1999, 1,140 in 2000 and 681 in 2001. According to documents provided by Enron to the IRS, in 2000, approximately 1,673 employees participated in the program and deferred amounts ranging from $166 to $282,000.[1725]

Pre-bankruptcy bonuses

In general

In the weeks immediately preceding the bankruptcy, Enron implemented two bonus programs for (1) approximately 60 key traders and (2) approximately 500 employees that Enron claimed were critical for maintaining and operating Enron going forward. The combined cost of the programs was approximately $104.9 million.[1726] The minutes of the Board of Directors meetings and Compensation Committee meetings in which such payments were approved, discussed below, are included in Appendix D.

Bonuses for traders

At the November 16, 2001, meeting of the Compensation Committee, Lawrence Gregory ("Greg") Whalley reported concerns of key employees that annual bonuses either would not be

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[1721] Power-point presentation explaining the bonus deferral programs. EC2 000018950.

[1722] Power-point presentation explaining the bonus deferral programs. EC2 000018951.

[1723] Power-point presentation explaining the bonus deferral programs. EC2 000018952.

[1724] Information provided September 4, 2002. EC 001872010.

[1725] As stated previously, information provided by Enron to the Joint Committee staff and to the IRS does not reconcile in many cases.

[1726] Attachment to the December 20, 2001, Compensation Committee meeting. EC2 000028654.

awarded or, if awarded, might not be funded by Enron.[1727] Mr. Whalley reviewed the terms of a proposed grantor trust of Enron North America to fund the payment of 2001 performance bonuses to certain key personnel of Enron North America as well as Enron Energy Services and Enron Canada. The bonus trust was approved by the Compensation Committee on November 16, 2001, and was approved by the Board of Directors on November 18, 2001.[1728] Pursuant to this approval, Enron established a 2001 annual bonus pool of $50 million to be paid to up to 100 key commercial employees (referred to as traders).[1729] Towers Perrin advised that such funding equaled about 2.5 percent of Enron Americas' earnings before income taxes, which was dramatically less than market median funding of 15 percent of earnings before income taxes for energy trading units.[1730]

Originally, it was approved that payments to the traders would be made as long as the employee was actively employed on the designated payment dates of January 4, 2002, and February 5, 2002. After the payment of pre-bankruptcy bonuses to the nontrader key employee group, discussed below, Enron decided to make payments from the trust in 2001 and impose the same restrictions required for payments to the nontrader group.

Pre-bankruptcy payments to key employees

In connection with Dynegy's withdrawal from the proposed merger with Enron, Enron established a 2001 bonus pool of approximately $54 million for approximately 528 critical noncommercial staff (i.e., persons other than traders). On November 28, 2001, the Board of Directors approved the establishment and adoption of the Enron Corp. Bonus Plan for calendar year 2001.[1731] While not stated specifically in the Bonus Plan, Enron documents show that it was Enron's intent to pay 2001 bonus payments to key and critical employees as soon as

[1727] Minutes of the Meeting of the Compensation Committee, at 1 (Nov. 16, 2001). EC2 000026922 - EC2 000026925. At the October 24, 2001, Special meeting of the Board of Directors, the Board approved the guarantee of minimum bonuses to be paid to key commercial personnel in January of 2002. EC2 000027260- EC2 000027262.

[1728] *Id.* Minutes of the Meeting of the Board of Directors, at 8 (Nov. 18, 2001). EC2 000028074 - EC2 000028081. The trust document is dated November 16, 2001. EC 001506928.

[1729] Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641. The letter is included in Appendix D.

[1730] *Id.*

[1731] Minutes of the Special Meeting of the Board of Directors, at 5 (Nov. 28, 2001). EC2 000028296 - EC2 000028306; EC2 000028310 - EC2 000028314. The minutes of the November 25, 2001, meeting of the Special Committee of the Board of Directors show that the Board approved the Enron Corp. Retention Plan to retain critical and key employees through the transitional period. EC2 000027122 - EC2 000027128. The number of employees to be included in such plan was 1,350 and the value was capped at $115 million. It is unclear whether this plan was implemented or whether the Enron Corp. Retention Plan was the predecessor of the Enron Corp. Bonus Program.

practicable after approval of the Bonus Plan.[1732] The payments would be made pursuant to the new Enron Corp. Bonus Plan and the Enron Corp. Annual Incentive Plan. The new bonus plan was needed to pay bonuses to key employees who were not eligible to participate in the Enron Corp. Annual Incentive Plan.[1733] It was also contemplated that remaining eligible employees would receive bonus payments at the end of calendar year 2001. It is unclear whether additional payments were made.

The Enron Corp. Bonus Plan was executed as of November 28, 2001. The stated purpose of the Enron Corp. Bonus Plan was to recognize, motivate, and reward exceptional accomplishment of annual corporation objectives during calendar year 2001.[1734] Employees of Enron and its subsidiaries and affiliated companies who were not eligible to participate in the Enron Corp. Annual Incentive Plan, and who were designated by the Compensation Committee, were eligible to participate in the plan. Employees eligible for payments under the Performance Bonus Trust, the grantor trust established by Enron North America, discussed above, were not eligible to participate in the Enron Corp. Bonus Plan.

The Enron Corp. Bonus Plan had an award fund in the amount of not more than $60 million, subject to downward adjustment by the Compensation Committee. Payments under the plan could be made in cash or in property having equivalent value. As a condition to receive payments under the plan, participants were required to execute an agreement requiring repayment of any amounts received if the participant voluntarily terminated employment prior to the expiration of 90 days following the receipt of any payment. Additionally, the agreement under the plan required a participant who makes repayments to Enron to pay an additional 25 percent of any payment as liquidated damages for terminating employment prior to the expiration of ninety days following receipt of payment. It appears that traders who received pre-bankruptcy payments were also required to execute such agreement. Sample agreements are included in Appendix D. Enron employees interviewed by Joint Committee staff maintained that a number of employees did not want to remain with Enron for the 90-day period and did not accept the bonus payment. The Plan was unfunded (i.e., no trust was created under the Plan).

The Bonus Plan and recommended payments were presented to the Compensation Committee on November 29, 2001. A total of up to $60 million of payments pursuant to the Enron Corp Bonus Plan and the Enron Corp. Annual Incentive Plan were approved.[1735] It was also approved that management was authorized to modify the list of employees and payment amounts as deemed appropriate, and it was confirmed that any awards to employees subject to

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[1732] Attachment to the minutes of the November 28, 2001, Special Meeting of the Board of Directors. EC2 000028310. The attachment is included in Appendix D.

[1733] Payments under the Enron Corp. Annual Incentive Plan could only be made to Section 16 executives.

[1734] EC2 000019658 - EC2 000019660.

[1735] Minutes of the Compensation Committee, at 1 (Nov. 29, 2001). EC2 000026930 - EC2 000026946.

Section 16 of the Securities Exchange Act of 1934 would be presented for approval by the Committee prior to such awards being made. At the November 29, 2001, meeting, payment to one Section 16 officer was approved.

The Board of Directors was advised that Weil, Gotshal, and Manges commented that it was not a legal decision to implement this type of plan, but that it was an issue of business judgment that could be second-guessed.[1736] Weil Gotshal thought, that based on Enron's analysis of the criticality of personnel and the need to protect key personnel, it was a compensation design for which reasonable justification existed.[1737] The minutes of the November 29, 2001, Compensation Committee meeting state that Towers Perrin confirmed that the approved payments were consistent with industry practices and with the past practices of Enron to retain key employees.

According to Towers Perrin, awards were equal to about 90 percent of the bonus for the prior year.[1738] Many current and former employees interviewed by Joint Committee staff stated that payments were 100 percent of the year 2000 bonus.

Recipients of these bonus payments interviewed by Joint Committee staff stated that the bonus payments to the nontraders were made in cashier's checks (net of payroll taxes) and were paid on the Friday preceding Enron's bankruptcy filing. The comments of one individual interviewed by the Joint Committee staff indicated that there was an air of secrecy involving the payments. Other individuals who received bonuses said that it became known that the payments were forthcoming and individuals waited in the office for the payments. The Joint Committee staff asked Enron why the payments were made in cashier's checks. According to Enron, the bonuses were paid in cashier's checks "to effect the retention strategy approved by the Compensation Committee as soon as possible."[1739]

Enron's response for requests for information

The Joint Committee staff asked Enron several questions about the pre-bankruptcy payments, including how it was determined who would be entitled to the payments and the amount of the payments. Enron responded that various management team(s) of each business unit reviewed the critical efforts that would need to be maintained to increase value for creditors going forward.[1740] Enron stated that the "90 Day Payments" to certain key management and employees were based on the following criteria: the extent to which the employees' skills were

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[1736] Attachment to the minutes of the November 28, 2001, Special Meeting of the Board of Directors. EC2 000028310. The attachment is included in Appendix D.

[1737] *Id.*

[1738] Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641. The letter is included in Appendix D.

[1739] EC 002679699.

[1740] Ecu000077383. Company response received January 13, 2003.

critical to business, marketable skills, trust factor with Enron, specialized skills, replaceability/cost of outside procurement (by consultants, etc.), multiskilled, and institutional knowledge.[1741] Enron provided a list of employees who received payments.[1742] See Appendix D for the list. The list included approximately 584 employees for payments totaling approximately $104.6 million. Additional information provided by Enron states that 490 employees received key employee bonuses totaling $50.404 million, which were paid from general company assets.[1743] Trader/Dynegy bonuses were paid to 67 employees totaling $46.074 million, which were made from the trust discussed above.[1744] In addition, 27 Canadian employees received bonuses totaling $8 million, which were paid by Enron Canada Corp.[1745] The payments ranged from $2,500 to $8 million. It appears that three employees terminated employment with Enron before the end of the 90-day retention period.[1746] In each of the three cases, Enron indicated that repayment of the bonus has been demanded, but the employee disputes the obligation and has not repaid.

Post-bankruptcy bonuses

Bonuses have been awarded after Enron's bankruptcy filing.[1747] With the approval of the Bankruptcy Court, Enron implemented the Key Employee Retention Program ("KERP") to provide an employment incentive for certain existing and newly hired employees deemed essential to the successful liquidation of Enron assets, divestiture of certain non-core businesses, restructuring of profitable core businesses, and management of litigation and government investigations.[1748] As approved by the court, the KERP provides for the following: retention

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[1741] Ecu000077383. Company response received January 13, 2003.

[1742] Ecu000077384 - Ecu000077395. Company response received January 13, 2003.

[1743] EC 002679698.

[1744] EC 002679698.

[1745] EC 002679698.

[1746] Ecu000077396. Company response received January 13, 2003. Information regarding individuals who terminated employment with Enron before completing the 90-day service requirement is included in Appendix D.

[1747] On December 20, 2001, the Compensation Committee ratified a retention program to be used for bankrupt companies. Minutes to the Meeting of the Compensation Committee, at 3 (Dec. 20, 2001). EC2 000028575 - EC2 000028578; EC2 000028654. The Joint Committee staff was not provided minutes of meetings held after December 2001; therefore, it is unclear whether other post-bankruptcy retention plans were considered.

[1748] Enron's motion for approval of the KERP, dated March 29, 2002, and the Bankruptcy Court's order approving the KERP, dated May 8, 2002. The motion and order also provided for indemnification of officers and directors for claims related to their post-bankruptcy-petition services, to the extent not covered by insurance, and treatment of costs related thereto as priority administrative expenses.

payments, liquidation incentive payments, and severance benefits.[1749] Employees are not permitted to participate in the retention payment program and the liquidation incentive program simultaneously. The KERP is effective March 1, 2002, through February 28, 2003.

Under the retention payment program, employees are entitled to payments of a percentage of base salary for continued employment during each quarter ending May 31, 2002, August 31, 2002, November 30, 2003, and February 28, 2003, as long as the employee neither resigns nor is involuntarily terminated for cause during the quarter. The program was expected to cover up to 1,285 employees. Payments up to a total of $40 million can be made under the program.

The liquidation incentive program is intended to correlate incentive payments to performance for employees involved in the liquidation of Enron's trading assets and certain non-core businesses between March 1, 2002, and February 28, 2003. The amount payable under the program is determined as a percentage of $1 billion increments of the cash collected from the liquidation of assets, with a threshold collection amount of $500 million. The percentage is .5 percent of collections from $500 million to $3 billion, 1 percent of collections over $3 billion up to $6 billion and 1.5 percent of collections over $6 billion up to $9 billion, for a maximum amount of $90 million. The minimum aggregate amount payable is $7.4 million.

The severance benefit program provides severance benefits for about 850 employees not eligible to participate in either of the other programs and about 700 employees eligible under the retention payment program, whose severance benefits will be offset by any retention payments received. Severance benefits consist of two weeks of base salary for each year or partial year of the employee's total service, with a minimum of $4,500 and a maximum of eight weeks of base salary. The maximum amount of severance benefits for employees not eligible for the other programs is $7 million; the maximum amount of severance benefits for employees also covered by the retention is $500,000. The KERP was later amended to reduce the amount available for severance benefits by $1.3 million in order to pay divestiture bonuses to certain employees in connection with the sale of the Enron Metals and Commodity Corporation.

[1749] In addition to approval of the KERP, the motion also requested approval to waive the right to seek recovery from 237 potential KERP participants (150 retention participants, 37 liquidation incentive participants, and 50 severance benefit participants) of payments made before the filing of Enron's bankruptcy petition, which were scheduled to vest on February 28, 2002. These payments were subject to challenge as preference payments or fraudulent transfers under bankruptcy law. Enron proposed to release any claim for disgorgement of these payments by a participant if the participant would agree to remain employed by Enron until August 31, 2002 (or an earlier termination of employment without cause).

3. Special compensation arrangements

In general

While executive compensation at Enron generally included base pay, bonus and long-term incentive, Enron had certain compensation arrangements for limited groups of people or for specific individuals. For example, Enron had a Project Participation Plan for employees in its international business unit. The Project Participation Plan is discussed below.

Enron also had arrangements for a small number of employees or in some cases just one employee. For example, one executive, Mr. Lou Pai, received the use of a 1/8 fractional interest in a jet aircraft Hawker 800 as part of his compensation.[1750] A few employees received loans from Enron and had split dollar life insurance policies. These arrangements are discussed in further detail below. As discussed below in further detail, Enron purchased two annuities from Kenneth L. Lay and his wife as a part of his compensation package for 2001. Certain executives were allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

Project Participation Plan

In general

On September 23, 1993, Enron Development Corporation adopted the Enron Development Corp. Project Participation Plan. The Project Participation Plan was used for international developers and other employees working on international projects. The Enron Development Corp. Project Participation Plan was amended and restated effective January 1, 1996; this restatement replaced the prior plan originally effective January 1, 1993.[1751] All projects were not subject to the restated plan. Generally, projects for which an incentive payment was made with respect to an event occurring on or before December 31, 1995, were not subject to the restated plan, but continued to be governed by the terms of the plan in effect prior to the January 1, 1996, restatement. The Project Participation Plan was principally used in the 1990's when Enron was competing for various international projects. According to the terms of the plan, the plan terminated as of December 31, 2000; however, payments for awards granted before 2001 could be made from the plan after such date.

One former Enron executive told the Joint Committee staff that the Project Participation Plan was terminated because it was viewed as not in the interests of the shareholders. He indicated that if someone had an interest in a project, and the project was not likely to be a good project, it was hard to move people off the project, because they had a stake in it. Every time

[1750] As part of the executive's separation from Enron, he assumed and became financially responsible for the 1/8 fractional interest in the jet aircraft Hawker 800. EC 002634790.

[1751] The Project Participation Plan was amended as of February 1, 1997, and as of January 1, 1998.

Enron wanted to move someone off a project, compensation had to be renegotiated. He said that the Project Participation Plan made staffing inflexible, time consuming, and difficult.

In the late 1990's, the name of the Project Participation Plan and all references to "Enron Development Corp." were changed to "Enron International, Inc.,"[1752] thus changing the name of the plan to the Enron International, Inc. Project Participation Plan. The stated purpose of the plan was to provide a means whereby certain selected employees could develop a sense of proprietorship and personal involvement in the development and financial success of Enron International, Inc., to attract and retain employees of outstanding competence and ability, and to encourage them to devote their best efforts to the business of Company, and to reward them for outstanding performance benefiting Enron and its stockholders.[1753]

Projects under the Project Participation Plan included:[1754]

- Bitterfeld;
- Centragas - Columbia Pipeline;
- Dabhol India - Phase I;
- Latvian Storage;
- Mostransgaz - Optical Disk Imaging;
- Severnaya Compressor Station;
- Subic Bay Power Plant;
- Yucatan (Merida);
- YPFB - Joint Venture;
- Volgograd Compressor;
- Italy - Saras;
- Poland;
- Puerto Rico;
- Panama;
- Puerto Caldera - Costa Rica;
- Sao Paulo - Brazil;
- Ecuador;
- CEMIG - Brazil;
- YPFB - Capitalization;
- CEMAT-Mato Grosso - Bolivia;
- Enersul-Mato Grosso Do Sul;
- LNG Commercial Development;

[1752] The change was executed in August 1999, to be effective February 1, 1997. By error or omission, the Board did not adopt the First Amendment on or about February 1, 1997, which would have changed the name of the plan. EC2 000019327.

[1753] Project Participation Plan document. EC 000767561.

[1754] This is not intended to be an inclusive list. Other projects may have also been under the Project Participation Plan.

- Israel Marketing;
- Mozambique - Integrated;
- Oman;
- Qatar;
- Jordan Marketing;
- E. Java - Indonesia;
- Ilijan Philippines Gas;
- China-Hainan;
- Vietnam;
- E. Kalamintan;
- Thailand IPP LPG;
- Song Yu;
- Hainan LPG Storage Terminal;
- Dong Fong Natural Gas Reserve;
- Dabhol India - Phase II;
- Multan - Pakistan;
- Dabhol India - Phase I - Implementation;
- India Marketing; and
- Dominican Republic.[1755]

All employees were eligible to be selected for participation in the Project Participation Plan. Under the plan, employees would be granted participation interests in particular projects. Participation interests would be expressed as a percentage of the value of the project. Payments with respect to a project would be triggered upon the occurrence of a plan payment date, which generally occurred upon (1) financial closure of the project, (2) operation of the project, or (3) the sale or transfer of the project. The incentive payment generated upon a payment date would be allocated among the participants who had a participation interest in the project at such time based upon the relative size of their participation interests.

Typically, awards would be paid 50 percent upon financial closure of the project and 50 percent upon operation of the project, as defined by the Project Participation Plan. The plan also included provisions which provided how participants would be compensated in the event that the particular project was sold or transferred before the achievement of financial closure or commercial operation. Under the Project Participation Plan, the total participation interests in any given projects could not exceed 10 percent. The financial closure payment would generally be five percent of the net project value; the commercial operation payment would generally be 10 percent of net project value reduced by any prior financial closure payment paid or payable. Some projects were specifically excluded from the Project Participation Plan and certain projects had special features under the plan. The plan defined how the value of the project was determined and included provisions for cases in which the value was disputed.

Payments would be made in cash, in shares of common stock, or in a combination of cash and shares. The amendment to the Project Participation Plan effective January 1, 1998, allowed

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[1755] EC 000767596 - EC 000767597.

participants in certain projects (Italy and Poland) to elect to receive payments in cash and stock options. Such options were granted under the 1994 Stock Plan.

The Project Participation Plan was administered by a committee which was charged with selecting participants in the plan and determining the participation interests to be awarded each participant. According to the plan document, the plan constituted an unfunded, unsecured obligation of Enron to make payments of incentive compensation from its general assets in accordance with the plan.

Awards under the Project Participation Plan could vary greatly. Attention has been given to the plan because of the large amounts that were awarded under the plan and because the method used to determine award amounts, a percentage of the estimated project value, could create an incentive to overstate the value of projects. Awards for top developers could be as high as $5 million or $7 million for single projects.[1756]

Former and current employees interviewed by Joint Committee staff regarding the magnitude of the payments responded that such large payments could be attributable to years of work on a particular project. While many executives greatly benefited from Project Participation Plan awards, all awards under the plan were not very large; some awards were less than $10,000.[1757]

Deferrals

The Project Participation Plan was amended effective February 1, 1997, to allow deferral of payments under the plan from the time they would otherwise be paid. A participant could elect to defer receipt of a portion of any plan payment that was to be made in cash to a date that is after the participant's termination of employment with Enron. Up to 100 percent of payments could be deferred. Payments deferred by a participant would be credited to the participant's deferral account as of the date that the participant would have received such payment under the plan had such payment not been deferred.

Deferrals were credited with Enron's mid-term cost of capital for the period. For 2001, deferrals were to earn a 7.4 percent annual rate of return.[1758] Deferral accounts would be paid to participants in the event of retirement, disability, death, or termination of employment. Payments could also be requested in the event of a hardship.

[1756] EC 000102338 (Project Puerto Rico); EC2 000032354 (Project Puerto Rico). The Joint Committee staff does not have a list of all payments, so it is not clear whether these were the highest awards.

[1757] EC2 000032354.

[1758] Participant election form for 2001 deferrals. EC2 000018648.

Documents provided by Enron show that there were 11 participants who deferred amounts under the Project Participation Plan.[1759] Enron documents show that as of December 31, 1999, there were five participants with total account balances of $450,054.[1760] As of December 31, 2000, there were 10 participants with accounts balances totaling $7.9 million.[1761] As of December 31, 2001, the Project Participation Plan had 11 participants with account balances totaling $9.4 million.[1762]

Project Participation Plan trade-outs

In 1997, Enron allowed certain participants in the Project Participation Plan to trade their interests in the plan for stock options and restricted stock, thus allowing their compensation to grow as Enron's stock price increased. On February 10, 1997, the Compensation Committee approved the trade-out of fixed interests owned by five Enron International executives in the Project Participation Plan by providing $10 million in stock options and $10 million in restricted stock. The trade-out was reported by the Board of Directors on February 11, 1997. According to IRS information, in addition to the five executives referred to above, seven other employees agreed to trade-out their participation interests in the Project Participation Plan for grants of stock options and restricted stock later in August 1997.[1763]

According to IRS documents, the value of the stock options and restricted stock conveyed to the 12 employees totaled approximately $22 million at the date of grant.[1764] Also according to IRS information, the fair market value of the options granted to two executives totaled 74 percent of the total value conveyed. Stock options were valued using the Black-Scholes valuation method. Restricted stock was assigned a value equal to the closing price of the stock on the date of the exchange.

Enron treated the stock options and restricted stock attributable to the trade-out of the Project Participation Plan interests the same as options and restricted stock are treated generally for Federal tax purposes. That is, no income was reported to employees at the time of the trade-out/grant. Rather, income was reported at the time of exercise (in the case of options) and when

[1759] EC 000768136. This list is not all participants in the Project Participation Plan, but only those who elected to defer payments.

[1760] EC 000768234.

[1761] EC 000768234.

[1762] EC 000768234.

[1763] The additional trade-outs do not appear to be reflected in the Compensation Committee meeting minutes.

[1764] Other IRS documents state that the fair market value of the stock options and restricted stock conveyed to the 12 employees totaled approximately $26.8 million; $11.6 million on the February 10, 1997, grant date, and $15.2 million on the August 11, 1997, grant date. While these two amounts do not reconcile either amount is substantial.

the restrictions lapse (in the case of restricted stock). Similarly, Enron had a corresponding income tax deduction at such times. In the case of restricted stock, the deduction is equal to the fair market value of the stock multiplied by the number of shares with respect to which restrictions lapsed. In the case of options, the deduction is equal to the difference between the fair market value of the stock at the time of exercise and the exercise price.

Because the compensation expense was deducted when the options were exercised and the restrictions lapsed, and the stock price continued to rise, Enron's deduction was much larger than the deduction would have been if Enron had paid the awards in cash or unrestricted stock as originally contemplated by the arrangement. According to IRS documents, due to the increase in Enron stock, amounts deducted by Enron, and reported as compensation to the individuals, were about $82 million more than the value at the grant dates.[1765] According to the IRS, two individuals reported more than 90 percent of the spread.[1766] The Joint Committee staff did not discover any information indicating whether the potential increase in the deduction was a motivating factor behind the trade-outs.

4. Board of Directors compensation

In general

Nonemployee director compensation at Enron was composed of annual fees and equity grants. For the years 1999 through 2001, each nonemployee director received an annual service fee of $50,000 for serving as a director. This was an increase from the $40,000 fee paid in 1995 through 1998. In 1994 and the beginning of 1995, the annual service fee was $22,000. Additional fees for serving on committees were eliminated effective May 2, 1995. Prior to the elimination of such fees, nonemployee directors were paid $4,000 for serving on committees.

Committee chairs received an additional $10,000 annually in 1999 through 2001, which was an increase from $5,000 paid in 1995 through 1998, and $4,000 paid in prior years. Meeting fees were $1,250 for each Board of Directors and committee meetings attended. Before 1999, meeting fees for committee meetings were $1,000. Enron periodically hired compensation

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1765 Internal IRS Memorandum regarding EDC Participation Plan Stock Trade-Out dated February 22, 2002. An earlier IRS correspondence (dated January 25, 2002) stated that the deduction could exceed $70 million.

1766 In connection with the 1997 audit, IRS international examiners raised issues with respect to the trade-outs, including whether the grant or exercise date should be used for valuing the compensation for purposes of deductions, capitalizing costs by Enron, and determining service fee income to be reported by Enron Development Corp. The IRS concluded that there was authority for the taxpayer to use the grant date in determining the value of the trade-outs for certain purposes. The IRS also raised other issues related to the Project Participation Plan trade-outs, including whether the stock-based compensation spread was an ordinary and necessary business expense under section 83(h). For a discussion of international issues relating to the Project Participation Plan, see Part IV.D. of Part Three, above.

consultants, particularly Towers Perrin, to perform studies to determine if the level of compensation for nonemployee directors was competitive with market practices.

Directors' fees could be paid in cash, deferred under the Enron Corp. 1994 Deferral Plan, or received in a combination of phantom stock and stock options in lieu of cash under the Enron Corp. 1991 Stock Plan. As discussed below, beginning in 1997, directors were required to defer 50 percent of their annual service fee into the Phantom Stock Account of the 1994 Deferral Plan.

For 2000, total directors' fees (whether paid in cash, deferred, or paid in the form of phantom stock or stock options) were $1.1 million, or an average of $79,107 per nonemployee director. The average fee for nonemployee directors was $86,829 in 1999 and $63,500 in 1998. These averages do not include the value of stock options and phantom stock units annually granted to directors. Table 17 below shows totals fees paid in cash, deferred, or received in a combination of phantom stock units and stock options in lieu of cash for the years 1993 through 2000 for all nonemployee directors.[1767]

Table 17.–Total Directors Fees for All Nonemployee Directors 1993 - 2000 (Thousands of Dollars)

1993	1994	1995	1996	1997	1998	1999	2000
$551	$481	$601	$701	$813	$889	$1,172	$1,107

Deferrals

Beginning January 1, 1997, nonemployee directors were required to defer 50 percent of their annual service fee into the Phantom Stock Account of the 1994 Deferral Plan. Directors could elect to receive remaining fees (i.e., annual service fee has less mandatory deferrals) in cash, defer receipt of the fees to a later specified date under the 1994 Deferral Plan, or receive the fees in a combination of phantom stock units and stock options in lieu of cash under the 1991 Stock Plan.[1768] Before the mandatory deferral requirement was adopted in 1997, directors could elect to receive fees in cash, defer receipt of the fees to a later specified date under Enron's 1994 Deferral Plan, or receive the fees in a combination of phantom stock units and stock options in lieu of cash under Enron's 1991 Stock Plan. Prior to 1997, restricted stock was used instead of phantom stock units.

In some countries, deferrals into the 1994 Deferral Plan could create adverse tax consequences for the director. In August 1999, the Compensation Committee approved a change that upon notification by Enron management of the applicable international tax laws, a director could receive an award of phantom stock units under the 1991 Stock Plan in lieu of mandatory

[1767] 1994 through 2001 Enron Corp. Proxy Statements.

[1768] December 11, 2000, letter to members of the Board of Directors regarding deferral program opportunities. EC2 000018652.

deferrals into the Phantom Stock Accounts of the 1994 Deferral Plan. After such change, Lord Wakeham was allowed to receive phantom stock units in lieu of deferrals into the Phantom Stock Account.

Directors were required to annually complete election forms to make their deferral plan choices.[1769] Directors could elect to defer compensation annually in December prior to the year in which the compensation was earned and payable. Voluntary deferrals could be placed into the Flexible Deferral Account and/or the Phantom Stock Account at the director's discretion.[1770] Earnings on amounts invested in the Flexible Deferral Account or the Phantom Stock Account would be determined in the same way as all other 1994 Deferral Plan participants. Earnings on deferrals into the Flexible Deferral Account would be credited with cumulative appreciation and/or depreciation based on the market price of the chosen investments. Investments in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Deferral accounts would be paid as specified in the participant's election form during the first quarter of the year following the termination event (retirement, death, disability or termination).[1771] The 1994 Deferral Plan also provided an opportunity for in-service distributions.

Under the 2001 annual election form, in electing stock in lieu of fees, a director could choose a vesting period for phantom stock units between six and 60 months. Stock options (in lieu of the annual retainer fee) would be 100 percent vested on the grant date and have a ten-year term. Regular and special purpose deferrals could be elected.

Nonemployee directors were also eligible to participate in the deferral of stock options gains and deferral of restricted stock programs. The deferral of stock option gains program allowed deferrals to the 1994 Deferral Plan in lieu of receiving financial gains upon the exercise of stock options granted under an Enron Corp. stock plan. The deferral of restricted stock program allowed deferrals under the 1994 Enron Corp. Deferral Plan in lieu of the release of shares of restricted stock granted under an Enron Corp. stock plan. The programs are discussed in more detail in the nonqualified deferred compensation section of this Report.[1772]

During 2000, eight of the 13 eligible directors elected to defer fees under the 1994 Deferral Plan. In 2000, four directors elected to receive stock in lieu of fees in a combination of phantom stock units and stock options under the 1991 Stock Plan. In 1999, nine directors elected to defer fees under the 1994 Deferral Plan, while one director elected to receive stock in lieu of fees in a combination of phantom stock units and stock options according to the terms of the 1991 Stock Plan.

[1769] *Id.*

[1770] *Id.*

[1771] *Id.*

[1772] *See* Part III.C.1, below.

In prior years, Enron maintained "Directors Deferral Plans." Documents provided by Enron show that the Director Deferral Plans included HNG, InterNorth, and Enron.[1773] Documents provided by Enron show that there were approximately 29 participants in such plans. In prior years, directors also deferred into the HNG Deferral Plan and the 1985 Deferral Plan.

Directors' account balances

On December 11, 2001, Enron sent letters to the Board members advising them of the status of their nonqualified deferred compensation.[1774] Distributions to deferral plan participants who were in pay status ceased as of November 30, 2001. Enron stated that after the first phase of the bankruptcy, it would begin to explore options with its creditors to seek approval to reinstate deferral plan payments, or to somehow otherwise restore the value lost to deferral plan participants. In general, claims under the deferral plans have the same status as Enron's other unsecured general creditors, which are paid after the claims of secured creditors. Board members were informed that claims for deferral plan benefits should be made against Enron's bankruptcy estate.

Nonemployee director balances in nonqualified deferred compensation plans as of November 30, 2001, are provided in Table 18, below.[1775]

Table 18.–Nonemployee Director Balances in Nonqualified Deferred Compensation Plans (November 30, 2001) (Thousands of Dollars)

	Enron Corp. 1988 Deferral Plan	Enron Corp. 1994 Deferral Plan	Enron Directors Deferral Plan	HNG Deferred Income Plan	Total
Robert Belfer	3,894	485	1,708		6,087
Norman Blake, Jr.		250	39		288
Ronnie Chan		2*			2*
John Duncan		*			*
Wendy Gramm		686			686
Robert Jaedicke		220	1,068	175	1,463
Charles LeMaistre		92			92
John Mendelsohn		3*			3*
Paulo Pereira		4*			4*

1773 EC 000758146.

1774 It is unclear whether such letters were sent to all nonqualified deferred compensation participants or just to Board members.

1775 The information in the table was obtained from letters sent to directors by Enron informing them of their bankruptcy rights and the status of their deferred compensation. EC 000171608 - EC 000171674.

	Enron Corp. 1988 Deferral Plan	Enron Corp. 1994 Deferral Plan	Enron Directors Deferral Plan	HNG Deferred Income Plan	Total
William Powers		18			18
Frank Savage		3*			3*
Lord John Wakeham		*			*
Herbert Winokur		*			*
Joe Foy		176	484	46	706
Jerome Meyer		58			57
Total					9,411

* Denotes that balance is relatively minimal because 100% invested in the Phantom Stock Account (value of Enron common stock at $.26 per share).

Equity grants

In addition to the fees discussed above, nonemployee directors were annually granted stock options and phantom stock units. Under the Enron Corp. 1991 Stock Plan, nonemployee directors were granted shares of phantom stock units and nonqualified options to purchase stock effective the Monday following the annual meetings of the shareholders. The number of shares of phantom stock units was equal to 50 percent of the prior year's average retainer fee divided by the stock price on the date of grant rounded to the next highest increment of ten. The number of stock options was equal to four times the number of shares of phantom stock units. In some years, additional stock options were granted.[1776] For 2001, each nonemployee director was granted 460 phantom stock units and 11,175 stock options.[1777] The awards were based on an average 2000 retainer fee of $52,871 and a May 7, 2001, closing stock price of $58.04. During 2000, each nonemployee director received 360 phantom stock units and options to purchase 10,775 shares according to the terms of the 1991 and 1994 Stock Plans. Phantom stock units and options granted in 2000 and 2001 vest over a five-year period. The Senate Permanent Subcommittee on Investigations computed that for 2000, total stock/option value when granted was $250,626 per director.[1778] Table 19, below, shows the number of restricted stock shares, phantom stock units, and stock options received by directors in the years 1993 through 2001.

[1776] In most recent years (2000 and 2001), nonemployee directors were granted stock options equal to four times the number of phantom stock units plus 9,335 options.

[1777] Letter from Mary K. Joyce to Charles A. LeMaistre dated May 11, 2001, regarding May 2001 director awards. EC 000257935.

[1778] Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse*, May 7, 2002, Exhibit #35a.

Table 19.–Directors' Restricted Stock, Phantom Stock, and Stock Options (1993-2001)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Restricted stock shares	480	490	450						
Phantom stock units				480	510	400	560	360	460
Stock options	1,920	1,960	1,800	1,920	2,040	1,600	8,240	10,775	11,175

The 1991 Stock Plan permitted nonemployee directors whose ownership of Enron Corp. common stock would result in a materials conflict of interest for business, employee, or professional purposes, to submit an opinion of counsel of such fact to the Compensation Committee with a request that such nonemployee director not be eligible to receive further grants under the 1991 Stock Plan and to forfeit all outstanding grants made to such nonemployee director until such time as the Committee is satisfied that such conflicts have been removed or no longer apply. In December 1998, Dr. Gramm provided to the Compensation Committee a written opinion of counsel indicating that her continued participation in the 1991 Stock Plan could be considered a conflict of interest. Dr. Gramm chose not to receive further grants under the 1991 Stock Plan, and therefore, did not receive stock options or phantom stock units in 1999 or 2000. Instead, on behalf of Dr. Gramm, Enron contributed the value of phantom stock units and stock options into her Flexible Deferral Account under the 1994 Deferral Plan.

Table 20, below, represents the value of directors compensation as of August 21, 2002, and July 31, 2001, from documents provided by Enron.[1779] The top number shows the value as of August 21, 2000 (when the stock value was $86), while the bottom number shows the value as of July 31, 2001 (when the stock value was $45).

[1779] EC 000257928 - EC 000258305. The values as of August 21, 2000, were published by the Permanent Subcommittee on Investigations. Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse*, May 7, 2002, Exhibit #35b.

Table 20.–Value of Directors Compensation as of August 21, 2000 and July 31, 2001 (Thousands of Dollars)

	Stock Option as of 8/21/00 as of 7/31/01	**Restricted/ Phantom Stock** as of 8/21/00 as of 7/31/01	**Total Equity Value** as of 8/21/00 as of 7/31/01	**Deferral Plan Account Balance**[1780] as of 6/30/00 as of 6/30/01
Charles LeMaistre	$3,111 860	$162 72	$3,273 932	$263 242
Robert Jaedicke	3,111 860	162 72	3,273 932	1,670 1,809
Wendy Gramm	N/A	N/A	N/A	699
John Duncan	3,111 860	162 72	3,273 932	170 149
Ronnie Chan	1,295 N/A	213 N/A	1,508 N/A	357 N/A
Norman Blake	2,809 330	266 142	3,074 472	449 409
Robert Belfer	2,479 860	162 72	2,641 932	5,900 6,414
John Mendelsohn	516 61	69 49	586 110	113 141
Jerome Meyer	852 N/A (resigned)	178 N/A	1,030 N/A	247 N/A
John Urquhart	2,479 N/A	162 N/A	2,641 N/A	962 N/A
Lord Wakeham	1,472 413	208 119	1,680 532	149 115
Herbert Winokur, Jr.	2,479 860	162 72	2,641 932	170 149
Paulo V. Ferraz Pereira	140 0	53 45	193 45	39 74
Frank Savage	140 0	31 49	170 49	46 65

Miscellaneous

Liability insurance was provided to directors with a maximum indemnification of $300 million for sums that they become legally obligated to pay for claims made because of a wrongful act for which Enron does not provide reimbursement. Directors were also provided

[1780] The deferral account balances are reflected as of June 30, 2000, and June 30, 2001. The top number is the value as of June 30, 2000; the bottom number is the value as of June 30, 2001. The account balance reflects combined balances under the 1994 Deferral Plan, 1985 Deferral Plan and Director's Deferral Plans.

coverage in the case of an accident resulting in death on a company aircraft and could participate in Enron's matching gift program under which Enron would match charitable contributions by employees.

C. Discussion of Specific Issues

1. Nonqualified deferred compensation plans

Present law

In general

Deferred compensation occurs when the payment of compensation is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the individual's retirement, death, disability, or other termination of service, or until a specified time in the future. Nonqualified deferred compensation plans do not receive the favored tax treatment afforded to qualified retirements plans under the Code.[1781]

ERISA contains exemptions from its requirements for certain nonqualified deferred compensation arrangements. Most nonqualified deferred compensation arrangements are designed to fall within these ERISA exemptions.

A "top-hat plan" is the term generally used for certain nonqualified deferred compensation plans that are exempt from most ERISA requirements. The ERISA exemption applies to a plan that is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. ERISA does not provide statutory definitions of "select group," "management," or "highly compensated employees," and the Department of Labor has not issued regulations defining these terms.[1782] Employees sometimes claim ERISA protection (such as vesting or funding) for benefits under a nonqualified deferred compensation plan. However, most nonqualified deferred compensation arrangements are intended to fall under the top-hat exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility.[1783] A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions under ERISA. However, under Department of Labor regulations, the reporting and disclosure requirements are satisfied by (1) a one-time filing with the Secretary of Labor of a statement that includes the name and address of the employer, the employer's tax identification number, a declaration that the employer maintains a plan or plans primarily for the purpose of providing

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[1781] This favorable treatment includes: (1) a current deduction for the employer's contributions; (2) assets of the plan set aside in a trust for the exclusive benefit of the employees; (3) tax-exempt status of the trust; and (4) no income inclusion by employees until distributions are received (i.e., constructive receipt does not apply).

[1782] The Code definition of "highly compensated employee" (sec. 414(q)) has not been applied for this purpose.

[1783] ERISA secs. 201(2), 301(a)(3), and 401(a)(1).

deferred compensation for a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each, and (2) providing plan documents, if any, to the Secretary of Labor upon request.[1784]

Types of nonqualified deferred compensation arrangements

Nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee, or employees, covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

In the simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified defined compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide security to the employee.

Some nonqualified deferred compensation arrangements are structured as formal plans with formal governing documents. In such cases, the plan generally specifies the employees covered by the plan. In other cases, nonqualified deferred compensation may be provided for under the terms of an individual's employment contract and apply only to that particular individual.

A nonqualified deferred compensation arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., commissions or bonuses), or supplemental compensation. The arrangement may permit the employee to elect, such as on an annual basis, whether to defer compensation or to receive it currently, similar to a salary reduction or cash-or-deferred arrangement under a qualified employer plan. Alternatively, the arrangement may provide for mandatory deferral of compensation.[1785]

A nonqualified deferred compensation arrangement may be structured as an account for the employee (similar to a defined contribution or individual account plan) or may provide for specified benefits to be paid to the employee (similar to a defined benefit pension plan). Under an account structure, depending on whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the employee, to which specified contributions and earnings are credited. The benefits to which the employee is entitled are based on the amount in the account. Under a defined benefit structure, the terms of the nonqualified arrangement specify the amount of benefits (or formula for determining benefits) to be paid to the employee.

[1784] 29 CFR 2520.104-23.

[1785] Such plans are discussed in Part II.A., above.

Timing of income inclusion for the individual -- in general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[1786] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts and nonqualified annuities.[1787]

The following general rules regarding the taxation of nonqualified deferred compensation result from these provisions. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Timing of income inclusion under an unfunded arrangement

In general

As mentioned above, in the case of an unfunded nonqualified deferred compensation arrangement, amounts are includible in gross income when the amount is actually or constructively received.

An amount is constructively received if it is credited to an individual's account, set apart, or otherwise made available to the individual so that he or she can draw on it at any time, even if the individual has not actually received the income.[1788] Income is not constructively received if there is a substantial limitation or restriction on the individual's ability to withdraw it. A requirement that the individual provide advance notice in order to withdraw (or receive) the income is not considered a substantial limitation on the ability to withdraw it. However, a requirement that the individual relinquish a valuable right in order to withdraw the income is a substantial limitation.

[1786] *See, e.g., Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[1787] Secs. 402(b) and 403(c). For a detailed discussion of the background of the taxation of nonqualified deferred compensation, *see* Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 7, 2002.

[1788] Treas. Reg. sec. 1.451-2(a).

For years before 1982, the constructive receipt doctrine applied to amounts payable under a qualified retirement plan.[1789] Various IRS revenue rulings held that amounts held within a qualified retirement plan were not constructively received if, in order to receive a distribution, the participant was required to discontinue participation in the plan (either permanently or for a period of at least six months), forfeit a portion of his or her benefits, or lose past service credits or job retention rights in the case of reemployment.

A variety of methods are used under nonqualified deferred compensation arrangements to provide some flexibility to individuals covered by the arrangement in obtaining distributions while attempting to avoid constructive receipt. For example, nonqualified deferred compensation arrangements frequently provide that distributions can be made in the event of financial hardship. Another technique sometimes used is to provide that the employer, plan administrative committee, or similar body can make distributions in its sole discretion. Another mechanism is to provide that withdrawals can be made at any time, but that a portion of the amount withdrawn, such as 10 percent, is forfeited to the employer if the distribution is made before some stated time or event. Other ways to try to avoid constructive receipt may also be used.

Subsequent elections

While it is generally accepted that, to avoid constructive receipt, the election to defer compensation must be made before the performance of services giving rise to the compensation, the required timing of subsequent elections to avoid constructive receipt is unclear. Revenue Procedure 71-19 sets guidelines for obtaining an advance ruling from the IRS regarding the application of the doctrine of constructive receipt to unfunded nonqualified deferred compensation arrangements.[1790] Under the revenue procedure, a ruling letter will be issued only if the plan meets certain requirements. If the plan provides for an election to defer payment of compensation, such election must be made before the beginning of the period of service for which the compensation is payable, regardless of the existence in the plan of forfeiture provisions. In addition, if any elections, other than the initial election may be made by an employee subsequent to the beginning of the service period (i.e., a "subsequent election"), the plan must set forth substantial forfeiture provisions that must remain in effect throughout the entire period of deferral.[1791] Revenue Procedure 92-65 amplified Revenue Procedure 71-19 and clarified that the period of service is generally the employee's taxable year for cash basis, calendar year taxpayers, with exceptions for new plans and new participants in existing plans.[1792]

[1789] Before 1982, amounts were includible in income when distributed or made available. Since 1982, qualified retirement plan benefits are includible in income when distributed.

[1790] 1971-1 C.B. 698, amplified by Rev. Proc. 92-65, 1992-2 C.B. 428.

[1791] Revenue Procedure 71-19 provides that a substantial forfeiture provision will not be considered to exist unless its condition imposes upon the employee a significant limitation or duty which will require a meaningful effort on the part of the employee to fulfill and there is a definite possibility that the event which will cause the forfeiture could occur.

[1792] Rev. Proc. 92-65, 1992-2 C.B. 428.

Revenue Procedure 92-65 further provides that, for an advance ruling, the plan must define the time and method for payment of deferred compensation for each payment event and also states that a plan may provide for the payment of benefits in the case of an unforeseeable emergency.[1793] Courts have sometimes taken a more lenient approach than the IRS ruling position in allowing subsequent elections.

Various courts that have dealt with the issue of subsequent elections have held that a subsequent election to change the timing or manner of payment of deferred compensation does not result in constructive receipt. Because each decision is fact specific, there is no case which can be cited for the rule that, unequivocally, constructive receipt does not result from the making of a subsequent election. While the holding of each case legally applies only to its specific facts, there are several cases that are principally cited for support of permitting subsequent elections without triggering constructive receipt.

In *Veit v. Commissioner* (known as "*Veit I*"), a subsequent election made after the performance of services was complete did not result in constructive receipt.[1794] At the time of the subsequent election, however, the amount due was not ascertainable. Additionally, the election was bilateral and was mutually beneficial to both the employer and the employee. In *Commissioner v. Oates*, constructive receipt did not apply when the taxpayer was given the right to elect to receive payments as provided in an original contract or to have them paid in monthly installments over a period not to exceed 15 years.[1795] While all services necessary to earn the payments had been performed, the final amount to be paid was not determinative. *Veit I* and *Oates* are relied upon by taxpayers for the position that constructive receipt does not result when a subsequent election is made before payment is due and the amount of compensation to be paid is ascertainable.[1796]

Taxpayers also rely on other decisions for the position that subsequent elections do not result in constructive receipt. In *Martin v. Commissioner*, a change in the payment schedule did not result in constructive receipt.[1797] In *Martin*, however, the election to receive either a lump-sum distribution or installment payments could only be made before the amounts became due and fully ascertainable. In *Veit v. Commissioner* (known as "*Veit II*"), a subsequent election

[1793] The other requirements for an advance ruling are that the plan must provide that participants have the status of general unsecured creditors of the employer and that the plan consitiutes a mere promise by the employer to make benefit payments in the future. If the plan refers to a trust, it must conform to the terms of Revenue Procedure 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

[1794] *Veit v. Commissioner*, 8 T.C. 809 (1947).

[1795] *Commissioner v. Oates*, 207 F.2d 700 (7th Cir. 1953).

[1796] The IRS acquiesced in both *Veit I* and *Oates*.

[1797] *Martin v. Commissioner*, 96 T.C. 814 (1991).

made after the amount of payments was determinable, but before payment was due, did not result in constructive receipt.[1798] In *Veit II*, the subsequent election was bilaterally negotiated.

Even though the IRS has attempted to enforce its position on constructive receipt, it appears that courts generally have been hesitant to apply the doctrine of constructive receipt. Many practitioners rely on case law for the position that subsequent elections to change the timing and manner of payment do not result in constructive receipt. It is not uncommon for plans to allow participants to make some type of subsequent election to change the time or manner of payment.

Income inclusion under a funded arrangement

As stated above, if a nonqualified deferred compensation arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture. An arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property.[1799]

Under section 83, the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property is includible in the income of the person performing the services. Income is generally includible for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture. The amount includible in income is based on the fair market value of the property at that time.[1800]

Section 83 applies to a transfer of property to any service provider; its application is not limited to employees or even to individuals. A transfer of property occurs for purposes of section 83 when a person acquires a beneficial ownership interest in such property.

The term "property" is defined very broadly for purposes of section 83.[1801] Property includes real and personal property other than money or an unfunded and unsecured promise to

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[1798] *Veit v. Commissioner*, 8 T.C.M. 919 (1949).

[1799] The application of section 83 to a funded nonqualified deferred compensation arrangement is based in part on the broad scope of section 83 (i.e., section 83 applies to any transfer of property in connection with the performance of services) and the broad definition of property under section 83. Depending on the design of a particular nonqualified deferred compensation arrangement (e.g., if it covers only employees), either the economic benefit doctrine or Code provisions dealing with nonexempt employee trusts and nonqualified annuities may be relevant as legal authority for this tax treatment in addition to section 83.

[1800] Under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.

[1801] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83.[1802]

Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services (such as full-time services for two years or more) or on the nonperformance of services (such as a noncompete requirement). In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur.[1803] Under a special rule, property is considered to be subject to a substantial risk of forfeiture if sale of the property at a profit could subject the person to suit under section 16(b) of the Securities Exchange Act of 1934 (relating to short-swing profits).

Risks that do not fall within this legal definition, such as the risk that the property will decline in value, do not result in a substantial risk of forfeiture. Whether a substantial risk of forfeiture exists depends on the facts and circumstances, including whether the service requirement or other condition will in fact be enforced. Property that is subject to a substantial risk of forfeiture is referred to as nonvested property; property that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested property.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. Property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture. A temporary restriction on the transferability of property (called a "lapse" restriction) is disregarded in determining the value of the property for purposes of section 83. A permanent restriction on the transferability of property (a "nonlapse" restriction) is taken into account in determining the value of the property.

[1802] In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, the cost of the current life insurance protection thereunder (i.e., the reasonable net premium cost as determined by the Commissioner) is includible in income.

[1803] For example, if contributions are made to a trust exclusively for the purpose of reimbursing employees for education expenses, but reimbursement is available only if an employee takes a course and earns a passing grade, the employee's interest in the trust is subject to a substantial risk of forfeiture until he or she takes and passes a course.

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978[1804] was enacted in response to proposed Treasury regulations published in the Federal Register for February 3, 1978.[1805] These regulations provided that, if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for the taxpayer's exercise of such option, the amount is treated as received by the taxpayer in such earlier taxable year.[1806] Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.

The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 of the Revenue Act of 1978 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.

Attempts to provide security for nonqualified deferred compensation

In general

Because amounts deferred that are funded are includible in gross income in the year the amount is transferable or is no longer subject to a substantial risk of forfeiture, funded arrangements can result in the imposition of tax even when no amount is actually received. For example, suppose a nonqualified deferred compensation plan provides that an employer will pay an employee (or the employee's beneficiary) $500,000 when the employee attains age 55 or dies. Further suppose that the plan is funded and provides that the employee's right to the $500,000 vests after five years of employment. Because the arrangement is funded, the employee must include the present value of $500,000 in income after he or she completes five years of employment, even if that is many years before the employee attains age 55. Given this type of result, individuals covered under nonqualified deferred compensation arrangements typically prefer for such arrangements not to be funded for tax purposes.

Nevertheless, such individuals are often interested in providing some security with respect to payment of the deferred compensation. Unfunded status presents the risk that the

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1804 Pub. L. No. 95-600 (1978).

1805 Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

1806 *Id.*

employee will not receive his or her deferred compensation payments when due.[1807] Thus, a goal of many plans is to maximize the security that can be provided for the individual without incurring current income tax consequences, i.e., without having the arrangement being considered funded for tax purposes. Various arrangements have been developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion.

Rabbi trusts

A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made.[1808] The trust or fund is generally irrevocable[1809] and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of bankruptcy or insolvency.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[1810] As a result, no amount is currently included in the income of a beneficiary of a rabbi trust by reason of the rabbi trust; income inclusion occurs as the deferred compensation is paid or made available.

The IRS has issued guidance setting forth model rabbi trust provisions.[1811] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

[1807] This risk is not a substantial risk of forfeiture as defined under section 83.

[1808] A rabbi trust is generally a grantor trust of the employer for tax purposes, so trust earnings are treated as income to the employer.

[1809] Some trusts provide that the trust is funded or irrevocable only upon the occurrence of a certain events, such as a change in control of the employer.

[1810] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[1811] Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

Since the concept of a rabbi trust was developed, other techniques have been developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets. In such a case, the existence of the assets may be unknown or the assets may be protected from creditors under the laws of the jurisdiction where the trust is located.

Secular trusts

In contrast to a rabbi trust, a "secular" trust is a trust established by an employer exclusively for the purpose of providing nonqualified deferred compensation; assets are not subject to claims of creditors. A secular trust constitutes a funding of a nonqualified deferred compensation arrangement, so that vested amounts are includible in income by the employees (i.e., such amounts are not tax-deferred).[1812] A secular trust provides security for the employees, but also causes current taxation. In some cases, under the terms of the nonqualified deferred compensation arrangement, the employer pays the taxes attributable to the deferred compensation by grossing up the employees' current compensation by a corresponding amount.

Other forms of security

Other methods are sometimes used in an attempt to provide employees with security that deferred compensation payments will be made when due, such as third party guarantees, letters of credit, and surety bonds. There is little specific guidance as to how these arrangements should be treated for tax purposes. In addition, the tax treatment depends on the facts of the particular arrangement.

Timing of employer income tax deduction

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[1813] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

Payroll taxes and wage reporting

In general

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act ("FICA"), consisting of social security tax and Medicare tax.

[1812] A secular trust is generally structured as a separate entity for tax purposes, and earnings are includible in the income of the trust.

[1813] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

Income tax withholding

Nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee's income as discussed above. In addition, such amounts must be reported as wages on a Form W-2. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. For example, if nonqualified deferred compensation is includible in income only as payments are made after retirement, income taxes must be withheld from the payments and the payments must be reported on a Form W-2.

Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee. For example, if nonqualified deferred compensation is provided by means of vested contributions to a funded arrangement, the amount of the contributions is includible in the employee's income and is subject to income tax withholding[1814] and Form W-2 reporting. Additional income tax withholding and reporting may be required when payments are made from the funded arrangement to the extent a portion of the payments are includible in income (i.e., amounts in excess of the employee's basis). Such amounts are subject to the income tax withholding rules that apply to pensions and are reported on a Form 1099R.

Generally, the employer is responsible for income tax withholding and Form W-2 reporting (or Form 1099R, if applicable) with respect to nonqualified deferred compensation. However, if nonqualified deferred compensation payments are made by a third party, such as the trustee of a trust, and are not under the control of the employer, the payor is responsible for income tax withholding and reporting.

Social security and Medicare taxes

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation. In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which, as described above, is relevant in determining when amounts are includible in income (and subject to income tax withholding). Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage

[1814] The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

Factual Background

Executive deferral programs in general

In recent years, Enron had two principal active deferral plans: the Enron Corp. 1994 Deferral Plan (the "1994 Deferral Plan") and the 1998 Enron Expat Services, Inc. Deferral Plan (the "Expat Deferral Plan"). The 1994 Deferral Plan was the principal deferral plan used by Enron. The 1994 Deferral Plan and the Expat Deferral Plan had almost identical terms and features, with the principal difference that the Expat Deferral Plan was used for employees of Enron Expat Services Inc., while the 1994 Deferral Plan was used for all other employees. Enron also had several older deferral plans, which did not allow current deferrals, but pursuant to which participants had made deferrals in previous years. In addition, Enron had a Project Participation Plan for international developers, which was put in place in the early 1990's. The Project Participation Plan was terminated December 31, 2000, except that payments could be made after that date with respect to awards made before such date. The Project Participation Plan allowed participants to defer receipt of payments that would otherwise be made.[1815]

Nonqualified deferred compensation was a major component of executive compensation for Enron. Documents provided by Enron show the approximate amounts deferred under all deferred compensation plans for the top-paid 200 employees for the years 1998-2001.[1816] Amounts deferred in these years are shown in the following table.

Table 21.–Amounts Deferred by Top-Paid 200 Employees 1998-2001

Year	Amounts Deferred Under All Deferred Compensation Plans for the Top-200 (millions of dollars)
1998	$13.3
1999	19.7
2000	67.0[1817]
2001	54.4

1994 Enron Corp. Deferral Plan

In general/background

Enron adopted the Enron Corp. 1994 Deferral Plan effective January 1, 1994. The stated purpose of the Plan is to allow key employees and outside directors of Enron Corp. to reduce current compensation and thereby reduce their current taxable income, earn an attractive, tax-free rate of growth on monies deferred, and accumulate funds on a tax-favored basis which can be

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[1815] The Project Participation Plan is discussed in Part III.B.3., above.

[1816] EC 000599639 - EC 000599654(1998); EC 000599620 - EC 000599638 (1999); EC 001872078 - EC 001872081 (2000); and EC 000599599 - EC 000599619 (2001).

used for retirement planning or other future financial objectives. The summary of the 1994 Deferral Plan for participants states that the "Plan provides you with an opportunity to delay payment of federal and state income taxes, and earn tax-deferred returns on your deferrals. You have the flexibility of choosing an investment strategy and payment schedule to meet your financial needs."[1818]

Participation in the 1994 Deferral Plan was originally offered to approximately 300 executives and key employees.[1819] Approximately 100 individuals[1820] elected to defer 1994 compensation, including salary, bonus, and long-term incentive for total deferrals of $3 million in 1994.[1821] Enron anticipated offering the same deferral opportunity for seven consecutive years, subject to further renewal after that time, according to the value of the 1994 Deferral Plan.[1822] To provide a level of security to executives and an asset to cover Enron's future payment liabilities, a rabbi trust was approved for the 1994 Deferral Plan.[1823] The rabbi trust is discussed below in further detail.

Many executives participated in Enron's deferral programs. Information provided by Enron shows that for the years 1999-2001, there were approximately 340 participants in the 1994 Deferral Plan.[1824] As of December 2000, there were approximately 295 participants in the 1994 Deferral Plan, with account balances totaling $153.4 million. As of December 2001, there were approximately 304 participants in the 1994 Deferral Plan, with account balances totaling approximately $51.6 million. The decrease in account balances was principally due to the decline in the value of Enron Stock and the accelerated distributions, discussed below, that were made immediately preceding Enron's bankruptcy filing.

The 1994 Deferral Plan was amended and restated several times. The original plan, after being amended seven times, was restated as of August 11, 1997. The 1994 Deferral Plan,

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[1817] According to the documents provided by Enron, in 2000, Mr. Lay deferred $32 million under the 1994 Deferral Plan in 2000. EC 001872080.

[1818] Added Value for your Future (a participant brochure). EC 000768171.

[1819] Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

[1820] When the 1994 Deferral Plan filed notification of its effectiveness with the Department of Labor, the plan covered 104 highly compensated employees.

[1821] Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

[1822] *Id.*

[1823] *Id.*

[1824] EC 000768148.

restated as of August 11, 1997, was amended three times and was restated again as of October 6, 2000.[1825] The 1994 Deferral Plan was amended August 14, 2001.[1826]

In connection with Enron's financial situation, the 1994 Deferral Plan was amended November 28, 2001, to suspend deferrals under the Plan, effective at the end of business on November 29, 2001, until such time that the Board of Directors removed such suspension.

Eligibility

Under the 1994 Deferral Plan, key management and highly compensated employees of Enron, as determined by the Deferral Plan Committee,[1827] and outside directors of Enron Corp. and participating subsidiaries were eligible to be designated participants under the 1994 Deferral Plan. The 1994 Deferral Plan allowed Enron to determine which executives would be eligible for participation. Over time, Enron changed participation eligibility requirements.

For 2001, the following employees were eligible to participate in either the 1994 Deferral Plan or the Expat Deferral Plan, whichever was applicable: (1) vice president level and above employees of Enron Corp. or a participating subsidiary who were eligible for stock awards under the Executive Long-Term Incentive program, on the executive pay structure (job level structure), and on local payroll; and (2) lower than vice president level employees who were making current (year 2000 for 2001 eligibility) deferrals under one of the plans.[1828] Enron believed that linking deferral plan eligibility to job level and participation in another Enron-sponsored program was a

[1825] This is the most recent version of the plan. In the October 6, 2000, restatement of the 1994 Deferral Plan, certain amendments were made. On October 6, 2000, the Compensation Committee approved a restatement of the 1994 Deferral Plan which included amendments to: (1) clarify provisions relative to deferral of gains realized upon the exercise of options utilizing a stock swap and the deferral of restricted stock that would otherwise be released; (2) provide consistency with respect to Enron's definition of retirement; (3) clarify current administrative processes; and (4) eliminate a reference that the plan may be adopted by other employing companies due to multiemployer trust issues.

[1826] The 1994 Deferral Plan as restated October 6, 2000, was first amended August 14, 2001, to: (1) allow daily investment changes instead of only once a month; (2) allow participants to make an election covering all future aggregate deferrals and to have the ability to change past and future elections by submission of a revised payout election; and (3) allow participants the ability to submit a beneficiary designation via an electronic process.

[1827] The "Deferral Plan Committee" refers to the committee established under the 1994 Deferral Plan to administer the plan. The duties and authority of the Deferral Plan Committee are discussed below.

[1828] Interoffice memorandum from Executive Compensation Department to unspecified distribution list regarding deferrals, dated October 12, 2000. EC2 000018424.

very straight-forward and thoughtful approach to determining the eligible group for executive deferrals.[1829]

In the few years preceding the bankruptcy, the group of eligible participants had changed. For 1999, employees with a September 15, 1998, salary of $130,000 or above, who were employees of Enron Corp. or a participating subsidiary, were eligible to participate in the 1994 Deferral Plan.[1830] For 2000, there was a change in eligibility for the 1994 Deferral Plan. Each business unit had the ability to select the executive and management employees who would be eligible to participate. The number of eligible participants was determined based on the numbers in each group that had been eligible to participate in the past at the advice of legal counsel. For 2000, all managing directors, executive vice presidents, business unit heads, and employees participating in the Plan during 1999 were automatically eligible to participate. Up to 43 additional employees in a group could be selected to participate based on specified criteria. In order to participate, an employee had to earn a minimum base salary of $120,000.

Regular deferrals

Under the 1994 Deferral Plan, a participant could defer up to 35 percent of base salary, up to 100 percent of annual bonus payments and up to 100 percent of select long term incentive payments. Prior to the Third Amendment to the 1994 Deferral Plan (as amended and restated effective as of August 11, 1997) dated August 8, 2000, participants could defer only up to 25 percent of base salary. The minimum deferral for each category of compensation was $2,000 for any deferral year.

Deferral elections were to be made in writing. Elections to defer compensation were irrevocable and were required to be made prior to the first day of the calendar year in which the compensation to be deferred was earned and payable.[1831] As discussed below, the 1994 Deferral Plan also allowed for stock option deferral and restricted stock deferral for certain employees. Enron could also make company deferral contributions on a participant's behalf.

Under the 1994 Deferral Plan, Enron would establish a deferral account in the name of each participant on its books and records. The account would carry the amount of the deferrals made, plus any earnings thereon, as a liability of Enron to the participant. Participant materials state that the account would be utilized solely as a device for the measurement and determination of the amount to be paid to the participant pursuant to the Plan.

Participants could choose to have their deferrals treated as having been invested in two types of investment accounts -- the Phantom Stock Account and the Flexible Deferral Account. A percentage of deferred compensation could be allocated to either account or the entire deferral could be allocated to only one account.

[1829] *Id.*

[1830] Interoffice memorandum from Corporate Compensation Department regarding 2000 deferrals, dated October 21, 1999. EC2 000018664.

[1831] A special rule applied for deferral elections of new employees.

Deferrals invested in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Under the Plan, credits for dividends declared for Enron Corp. common stock would be made quarterly to the Participant's Phantom Stock Account Deferral Account, and would be administered as though reinvested in Enron Corp. common stock.

During 1994 and 1995, deferrals into a participant's Flexible Deferral Account earned a fixed annual return of nine percent. Beginning in 1996 and thereafter, participants were allowed to select investment funds for the crediting of earnings to their account balances, and returns on Flexible Deferral Accounts were based on the performance of the participant's investment choices, less an administrative fee. Investment options were to include different levels of risk and return such as growth, balanced asset and bond funds, and fixed interest accounts. In 1999, in connection with a change to the Enron Savings Plan's recordkeeper, the investment options under the Flexible Deferral Account were changed to mirror those of the Enron Savings Plan. For 2001, participants could allocate among 17 investment choices that mirrored funds available in the Enron Savings Plan.[1832] The account would be credited with cumulative appreciation and/or depreciation based on the market price of chosen investments.

It appears that participants' deferrals were not actually invested to match participants' investment elections, but that participants' investment elections may have been followed generally in investing the assets of the rabbi trust associated with the 1994 Deferral Plan. According to Enron, only initially did Enron direct investments to generally correspond with participant elections.[1833] The investment of the trust's assets is discussed in further detail below. According to Enron's summary of the 1994 Deferral Plan,[1834] because of constructive receipt rules, Enron could credit a participant deferral account with earnings that tracked a chosen mix of investment funds, but the actual investments were required to be made by Enron Corp. or by the Trustee appointed by Enron Corp. at the direction of Enron Corp.

A participant could not transfer balances between the Phantom Stock Account and the Flexible Deferral Account, but could change investment choices within the Flexible Deferral Account once each calendar month. The First Amendment to the 1994 Deferral Plan dated August 14, 2001, allowed for daily changes in election choices instead of monthly changes.

[1832] For 2001, the Flexible Deferral Account investment choices were: Stable Asset Fund, Fidelity Balanced Fund, Fidelity Equity-Income Fund, Fidelity Growth & Income Portfolio, Fidelity Magellan Fund, Fidelity Growth Company Fund, Fidelity OTC Portfolio, Fidelity Overseas Fund, MSDW Institutional International Equity Fund, MSDW Institutional Equity Fund Growth Portfolio, PIMCO Total Return Fund II, T. Rowe Price Small Cap Stock Fund, Vanguard Index Trust 500, Vanguard Windsor II, Vanguard Conservative Growth Portfolio, Vanguard Moderate Growth Portfolio, and Vanguard Growth Portfolio.

[1833] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1834] EC2 000018443.

Under the 1994 Deferral Plan, within 120 days after the close of each plan year, each participant was to be provided a statement setting forth the participant's balance in the deferral accounts.

Distributions

Distributions from the 1994 Deferral Plan could be made upon the participant's retirement, disability, death or termination of employment. The 1994 Deferral Plan provides how retirement benefits, disability benefits, death benefits and termination benefits would be triggered and paid.

The 1994 Deferral Plan originally provided that elections with respect to payment options had to be made annually at the time the election to defer was made. Participants could elect to receive payments in a lump sum or up to 15 annual installments. Payments from an account could be received beginning the first quarter of the year following retirement, death, disability or termination. Payment elections could be revised at any time, but would not be effective until one full calendar year after receipt of the revised payment election form. Only one installment payment option could apply at any given time, e.g., an employee could not elect to have certain deferrals payable over 10 years and other deferrals payable over 15 years. If a participant was terminated for cause, the participant would receive deferrals only, with no earnings, in a lump sum during the first quarter of the year following termination.

The First Amendment to the 1994 Deferral Plan (as amended and restated October 6, 2000) dated August 14, 2001, changed the Plan to allow participants to make an election covering all future aggregate deferrals, rather than requiring payment option elections to be made annually, and to have the ability to change past and future elections by submission of a revised payout schedule. The 1994 Deferral Plan provided specific rules for beneficiary designations and the First Amendment allowed beneficiary designations by electronic processes.

In addition to distributions on account of retirement, death, disability or termination, the 1994 Deferral Plan allowed for hardship withdrawals. Participants were required to petition the Deferral Plan Committee, described below, in writing for such distributions, which could be granted, in the sole discretion of the Deferral Plan Committee, on account of unforeseeable circumstances causing urgent and severe financial hardship for the participant. According to the 1994 Deferral Plan, the types of circumstances that usually met the criteria were accidents and illness, large theft and fire loses, severe financial reversals, and large personal judgments. The distribution amount was limited to a reasonable, necessary amount to eliminate the hardship. The 1994 Deferral Plan was amended in 1996 to prohibit hardship distributions from the Phantom Stock Account for participants subject to section 16(b) of the Securities Exchange Act of 1934.

For circumstances other than financial hardship, an accelerated withdrawal of all or a portion of the account balance was also available, subject to the consent of the Deferral Plan Committee. The accelerated distribution provision was added to the plan in the First Amendment to the 1994 Deferral Plan (as restated effective August 11, 1997) dated October 13, 1997. If a participant elected an accelerated withdrawal, 10 percent of the elected distribution amount was required to be forfeited and 90 percent of the elected distribution would be paid to the participant. Upon such distribution, a participant would not be eligible to participate in the 1994 Deferral Plan for at least 36 months following the distribution. The account balance distributed would be determined as of the last day of the month preceding the date on which the Deferral Plan Committee received the written request of the participant.

Deferrals into the Phantom Stock Account would be paid out in shares of Enron Corp. common stock, with the exception of pre-1998 deferrals, which would be paid out in cash unless the participant signed a waiver to receive stock. The plan provides that the value of the shares, and resulting payment amount, would be based on the closing price of Enron Corp. common stock on the January 1 before the date of payment. Dividends would be credited to a participant's Phantom Stock Account and would be administered as if reinvested in Enron Corp. common stock.

Payments from the Flexible Deferral Account would be made in cash over the payment period selected. Earnings/losses would be applied to the Flexible Deferral Account during the payout period, based upon the investment choices made. Earnings on the declining account balance would be paid annually. Losses, if any, would be subtracted from the remaining account balance, which could shorten the payment period. Payments would begin during the first quarter of the year following the termination event.

Special purpose deferrals

The Second Amendment to the Enron 1994 Deferral Plan (as restated effected August 11, 1997) dated October 12, 1998, changed the Plan to allow participants to elect to make special purpose deferrals beginning in 1999. Participants could receive special purpose deferral payments while remaining actively employed. Special purpose deferral payments could be received as soon as three years following the deferral in a lump sum or up to five annual installments. Special purpose deferrals were intended to assist with anticipated expenses, such as a child's college expenses.

Taxes

Participant information states that Federal and State income taxes associated with deferrals were not incurred until the receipt of payments. FICA and Medicare taxes on amounts deferred were due at the time of deferral. Such amounts were said to be subtracted from compensation that was not deferred.

Information supplied to the IRS by Enron states that, for all deferrals of compensation made to the various plans, FICA tax was withheld at the time the deferral was made and deposited along with other payroll taxes for the pay period in which the deferral was made.

Enron deferral contributions

The Second Amendment to the 1994 Deferral Plan (as restated effective August 11, 1997) dated October 12, 1998, allows for deferral contributions by Enron. Under the amendment, Enron could make contributions on a participant's behalf in any amount as Enron determined in its sole discretion and to any investment account under the 1994 Deferral Plan. Such contributions could be made on behalf of some participants to the exclusion of others, and could vary among individual participants in amount and/or with respect to the investment account in which they may be credited. Such Enron deferral contributions were said to be cash bookkeeping credits made to the records of the 1994 Deferral Plan.

Documents obtained from the IRS show that, as part of one executive's employment agreement, Enron agreed to make contributions to the 1994 Deferral Plan in the amount of $500,000 to be deposited each February 15th of calendar years 2000, 2001, 2002, and 2003. It is unclear to what extent Enron made deferral contributions on behalf of other employees.

Deferral of stock option gains and deferral of restricted stock

The 1994 Deferral Plan allowed for deferral of income attributable to stock options and restricted stock. The Stock Option Deferral Account was established by the Fifth Amendment to the 1994 Deferral Plan, dated December 10, 1996. The Restricted Stock Deferral Account was established by the Sixth Amendment to the 1994 Deferral Plan, dated May 5, 1997.

Under the deferral of stock option gains program, participants designated by the Deferral Plan Committee could make an advance written election to defer the receipt of shares of Enron Corp. common stock from the exercise of a stock option granted under a stock plan sponsored by Enron, when such exercise was made by means of a stock swap using shares owned by the participant.[1835] The deferral election applied to the number of shares that the employee was due to receive in addition to the shares exchanged in the stock for stock exercise.

In 2001, nonemployee directors and members of the Enron Executive and Policy Committees were eligible to participate in the deferral of stock option gains program. An election to defer stock was required to be made prior to the end of the tax year preceding the year in which the option was exercised and at least six months prior to the exercise. The election was irrevocable, remained in effect for all tax years subsequent to the year the election was made, and remained in effect until to the Phantom Stock Account was to be paid out.

If an executive made a deferral election, Enron would credit share units to the Stock Option Deferral Account under the 1994 Deferral Plan, to be payable in stock upon death, disability, retirement or termination as elected by the executive (over a period of one to fifteen years) instead of delivering shares to the executive upon exercise of the option. Credits for dividends would be accrued in a separate account and paid in cash pursuant to the distribution provisions under the 1994 Deferral Plan. Phantom stock units derived through deferral counted for purposes of meeting Enron stock ownership requirements for executives. The tax issues associated with this program are discussed below.

Under the deferral of restricted stock program, participants designated by the Committee could make an advance written election to defer the receipt of shares of Enron Corp. common stock to be released according to a grant of restricted shares under a stock plan sponsored by Enron Corp. In 2001, nonemployee directors and executives who were current deferral plan participants or who met criteria for deferral in accordance with ERISA regulations for top-hat

[1835] Issues relating to stock-for-stock exercises are discussed in detail in Part III.C.2, below.

plans, as determined by the Deferral Plan Committee, were eligible to participate in the deferral of restricted stock program under the 1994 Deferral Plan. Eligible holders of shares of restricted stock could make an advance election, in the nature of a deferred compensation election, prior to the end of the tax year preceding the release date, and at least six months prior to release date, to defer receipt of shares which would otherwise vest and be released. Instead of delivering shares of restricted stock upon vesting, Enron would credit the value of such shares of restricted stock to the participant's Phantom Stock Account under the 1994 Deferral Plan, to be payable in shares of Enron Corp. common stock upon death, disability retirement or termination, as selected by the participant, over a period from one to fifteen years. Credits for dividends would be accrued in a separate account and paid in cash pursuant to the distribution provisions under the 1994 Deferral Plan.

Administration

According to the plan document, the 1994 Deferral Plan was to be administered by a committee of not more than three people appointed by the Chief Executive Officer of Enron ("Deferral Plan Committee"). The Deferral Plan Committee had the authority to make, amend, interpret and enforce all appropriate rules and regulations for the administration of the 1994 Deferral Plan and decide or resolve any and all questions, including interpretations of the 1994 Deferral Plan. In addition to other enumerated powers, the Deferral Plan Committee had the right, power, authority and duty to determine the amount, manner and time of payment of any benefits under the 1994 Deferral Plan and to prescribe procedures to be followed in obtaining benefits.

Effective October 26, 2001, Kenneth L. Lay appointed Lawrence Gregory ("Greg") Whalley to serve as the sole member of the Deferral Plan Committee. Mr. Whalley accepted the appointment October 29, 2001. Even though eligible, Mr. Whalley was not a participant in the 1994 Deferral Plan. There is no record of a Deferral Plan Committee before October 2001. Enron employees interviewed by Joint Committee staff said that an informal administrative committee would be formed when an issue arose, which was infrequently. Informal committees may have been composed of the head of Human Resources, compensation staff members, and legal counsel.

Claims procedures

Under the 1994 Deferral Plan, any claim for benefits was required to be submitted to the Deferral Plan Committee. The Deferral Plan Committee was responsible for deciding whether such claim was within the scope provided by the 1994 Deferral Plan. Notice of a decision by the Deferral Plan Committee with respect to a claim was required to be furnished to the claimant within 90 days following the receipt of the claim. If a claim was wholly or partially denied, notice was required to be in writing and worded in a manner to be understood by the claimant.

Rights of participants

The 1994 Deferral Plan provides that compensation deferred is part of the general assets of Enron. Enron was not required to segregate, set aside or escrow compensation deferred, nor earnings credited thereon. With respect to benefits payable under the 1994 Deferral Plan, participants have the status of general creditors of Enron. Participants could look only to Enron and its general assets for payment of their account balances.

Establishment of rabbi trust

Under the 1994 Deferral Plan, Enron, in its sole discretion, could acquire insurance policies or other financial vehicles for the purpose of providing future Enron assets to meet its anticipated liabilities under the 1994 Deferral Plan. Such policies or other investments would at all times remain unrestricted general property and assets of Enron. Participants in the 1994 Deferral Plan would have no rights, other than as general creditors, with respect to such policies or other acquired assets. As discussed below, Enron did acquire insurance policies on the lives of certain participants in the 1994 Deferral Plan.

The 1994 Deferral Plan provides that, notwithstanding any other provision or interpretation of the plan, Enron shall establish a trust in which to hold cash, insurance policies or other assets to be used to make or reimburse Enron for payments to participants of the benefits under the plan, provided that the trust assets shall at all times remain subject to the claims of general creditors of Enron in the event of Enron's insolvency. The 1994 Deferral Plan further provides that Enron, and not the trust, shall be liable for paying the benefits under the 1994 Deferral Plan. On April 5, 1994, Enron Corp. established an irrevocable rabbi trust for the executive nonqualified deferred compensation program.[1836] The provisions of the trust document were incorporated in the 1994 Deferral Plan.

The use of variable life insurance products was approved for investment of trust assets, because such products provided tax-free buildup of earnings.[1837] Upon the establishment of the trust, 100 trust-owned life insurance ("TOLI") policies were purchased through Cigna on the lives of 100 participants in the Plan. It was also approved that the assets for the 1992 Deferral Plan, which credited deferrals with Enron's mid-term cost of capital, be included in the rabbi trust and used to purchase life insurance.[1838]

Documents obtained from Enron[1839] show that a new grantor trust agreement was entered into with Wachovia Bank, N.A. as trustee dated January 1, 1999.[1840] Even though approved by

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[1836] In response to questions asked by the Joint Committee staff, Enron responded that the trust was established April 5, 1995. This appears to have been an error; because several documents provided by Enron state that the trust was established in 1994.

[1837] Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

[1838] *Id.*

[1839] Trust under the Enron Corp. 1994 Deferral Plan. EC2 000030938.

[1840] The Trust Agreement dated January 1, 1999, was actually executed in August 2000. The minutes of the August 7, 2000, Compensation Committee meeting show that executive compensation staff, in-house and outside legal advisors, and trust experts from Wachovia conducted a thorough review of the trust document dated April 5, 1994, to make sure that it the Compensation Committee, members of the Compensation Committee interviewed by the Joint Committee staff did not know whether Enron had such a trust.

The January 1, 1999, trust replaced the prior trust dated April 5, 1994, and the assets from the prior trust were transferred to the 1999 trust.[1841] The 1999 trust was established with $1,000, plus the transfer of the assets from the 1994 trust.[1842] Enron could make additional deposits of assets, but according to Enron, other than the contribution in 1994 of the trust-owned life insurance policies, no additional funding other than a pay-as-you go mechanism was established (i.e., current deferrals funded current benefit obligations).[1843] According to Enron, the assets of

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incorporated sufficient protection to plan participants in the event of a change in control. Several changes were recommended and were incorporated into a replacement trust document. The new trust included several changes relating to the following areas: (1) the establishment and funding of a new trust (under the new trust, all income received by the trust could be returned to Enron upon request at any time prior to a change in control); (2) the trustee's responsibility regarding payments (the new trust provides a process for confirming the insolvency or alleged insolvency of Enron, and for tax or payment claims handling); (3) provisions regarding payments if a short fall of the trust assets occurs (the new trust described how payments would be handled in the event of a short fall of trust assets that could result if Enron were to become insolvent); (4) insurance contracts to provide an irrevocable trust (the new trust confirmed the trustee as owner of life insurance policies, and beneficiary of death proceeds); and (5) provisions regarding the resignation and removal of the trustee (the new trust allowed for removal or termination of the trustee with majority consent of participants following a change in control). EC 000101470.

[1841] The Third Amendment to the 1994 Deferral Plan (as amended and restated effective as of August 11, 1997) dated August 8, 2000, amended the plan to incorporate provisions of the new trust document in order to link the replacement trust to the 1994 Deferral Plan.

[1842] Minutes from the February 12, 1996, Compensation Committee meeting report that the deconsolidation of Enron Oil & Gas ("EOG") in December 1995, resulted in EOG establishing a 1996 Oil & Gas Deferral Plan which included the assumption of deferral plan liabilities for active participants. It was anticipated that EOG would assume the deferred compensation obligations attributable to EOG and that there would be a separation of the trust under the 1994 Deferral Plan into an Enron trust and an EOG trust. The minutes note that as of December 31, 1995, the assets to be placed in the EOG trust equaled $2.085 million, with all trust assets totaling $11.480 million. Evidently, the transfer did not take place when originally contemplated, as the minutes of the May 3, 1999, meeting of Compensation Committee state that they approved, for recommendation to the Board, a proposed amendment to the 1994 Deferral Plan to allow the transfer of assets to the EOG trust. It is unclear whether such transfer eventually took place.

[1843] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

the trust were not intended to be sufficient to entirely pay for the nonqualified deferred compensation obligations under the 1994 Deferral Plan.[1844]

Under the trust document, a change in control would trigger funding of the trust so that the trust would contain assets necessary to meet the liability for benefits credited under the plan.

Under the trust document, in the event that a participant or beneficiary was determined to be subject to Federal income tax on any amount credited under the 1994 Deferral Plan prior to the time of payment, whether or not due to the establishment of or conditions to the trust, a portion of the taxable amount equal to the Federal, state and local taxes owed would be, at the direction of Enron, distributed by the trustee as soon thereafter as practicable to such participant or beneficiary. Enron would reimburse the trust for such distributions. Enron would also bear the expenses to defend any tax claims (related to deferred amounts) asserted by the IRS against any participant or beneficiary.

Under the trust document, the trustee was to cease any payment of benefits if Enron were insolvent. The trust provides that, all times during the continuance of the trust, all principal and income of the trust is subject to the claims of all of the general creditors of Enron.[1845] The trust was to be used as a source of funds to assist Enron in satisfying its obligations under the 1994 Deferral Plan. No assets held by any trust established were to constitute security for the performances of obligations under the 1994 Deferral Plan.

The trust document provides that the trustee has the power to invest and reinvest the assets of the trust in its sole discretion. It also provides, however, that prior to a change in control, Enron shall have the right to direct the trustee with respect to the investment of all or any portion of the assets of the trust. One former Enron employee interviewed by the Joint Committee staff stated that the trust assets were invested in a manner to correspond to participant investment selections. In response to questions asked by the Joint Committee staff, Enron responded that only initially were investments of trust assets directed so as to correspond generally to participant elections.[1846]

[1844] One former employee interviewed by Joint Committee staff said that the assets of the trust were intended to be sufficient to satisfy obligations under the 1994 Deferral Plan.

[1845] At the February 12, 1996, Compensation Committee meeting, it was reported that Vinson & Elkins informed Enron that if one of Enron's subsidiaries were to file bankruptcy, the creditors of that company would not be able to obtain access to amounts in the trust because the trust was held at the corporate level. To prevent current taxation of deferred amounts, Enron management recommended, and the Compensation Committee approved, that all employees deferring compensation into the 1994 Deferral Plan be transferred into Enron Corp., with their payroll costs charged back to the original subsidiaries.

[1846] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

Employees were notified of the existence of the trust and were notified that they did not have any interest or ownership in the trust assets. Employee information[1847] regarding security of deferrals stated that the 1994 Deferral Plan was secured by a rabbi trust to hold assets that would be used to make payments directly to participants in the event that Enron Corp. defaults on its obligation to make payments, but that benefits were contractually payable by Enron. Participant information explained that the trust would secure deferrals in the event of a change in control, or for any other circumstances, except bankruptcy. Participants were informed that in the event of bankruptcy, trust assets would be subject to the claims of creditors in bankruptcy proceedings.

Distributions to participants were not made from the trust, but were made from the general assets of Enron. The 1994 Deferral Plan trust is still in existence. According to Enron, the cash surrender value of the 78 policies with CIGNA was $25 million as of October 28, 2002 (the latest valuation report received from the insurance company).[1848] According to Enron, the general ledger of Enron Corp. reflected a trust value of $31.1 million as of December 2001.[1849] According to Enron, earning from the trust were included in income when information was received from a third party recordkeeper.[1850]

1998 Enron Expat Service, Inc. Deferral Plan

The 1998 Enron Expat Services Inc. Deferral Plan ("Expat Deferral Plan") is very similar to the 1994 Deferral Plan and was established to allow key employees of Enron Expat Services Inc. to reduce current compensation and thereby reduce current taxable income, earn an attractive, tax-free rate of growth on monies deferred, and accumulate funds on a tax-favored basis which could be used for retirement planning or other financial objectives.[1851] The Expat Deferral Plan was established for expatriates who were ineligible to participate in the 1994 Deferral Plan because they were employed by Enron Expat Services Inc.[1852] A participant was eligible for either the 1994 Deferral Plan or the Expat Deferral Plan. Following repatriation,

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[1847] 2000 Deferral Plan Choices. EC2 000018665.

[1848] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002. In a subsequent response, Enron stated that Wachovia is the owner of the TOLI policies and Enron is the beneficiary. EC 002680494 - EC 002680495.

[1849] EC 002680493. Enron Corp.'s general ledger reflected a balance of $33.5 million as of November 2000; $32 million as of December 1999; $24.7 million as of November 1998; $18.4 million as of December 1997; $12.8 million as of December 1996; and $8.5 million as of December 1995.

[1850] EC 002680496.

[1851] Attachment to May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

[1852] Attachment to May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

compensation of participants in the Expat Deferral Plan would be deferred under the 1994 Deferral Plan.

The most recent version of the Expat Deferral Plan was restated as of September 1, 2001,[1853] and has most of the same features as the 1994 Deferral Plan. The Expat Deferral Plan mirrored the 1994 Deferral Plan in that it provided executives the benefit of having their deferral balances track a chosen mix of investment funds. Under the Expat Deferral Plan, participants could defer up to 35 percent of base salary, up to 100 percent of annual incentive plan bonus payments, and up to 100 percent of select long-term incentive payments into the Expat Deferral Plan. Deferrals could be allocated into the Phantom Stock Account or the Flexible Deferral Account. The 17 investment options in the Flexible Deferral Account were the same as those for the 1994 Deferral Plan. The Expat Deferral Plan also included the deferral of stock option gains and deferral of restricted stock programs.

Unlike the 1994 Deferral Plan, a trust or other funding mechanism was not established in connection with the Expat Deferral Plan. The Plan provides that Enron could acquire insurance policies or other financial vehicles for the purpose of providing future assets to meet its anticipated liabilities under the Expat Deferral Plan. However, documents provided by Enron show that because there were only a few eligible participants (approximately 25 in 1998), the Expat Deferral Plan was established on an unfunded basis.[1854] Enron Corp. periodically agreed to serve as guarantor of benefit payments from the Expat Deferral Plan.[1855]

Information provided by Enron shows that there were approximately 55 total participants in the Expat Deferral Plan.[1856] As of December 2000, there were approximately 45 participants in the Expat Deferral Plan, with account balances totaling $14 million.[1857] As of December 2001, there were approximately 48 participants in the Expat Deferral Plan, with account balances totaling $5.4 million.[1858]

In connection with Enron's financial situation, the Expat Deferral Plan was amended November 28, 2001, to suspend deferrals, effective at the end of business November 29, 2001, until such time that the Board of Directors removed such suspension.

[1853] There was a 1997 Expat Services Inc. Deferral Plan, which appears to have been merged into the 1998 Expat Deferral Plan.

[1854] Attachments to the May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

[1855] In 1997, the Compensation Committee approved Enron Corp. as the guarantor of payments made from the 1997 Enron Expat Services Inc. Deferral Plan. Attachments to the May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

[1856] EC 000768135.

[1857] EC 000768209.

[1858] EC 000768210.

The Expat Deferral Plan was also administered by a committee. As with the 1994 Deferral Plan, it appears that no formal committee was ever established.

One Enron employee told the Joint Committee staff that the Executive Vice President, Human Resources and Community Relations had been appointed to the Expat Deferral Plan committee. The Joint Committee staff interviewed this individual, and she said she had no recollection of such an appointment. Enron employees interviewed by Joint Committee staff stated that, as with the 1994 Deferral Plan, an informal committee would be formed when an issue arose, which was infrequently. It was suggested that the committee could be composed of the head of human resources, compensation department staff members, or legal counsel. An accelerated distribution from the Expat Deferral Plan in April 2001 was approved by three compensation staff members.[1859] When asked whether these individuals were the committee for the Expat Deferral Plan, Enron responded that although there is no documentation which reflects the appointment of a formal committee, plan administrators responsible for securing approvals of Expat Deferral Plan amendments and Expat Deferral Plan administration collectively approved the accelerated distribution in accordance with plan provisions.[1860]

Change in recordkeeper

In connection with the change in recordkeeper for the Enron Savings Plan, the recordkeeper for the 1994 Deferral Plan and the Expat Deferral Plan was changed from Northern Trust Retirement Consulting to Hewitt Associates. The change in recordkeeper occurred at the same time for the 1994 Deferral Plan, Expat Deferral Plan, and the Enron Savings Plan.[1861] The change was completed on November 13, 2001, which was an accelerated date. The originally scheduled date for completion of the change was November 20, 2001. In interviews with the Joint Committee staff, Enron employees who worked on the change in recordkeeper stated that there had been problems with the old recordkeeper for some time, but that because the deferral plans were relatively small plans, vendors generally were interested in recordkeeping only in conjunction with other, larger Enron plans. Thus, they had to wait until a change in recordkeeper was made for the Enron Savings Plan. Enron Compensation Department staff stated that they had minimal involvement in selecting the new recordkeeper. They stated that the Benefits Department staff, who were handling the change in recordkeeper under the Enron Savings Plan, took the principal role in selecting the criteria and making the final decision regarding the new recordkeeper.

[1859] The document provided by Enron lists three Enron Human Resources employees as the committee approving the accelerated distribution from the Expat Plan as of April 2001. EC2 00032287.

[1860] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1861] The change in recordkeeper under the Enron Saving Plan is discussed in Part II.C.4., above.

Because the investment accounts in the deferral plans mirrored those in the Enron Savings Plan, Enron employees interviewed by Joint Committee staff stated that Enron believed that there was an advantage to having the same recordkeeper for both the Enron Savings Plan and the 1994 Deferral Plans and Expat Deferral Plan. In 1999, when investment options for the 1994 Deferral Plan and the Expat Deferral Plan were changed to match those of the Enron Savings Plan, the recordkeeping services for the 1994 Deferral Plan and the Expat Deferral Plan were transitioned from Clark/Bardes to Northern Trust Retirement Consulting, who was the recordkeeper for the Enron Savings Plan at that time. For the future, Enron intended to keep the same recordkeepers for the Enron Savings Plan and the 1994 Deferral Plans and Expat Deferral Plan, as having one recordkeeper would be easier and more efficient for participants.

In connection with the change in recordkeeper of the 1994 Deferral Plan and Expat Deferral Plan, there was a blackout period from November 1, 2001, through November 13, 2001. During this period, reallocation of balances and changes to investment choices were restricted. According to Enron, participants were notified of the change in recordkeeper and blackout period through a notification, which was mailed with the notification sent regarding the Enron Savings Plan blackout.[1862] Information provided by Enron states that participants were mailed a brochure providing the first notice of the change in recordkeeper on October 4, 2001, and were mailed a transition date update postcard on November 8, 2001.[1863] Information provided by Enron shows that the notifications were mailed to 303 participants in the 1994 Deferral Plan and 48 participants in the Expat Deferral Plan.[1864] The notification informed participants that October 31, 2001, would be the last day to access account information.

Even though there was a blackout period for the 1994 Deferral Plan and the Expat Deferral Plan, the blackout did not result in a major interruption of activities for participants. Under the 1994 Deferral Plan and Expat Deferral Plan, participants were not allowed to change investments from the Phantom Stock Account. Other changes in investment could be made daily in the Flexible Deferral Account.[1865] Unlike participants in the Enron Savings Plan, participants in the 1994 Deferral Plan and Expat Deferral Plan received distributions during the blackout. The 1994 Deferral Plan and Expat Deferral Plan provide that a participant's account balance is determined as of the last day of the month preceding the date on which the Deferral Plan Committee received the written request of the participant. Therefore, the participants' account balances as of October 31, 2001 (which was the last day on which account information could be accessed), could be used for distribution requests submitted during the blackout.

[1862] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1863] *Id.*

[1864] *Id.*

[1865] As noted above, participant investment elections had the result of directing the source of investment returns, rather than directing actual investments.

Other deferred compensation plans

In general

Enron also had other deferral plans that were the predecessor programs to the active plans. These included the: InterNorth, Inc. Director's Unfunded Deferred Income Plan; InterNorth Deferral Plan; Houston Natural Gas Corporation Deferred Income Program for Directors; HNG Deferred Income Plan; HNG/InterNorth Deferral Plan; Enron Corp. Deferral Plan; Enron Corp. 1988 Deferral Plan; Enron Corp. 1992 Deferral Plan; Enron Corp. Director's Deferral Plan; Enron Deferral Repatriation Plan; Portland General Holdings, Inc. Management Deferred Compensation Plan; and Portland General Holding, Inc. Outside Directors' Deferred Compensation Plan.[1866]

Information provided by Enron shows that there were approximately 200 participants in the InterNorth, HNG/InterNorth, and 1988 Deferral Plans.[1867] As of December 31, 2000, there were approximately 87 participants in the HNG Deferral Plan, with account balances totaling $7.5 million.[1868] The account balances totaled $7 million as of December 31, 2001.[1869] According to Enron, no trusts or other funding arrangements were used in connection with any deferral plans other than the 1994 Deferral Plan.[1870]

1992 Deferral Plan

The 1992 Deferral Plan preceded the 1994 Deferral Plan. Enron filed the 1992 Deferral Plan with the Department of Labor on January 20, 1992, and stated that there were 76 employees participating in the Plan.[1871] Rather than allowing participants to select investments, account earnings under the 1992 Deferral Plan were based on Enron's midterm cost of capital. The 1992 Deferral Plan allowed distributions in the event of hardship, but did not permit the accelerated distributions (i.e., distributions with a 10 percent forfeiture) like the 1994 Deferral Plan and the Expat Deferral Plan. The 1992 Deferral Plan was amended in 1995 to allow Enron to establish a trust which would fund obligations of plans of deferred compensation of Enron provided that

[1866] Enron also had a deferred compensation agreement, which appears to have been a nonqualified deferred compensation plan for one individual.

[1867] EC 000768139 - EC 000768145.

[1868] EC2 000031598 - EC2 000031600.

[1869] EC2 000031601 - EC2 000031603.

[1870] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1871] Enron letter to the Department of Labor dated January 20, 1992. Documents provided by Enron show that there were 18 participants in the 1992 Deferral Plan. EC 000768147.

trust assets at all times remain subject to the claims of general creditors of Enron. According to Enron, no trust was established.

Directors' deferral opportunities

As discussed in the section of this report describing of Board of Directors compensation,[1872] beginning January 1, 1997, it was mandatory that 50 percent of the annual retainer fee of directors be deferred into the Phantom Stock Account under the 1994 Deferral Plan, which, as discussed above, tracked the performance of Enron Corp. common stock. Directors could elect to receive their remaining fees (less mandatory deferrals) in cash, elect to defer remaining fees into the 1994 Deferral Plan, and/or elect to receive Enron Corp. phantom stock units or stock options in lieu of remaining fees.[1873]

Before the use of the 1994 Deferral Plan, there were separate plans maintained for director deferrals. These included the InterNorth, Inc. Director's Unfunded Deferred Income Plan, the Houston Natural Gas Corporation Deferred Income Program for Directors, and the Enron Corp. Director's Deferral Plan. Information provided by Enron shows that there were approximately 29 participants in the Director Deferral Plans (HNG, InterNorth, and Enron).[1874] In prior years, directors also deferred into the 1985 Enron Corp. Deferral Plan and the HNG Deferral Plan.

As discussed above,[1875] Enron sent letters to directors on December 11, 2001, informing them of the status of their nonqualified deferred compensation in connection with the bankruptcy and provided them with a statement of their account balances.[1876] Documents provided by Enron show that nonemployee director account balances in the deferral plans as of November 30, 2001, totaled $9.4 million.[1877]

The Enron Deferred Repatriation Incentive Plan

The Enron Deferred Repatriation Incentive Plan ("EDRIP") was a plan designed for U.S. employees on long-term assignment to the United Kingdom.[1878] The stated purpose of the

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[1872] *See* Part III.B.4., above.

[1873] Letter to the Enron Board of Directors regarding deferrals, dated December 11, 2002. EC2 000018654.

[1874] EC 000768146.

[1875] *See* Part III.B.4.

[1876] It is unclear whether all deferral plan participants received such notification.

[1877] The account balance of one individual, Robert Belfer, totaled $6.086 million. *See* Part III.B.4.,above, for a table of individual director balances.

[1878] Added Value for your Future (a participant brochure). EC2 000018643.

EDRIP was to promote the success of Enron by providing a means of securing and retaining the continued success of key personnel on foreign assignments through their initial period of repatriation to the United States.[1879] Enron would nominate selected key personnel for participation in the EDRIP while on overseas assignments. Only those selected could choose to participate. Under the EDRIP, Enron made discretionary payments into a U.S.-based escrow account, which would pay out the total accrued balance, including interest, approximately six months after repatriation to the United States. In connection with the EDRIP, Enron would make discretionary bonus payments that were less than they would otherwise be. The employee could express a preference between an EDRIP payment and a bonus, but such preference would not be binding on Enron.

Documents provided by Enron show that the advantages of the EDRIP depended on four assumptions: (1) the U.K. Inland Revenue would not tax a payment that relates to future services; (2) the IRS would allow an election under section 83(b) to recognize earnings currently that may not be paid until some point in the future; (3) in using this election, the earnings were effectively treated as having been earned while on foreign assignment and became eligible for offset by foreign tax credits; and (4) traditionally the level of U.K. taxes has been higher than U.S. taxes and consequently there is often a surplus of foreign tax credit that could be used.[1880]

According to documents provided by Enron, the EDRIP was advantageous to employees because Enron would not withhold U.S. hypothetical taxes at their marginal rate (possibly 39.6 percent) on payments into the EDRIP. Instead Enron would take a flat (15 percent) special hypothetical tax on any deferrals. According to documents provided by Enron, an employee would benefit to the extent of the difference between his or her marginal U.S. tax rate and 15 percent.[1881] The EDRIP balance, including the accrued interest, from the escrow amount would therefore be paid to the employee, contingent on certain factors, free of any further U.S. or U.K. tax liability, except on the accrued interest income. Any earnings deferred into the EDRIP were subject to forfeiture in the event that the individual was not still in the employment of Enron approximately six months after returning to the United States.

Early distributions from deferral plans

Accelerated distributions[1882]

In general.–In the months preceding Enron's bankruptcy, early distributions from the 1994 Deferral Plan and the Expat Deferral Plan were made to certain participants. As discussed

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[1879] EC 002634805.

[1880] Added Value for your Future (a participant brochure). EC2 000018643.

[1881] EC2 000018842.

[1882] The amounts discussed herein as accelerated distribution are approximate amounts. Documents provided by Enron regarding early distributions do not exactly reconcile. The information summarized is from the document most recently provided by Enron, which is included in Exhibit D. EC 002634761 - EC 002634769.

above, the 1994 Deferral Plan and the Expat Deferral Plan had a special feature which allowed participants to request early withdrawals of their account balances subject to a 10-percent forfeiture. The request was subject to approval at the discretion of each plan's committee. Upon an early withdrawal, participants were also prohibited from participating in the plan for a period of three years. The plan was presumably designed this way to attempt to avoid constructive receipt.

In the fall of 2001, participants began to make requests for early distributions from their accounts in the 1994 Deferral Plan and Expat Deferral Plan. Documents provided by Enron show that, in the last quarter of 2001, there were a total of approximately 211 requests for accelerated distributions from the 1994 Deferral Plan and the Expat Deferral Plan.[1883] There have been reports in the media that certain employees were notified that they should make distribution requests; however, the participants interviewed by the Joint Committee staff stated that they were not notified that they should make an early distribution request. Several current and former employees mentioned that there were general rumors regarding the financial status of Enron circulating at the time the requests for early distribution were made.

The Joint Committee staff interviewed several current and former Enron employees regarding the early distribution requests. The Joint Committee staff also interviewed the sole member of the 1994 Deferral Plan Committee,[1884] who was responsible for making the determination of whether distribution requests from the 1994 Deferral Plan should be approved.

1994 Deferral Plan.–Documents provided by Enron show that there were approximately 181 requests for early distributions from the 1994 Deferral Plan.[1885] According to interviews with current and former Enron employees, accelerated distributions had not been made in the past from the 1994 Deferral Plan. Information provided by Enron shows that there were no accelerated distributions made in 1998, 1999, or 2000. In interviews with Joint Committee staff, Enron employees stated that in the fall of 2001, Enron had to create a form and process for handling early distribution requests, because such requests had not been made in the past. After the creation of a form to be used, requests for early distributions were accepted by the Enron Compensation Department, forwarded to the Deferral Plan Committee for consideration, and then, if payment was approved, were processed for payment by the Compensation Department.

Some current and former employees interviewed by Joint Committee staff, including one employee who was involved with administering the early distribution requests, stated that they believed the only early distribution requests approved were those made by active employees.

[1883] EC 002634761 - EC 002634769. At that time, there were approximately 350 participants in the plans.

[1884] As discussed above, Mr. Whalley was appointed as the Deferral Plan Committee as of October 26, 2001.

[1885] EC 002634761 - EC 002634769.

Documents provided by Enron show that while many requests made by inactive employees were not approved, some early distribution requests made by inactive employees were approved.[1886]

In an interview with Joint Committee staff, the sole member of the 1994 Deferral Plan Committee explained the procedure that was used in making the determination of whether requests for early distributions should be approved. This process was arrived at after discussions with several people, including legal advisors. According to the Deferral Plan Committee, participants with account balances were treated as unsecured creditors of Enron. Three possible primary operating conditions of Enron were identified and decisions were made as to whether distribution requests would be granted or not, depending on the operating condition.

(1) The first condition was when Enron was considered a going concern. Under such condition, all bills would be paid when due. Thus, if Enron was operating as a going concern, all requests for early distributions would be approved.

(2) The second condition was when Enron was operating as a going concern, but there were cash flow issues. Under the second condition, Enron would pay distribution requests made by active employees only, because active employees were needed to keep Enron operating, while inactive participants were providing no current service to Enron. The Deferral Plan Committee stated that Enron made similar assessments in handling other unsecured creditors.

(3) The third condition was when Enron was in bankruptcy or insolvent, in which case no early distribution requests would be paid.

According to the Deferral Plan Committee, in late October and early November, Enron was operating under the second condition (going concern with cash flow issues); therefore, the Deferral Plan Committee approved payments to all of the active employees who had made requests. On November 9, 2001, Enron closed the Dynegy deal and on November 12, 2001, received a large cash payment. At that time, Enron was operating under the first condition (going concern); therefore, all requests were approved. This included requests by inactive participants that had not been approved originally.[1887] This operating condition lasted approximately one week. According to the Committee, during the week of November 19, 2001, there were questions as to whether the Dynegy deal would go through and Enron was eventually downgraded below investment grade. The Committee did not believe that the inactive participants were paid after November 19, 2001.[1888]

[1886] *Id.* According to Enron and Mr. Whalley, no requests were formally denied, but amounts subject to a request were either paid or not paid. For simplicity, "approved" is used here for those distributions that were made, and "not approved" refers to distributions that were not made.

[1887] Documents provided by Enron show that requests by inactive participants made in October and early November 2001, were approved on November 14, 2001. EC 002634763.

[1888] Minutes from the November 28, 2001, meeting of the Board of Directors show that the Board had authorized management to pay bills selectively to maximize the value of Enron.

Documents provided by Enron detailing the timing of the approval of payments of early distributions requests are not inconsistent with the approval system discussed above as described by the Deferral Plan Committee. While most employees interviewed by the Joint Committee staff believed that all requests made by active employees were approved, and that requests by inactives were not, documents provided by Enron show that accelerated distribution requests made by active employees on November 30, 2001, were not approved.[1889] Documents provided by Enron show that while some requests made by inactive participants were approved, no such requests were approved after November 14, 2001, which was the last approval date before November 19, 2001.[1890] No requests made after the bankruptcy filing were approved.

Of the approximately 181 participants who requested early distributions from the 1994 Deferral Plan, approximately 109 participants received distributions from the Flexible Deferral Accounts totaling $46.2 million.[1891] Payments were made from the general funds of Enron and not from the 1994 Deferral Plan rabbi trust. In addition to the cash distributions from the Flexible Deferral Accounts, stock distributions from the Phantom Stock Account equal to $502,452 were made to participants.[1892] In the case of a distribution from the Phantom Stock Account, shares were withheld to cover taxes owed.[1893]

Expat Deferral Plan.–As discussed above, like the 1994 Deferral Plan, subject to the discretion of the Expat Deferral Plan Committee, the Expat Deferral Plan also allowed an accelerated withdrawal of all or a portion of a participant's account balance, with 10 percent of the elected distribution amount forfeited. An accelerated distribution had been approved from the Expat Deferral Plan in April 2001. In the fall of 2001, approximately 30 participants in the Expat Deferral Plan made requests for early distributions. The committee for the Expat Deferral Plan was responsible for determining whether early distribution requests should be granted.[1894]

[1889] EC 000768237.

[1890] EC 002634761 - EC 002634769.

[1891] EC 002634761. Approval of one request for distribution of an account balance of $4.8 million is listed as "pending." Distributions to 11 participants in the aggregate amount of $2.1 million were approved, but were not wired. Two distribution requests were withdrawn. One request was approved, but the check bounced. EC 002634761 - EC 002634769.

[1892] EC 002634761 - EC 002634769. Payments from the Phantom Stock Account were paid in shares of Enron Corp. common stock, with the exception of pre-1998 deferrals, which would be paid out in cash unless the participant signed a waiver to receive stock. Documents provided by Enron show varying amounts in participants' Phantom Stock Accounts. The amount cited above is from the document most recently provided by Enron, which is included in Appendix D.

[1893] According to Enron, Exhibit 3b.2 to the bankruptcy filing incorrectly considered the net value of the share distribution in the calculation of deferral payments.

[1894] As discussed above, there does not appear to have been a formal committee under the Expat Deferral Plan.

Distributions from the Flexible Deferral Account were made to approximately 18 participants in the amount of $6.9 million.[1895] In addition, distributions of stock equal to $52,342 were made from Phantom Stock Accounts.[1896]

Hardship requests

Three participants in the 1994 Deferral Plan and one participant in the Expat Deferral Plan made requests for hardship distributions in the weeks immediately preceding the bankruptcy.[1897] There were no hardship requests granted in 2001. Participants submitted distribution requests for both hardship distributions and early distributions. In at least one case, after an accelerated distribution was made, the participant requested the 10 percent forfeited as a hardship. The request was denied.

From Joint Committee staff interviews with Enron employees, it appears that the process for evaluating hardship withdrawal requests was more complicated and time consuming than the process for accelerated distribution requests. In the case of a hardship request, the participant had to prove hardship and necessary documentation was required. In an interview with Joint Committee staff, one Enron employee stated that Enron filed for bankruptcy before there was sufficient time to process the hardship withdrawal requests. Another former employee stated that none of the requests qualified for hardship under the terms of the plans. Many of the reasons for the requested hardship distributions claimed by participants were tied to the financial situation of Enron.

The older deferred compensation plans did not allow accelerated distributions, but did allow for hardship distributions. Documents provided by Enron show that hardship withdrawal requests were made in November 2001 from participants in the 1988 Deferral Plan, the 1992 Deferral Plan, the Project Participation Plan, the 1994 Deferral Plan and the Expat Deferral Plans totaling $5.9 million.[1898] There were 11 requests from the 1998 Deferral Plan, one request from the 1992 Deferral Plan, and three requests from the Project Participation Plan.[1899] As mentioned above, no hardship requests were granted. Although infrequent, hardship withdrawals had been made in the past. Documents provided by Enron show that one hardship request was granted from the 1992 Deferral Plan in 1998.

[1895] EC 002634761. Three distributions in the aggregate amount of $283,027 were approved for payment, but were not wired.

[1896] EC 002634763 - EC 002634769. Documents provided by Enron show varying amounts in participants' Phantom Stock Accounts. The amount cited above is from the document most recently provided by Enron.

[1897] EC2 000018410 - EC2 000018411.

[1898] EC2 000018404.

[1899] EC2 000018404 - EC2 000018411.

Discussion of Issues

In general

Nonqualified deferred compensation is a common form of executive compensation. From the executive's perspective, the desire to save taxes is generally the key motivating factor behind deferred compensation. Individuals may want to defer compensation to a future date because they believe that their tax burden will be lower in the future than it is currently, thus resulting in payment of lower taxes than if the compensation had been received currently. Individuals may defer compensation in order to provide a future income stream in retirement. Employers may structure deferred compensation arrangements to induce or reward certain behavior. In many cases, the desire to accommodate the compensation wishes of an individual that a company wants to attract or retain as an employee may be a sufficient motivating factor to provide a deferred compensation arrangement. In some cases, a company may require the deferral of certain amounts of compensation, e.g., salary in excess of $1 million, in order to comply with the limitation on the deductibility of compensation in excess of $1 million.[1900] ERISA's exemptions for nonqualified deferred compensation arrangements allow great flexibility in designing plans and individual arrangements.

Nonqualified deferred compensation arrangements are often compared and contrasted to qualified retirement plans. Qualified retirement plans are subject to rules that do not apply to nonqualified arrangements, including nondiscrimination rules designed to ensure that the plans cover a broad group of employees. The benefits of qualified plans include tax advantages for the employer and the employee,[1901] security for the employee,[1902] and flexibility regarding payment.[1903]

Some argue that nonqualified deferred compensation arrangements are necessary because of the limits on qualified plans.[1904] The structure of some nonqualified deferred compensation arrangements is similar to qualified plans without the restrictions imposed by the Code. In many

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1900 Sec. 162(m). This limitation is discussed in Part III.C.6., below.

1901 In the case of a qualified plan, the employer receives a current deduction, while in the case of a nonqualified plan, the deduction is postponed until the time at which the employee includes the amount in income.

1902 Assets of a qualified plan cannot be reached by creditors of the employer, and are set aside for the sole purpose of paying plan benefits. In addition, as described above, within limits, the PBGC guarantees benefits under defined benefit plans.

1903 Constructive receipt rules do not apply to qualified retirement plans. In some cases, however, the Code may restrict the earliest point at which benefits may be paid.

1904 The maximum benefit that can be payable out of a qualified defined benefit plan is $160,000 a year (sec. 415(b)). This is far less than the annual salary of many Enron executives. In addition, the ***annual*** limit on contributions to qualified defined contributions plans, $40,000 for 2003, (sec. 415(c)) is far less than the ***monthly*** salary of many Enron executives.

cases, nonqualified deferred compensation offers even greater advantages for executives than qualified plans. For example, while qualified plan distributions are subject to a 10-percent additional tax on early withdrawals,[1905] Enron executives could defer amounts under the 1994 Deferral Plan and structure the arrangement so that payment would be made in as little as three years from the time of deferral (i.e., special purpose deferrals). To the extent that nonqualified deferred compensation arrangements have features more like qualified plans, there may be less incentive for employers to adopt broad-based qualified retirement plans.

As discussed above, neither the Code nor ERISA limit the amount of nonqualified deferred compensation. Because the employer is denied a deduction for deferred compensation until the employee includes the compensation in income, there is often said to be a tension between the interests of the employer and the employee that will result in an appropriate limit on deferred compensation.

In Enron's case, the deferral of its tax deduction was not a paramount concern, and the supposed "tension" between the interests of the employer and the employee from a tax perspective did little, if anything, to limit the amount of deferred compensation. Many Enron executives participated in Enron's nonqualified deferred compensation programs. As discussed above, from 1998 through 2001, over $154 million in compensation was deferred.

In connection with Enron's financial problems, many executives lost a considerable amount of compensation that had been deferred. Participants who had balances remaining in the deferral plans as of the bankruptcy may recover some of those amounts as unsecured creditors in the bankruptcy proceeding. This would include participants in plans that did not allow early distributions (e.g., the 1998 Deferral Plan), participants who could have but did not request an early withdrawal, or participants whose requests for early withdrawals were not approved. In addition, the value of Phantom Stock Accounts is currently minimal, because the account balances were treated as if invested in Enron stock.

On the other hand, many executives were able to access their deferred compensation, primarily by means of the early withdrawal provisions under the 1994 Deferral Plan and the Expat Deferral Plan. In the few months immediately preceding the bankruptcy, approximately 117 people received distributions totaling over $53 million.

As described above, there are no clear rules governing many aspects of deferred compensation arrangements. As a result, taxpayers may design deferred compensation arrangements based on varying interpretations of authority that may not be strictly applicable to the situation in question. Under present law, a variety of practices have developed with respect to deferred compensation arrangements which are intended to achieve the desired tax deferral, while at the same time attempting to provide some sense of security to executives as well as some degree of flexibility regarding time of payment and other plan features. In order to make such arrangements more attractive to the employee, some taxpayers may push the limits of present law.

[1905] Sec. 72(t).

While deferred compensation arrangements vary greatly, many of the plan features used by Enron are not uncommon. Even though certain aspects of the plans may be within common practices, some issues may be raised with respect to whether they meet the requirements necessary to obtain the desired tax deferral. In addition, even if the present-law rules are satisfied, certain of the arrangements Enron maintained raise broader questions of whether they fall within the spirit of the present-law rules or whether they should, as a policy matter, result in tax deferral. Particular issues raised under the Enron deferral arrangements are addressed below.

Funding issues

It appears that Enron may have intended the rabbi trust used in connection with the 1994 Deferral Plan to comply with the safe harbor requirements of Revenue Procedure 92-64.[1906] It was certainly intended that the trust not result in current income taxation; Enron employees and counsel interviewed by Joint Committee staff stated that it was intended that current taxation not result from the structure of the deferred compensation arrangements. Even if the trust were a valid rabbi trust when evaluated solely on the basis of the trust document, there is an issue as to whether other provisions under the 1994 Deferral Plan would cause the trust to be considered funded for tax purposes.

As discussed above, in the case of a rabbi trust, trust terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes. In the case of Enron, even though the trust document provided that the assets of the trust were subject to the claims of creditors, because participants had the ability to obtain early distributions, there is an argument that the rights of such employees were effectively greater than the rights of the creditors, making the trust funded for tax purposes. If, in fact, the arrangement was not subject to the claims of creditors, the arrangement should be considered funded, and income inclusion should have occurred when there was no substantial risk of forfeiture.

It may be argued that the ability to obtain the money did not give the participants rights greater than general creditors. Under the terms of the 1994 Deferral Plan and the rabbi trust, participants had no interest in any particular assets of Enron. In addition, Enron employees told the Joint Committee staff that the decisions whether to approve requests for distributions were made in the same way as Enron would treat the claims of other unsecured creditors.

However, because of the early distribution provisions in the 1994 Deferral Plan and the Expat Deferral Plan, plan participants received over $53 million under the Plans within approximately two months preceding the bankruptcy, precluding such amounts from being available to the claims of creditors. They would not have been able to obtain this amount in the absence of the withdrawal provisions. The financial condition of Enron appears to have been a

[1906] Because the revenue procedure describes a "safe harbor," a trust may be a valid rabbi trust without satisfying the safe harbor. However, the IRS will not rule on trusts that do not satisfy the safe harbor, except in rare and unusual circumstances.

motivating factor behind the requests for distribution; such requests had not previously been received under the Plans.

Constructive receipt

In general

Income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer may draw on it at any time. Income is not constructively received if the taxpayer's control of the income is subject to substantial limitations or restrictions. While the 1994 Deferral Plan and the Expat Deferral Plan were designed to impose restrictions or limitations on the participant's control of amounts deferred, such restrictions or limitations could be seen as illusory. While under present law the plan provisions may not result in constructive receipt, there is an issue as to whether the existence of such features should result in the application of the constructive receipt doctrine. When viewed collectively, the existence of the opportunities for accelerated distributions, participant-directed investment, and change in participant elections lend credence to the argument that the doctrine of constructive receipt should apply.

Accelerated distributions

Even if the 1994 Deferral Plan is considered unfunded, there is an issue as to whether participants should have been considered in constructive receipt of deferred amounts. A participant's unfettered right to withdraw amounts deferred results in constructive receipt. As discussed above, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Enron's treatment of deferred amounts reflects the view that even though participants could receive accelerated distributions under the 1994 Deferral Plan and Expat Deferral Plan, the 10-percent forfeiture, the inability to participate in the Plan for three years following an accelerated distribution, and the requirement subjecting distributions to the discretionary authority of the plan committee were substantial limitations or restrictions on the right to receive deferred amounts.

The IRS has not explicitly authorized the use of forfeiture provisions (i.e., "haircuts") in nonqualified deferred compensation plans. Many nonqualified deferred compensation plans utilize a 10-percent forfeiture limitation preventing constructive receipt, based on the 10-percent early withdrawal tax applicable to distributions from qualified retirement plans and IRAs.[1907]

Some may argue that the fact that some participants made requests for early distributions, but such requests were not granted supports the argument that the discretionary authority of the plan committee was a substantial limitation or restriction on the right to receive the deferred amounts, which should prevent the application of constructive receipt.

As a practical matter, the 10-percent forfeiture provision did not appear to impose much of a deterrent for 1994 Deferral Plan participants in requesting distributions. As noted above, many participants requested distributions. One former Enron executive who did not request a

[1907] Sec. 72(t).

distribution indicated that he did not make a request because he did not want to contribute to the already bad financial position of Enron.

Participant-directed investment

An issue may also exist due to the ability of participants to direct investments of amounts deferred. As discussed above, participants in the 1994 Deferral Plan and Expat Deferral Plan were able to direct investments of amounts deferred into the Flexible Deferral Account. More precisely, they were able to direct how earnings on deferred amounts should be credited.

According to Enron, only initially did Enron direct investments to track generally with participant elections.[1908] According to Enron's summary of the 1994 Deferral Plan,[1909] because of constructive receipt rules Enron could credit an employee's deferral account with earnings that tracked a chosen mix of investment funds, but the actual investments were required to be made by Enron Corp. or by the Trustee appointed by Enron Corp. at the direction of Enron Corp.

The model rabbi trust safe harbor under Revenue Procedure 92-64 only requires that the trustee must be given some investment discretion, such as the authority to invest within broad guidelines established by the parties. It does not provide precise guidelines on how trust assets must be invested. The IRS has ruled, in the case of one taxpayer, that no amount would be considered made available as a result of the fact that the participant has a right to designated deemed investments.[1910] Some commentators have noted that allowing participant directed investments presents no tax issues and should be allowed in plans.[1911]

Change in participant elections

Participants in the 1994 Deferral Plan were allowed to change payout elections at any time. Elections would be effective one year after being received by Enron. As previously discussed, under present law, courts have generally been lenient in applying the constructive receipt doctrine with respect to subsequent elections. While no single case can be relied upon for the position that subsequent elections will not result in constructive receipt, given the case law in the area, the position that the ability to make a subsequent election has some support.

Nevertheless, allowing participants to change payout elections gives them control over the amounts deferred. Changing payout elections allows participants to control the timing and

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[1908] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

[1909] EC2 000018443.

[1910] Priv. Ltr. Rul. 200148054. (The private letter ruling involved a qualified governmental excess benefit arrangement under section 415.)

[1911] *See* SMITH, ET. AL, NONQUALIFIED DEFERRED COMPENSATION ANSWER BOOK (3rd ed. 1996).

amount of payment, which is the basis for the general principle of constructive receipt. Thus, the ability to make subsequent elections arguably should result in constructive receipt.

Fairness concerns relating to early distributions

Nontax issues have been raised regarding the pre-bankruptcy accelerated distributions made from the 1994 Deferral Plan and the Expat Deferral Plan. Media reports allege that distributions were wrongfully allowed. While it may seem unfair for some participants to receive their account balances while other participants' requests were not approved, the 1994 Deferral Plan and the Expat Plan documents clearly state that accelerated distributions are made subject to the consent of the relevant plan committee. The plans provide that the committee has 60 days to approve or deny a request, but do not discuss what criteria must be used by the committee in approving or denying requests. Furthermore, the plans provide generally that all determinations provided for in the plan shall be made in the absolute discretion of the committee and that determinations shall be binding on all persons.

Employees were aware that the committee had discretion regarding accelerated distribution payments. Employee materials state that the committee was to interpret the plans, including but not limited to decisions regarding suspension of deferrals, hardship withdrawals, accelerated distributions, and other matters that would arise under the terms of the plans.[1912] There appears to be no obvious violation of the terms of either plan.

While there may be some perceived inequity, modifying the rules relating to nonqualified deferred compensation arrangements to eliminate any perceived equities in the treatment of active and inactive employees would be counter to tax policy because such a modification would give participants in nonqualified deferred compensation arrangements greater control over their deferred amount.

Deferral of stock option gains program

As discussed above, Enron amended the 1994 Deferral Plan in 1996 to provide for the deferral of stock options gains program, which established a Phantom Stock Account to which gains realized from stock-for-stock exercises of options could be deferred. Under the program, executives were able to pay the exercise price of options with already-owned Enron stock, transfer their basis in the old stock to an equal amount of new stock, and transfer the additional stock that would otherwise be received into the Phantom Stock Account.

The deferral credited to the participant's stock option deferral account was an amount equal to the number of shares deferred multiplied by the current per share market price, and was treated as if the amount of the deferral had been used to purchase shares of Enron Corp. common stock at such per share market price. Credits for dividends would be accrued in a separate account and paid in cash, pursuant to the normal payment terms of the 1994 Deferral Plan.

[1912] Deferral plan questions and answers (brochure for participants). EC2 000018440.

The 1994 Deferral Plan includes an example of how the stock option gain deferral works:

- Executive optionee holds an option for 20,000 shares at $50 per share (an aggregate exercise price of $1 million).

- Optionee makes an advance election to defer receipt of the additional shares received in a stock-for-stock exercise until a fixed time in the future (from one to 15 years beginning at death, disability, retirement or termination).

- Optionee owns 12,500 previously acquired mature shares (held at least six months) with a current market price of $80 per share (an aggregate market value of $1 million).

- Optionee exercises the 20,000-share option in a stock-for-stock exercise (either by actual delivery of already-owned share or by "attestation," i.e., instead of delivering shares to Enron, the executive simply provides an affidavit of ownership of the shares).

- Enron credits 7,500 share units to a Phantom Stock Account under the Plan (executive retains the already-owned 12,500 shares at the original cost basis). During the deferral period, dividend equivalents would be credited in the form of cash.[1913]

- Upon death, disability, retirement or termination, the share units are converted to shares which are issued to the executive according to the payment election made by the executive at the time of the deferral election (i.e., if at termination there are 1,000 share units in the account and the executive chose 10 annual payments, 100 shares would be distributed each year, in addition to credits attributable to dividends on such shares which will be paid out in cash).

While this type of program may be commonly used, there are questions whether it should result in effective income deferral.[1914] There is no authority clearly addressing stock option gain deferrals.[1915] The program does not fit within the IRS ruling guidelines on the application of

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[1913] Absent the deferral, the executive would include in income the fair market value of the 7,500 additional shares, i.e., $600,000 (7,500 x $80). Rev. Rul. 80-244,1980-2 C.B. 234.

[1914] *See* Geer, "*Why not just pay the tax?*," FORBES (March 10, 1997) at 156.

[1915] Some taxpayers may attempt to rely on Priv. Ltr. Rul. 199901006 in taking the position that the IRS has approved the transaction. In addition to the fact that private letter rulings may not be used or cited as precedent, the ruling cannot be relied upon, as the facts of the ruling are different from that those of the stock option gains program. For example, in the ruling, the election to exchange options for deferred compensation was made before the options were vested. Additionally, distributions of the amounts deferred would generally be made at the time that the employee's options would have vested. Further deferral was not allowed at the election of the employee.

constructive receipt to nonqualified deferred compensation.[1916] The principles used are a combination of the rules relating to a stock-for-stock exercise and nonqualified deferred compensation.

As discussed above,[1917] upon a stock-for-stock exercise, the employee is taxed on the fair market value on the additional shares received. Under the deferral of stock option gains program, the employee would not be taxed on the shares, but would defer the gain recognition to some time in the future. Enron took the position that the Phantom Stock Account would amount to an unfunded promise to pay, thereby avoiding inclusion of the gain amount.[1918] Upon exercise, the employee would be treated as receiving the number of already-owned shares that he or she used for payment (in a tax-free exchange) and the employer's promise to deliver additional shares in the future. It appears that the timing of income inclusion is deferred by having the employer and employee alter the terms of the original option agreement so that the employee's right to receive the additional shares is delayed until a specific time in the future.

To avoid possible constructive receipt, Enron required that the exercise occur six months or more after the deferral election was made. Deferrals were required to be made prior to the end of the preceding tax year and at least six months prior to exercise. The timing of the election is different from the timing that is typically required for an election to effectively defer compensation. In order to obtain a ruling concerning the application of constructive receipt to unfunded deferred compensation arrangements, generally elections must be made before the beginning of the period of service for which the compensation is payable.[1919] In the case of option gain deferral in Enron's plan, the election could be made after the options are vested and after services have been performed with respect to such compensation, as long as it is made at least six months prior to exercise.

The tax position taken with respect to the deferral of stock options gains is similar to that of the exercise of an option for stock which is restricted. If an individual were to engage in a stock-for-stock exercise receiving stock subject to a substantial risk of forfeiture, the stock would not be included in income until the substantial risk of forfeiture expires. In the deferral of stock option gains, taxation is not postponed by imposing restrictions on the stock, but by having the employee's right to receive the shares delayed until a specified time in the future. Because the employee only has an unfunded promise to pay, which is not property under section 83, income inclusion is postponed.

[1916] Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

[1917] *See* Part III.C.2., above.

[1918] The company's deduction is postponed until the amounts are distributed and included in the employee's income.

[1919] Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

Documents provided by Enron show that Mr. Lay participated in the deferral of stock option gains program.[1920] It is unclear to what extent other employees participated in the program. Enron-provided documents show that spread at exercise was subject to FICA/FUTA and Medicare taxes. Documents provided by Enron show that upon a stock-for-stock exercise where shares were deferred, shares were withheld for Medicare taxes.[1921]

Recommendations

In general

The experience with Enron demonstrates that the theoretical tension between the employer's interest in a current tax deduction and the employee's interest in deferring tax from a tax perspective has little, if any, effect on the amount of compensation deferred by executives. In Enron's case, because of net operating loss carryovers, denial of the deduction did not have a significant impact on its tax liability. Despite any possible effect on its tax deduction, Enron's deferred compensation arrangements allowed executives to defer millions of dollars in compensation that would otherwise be currently includible in income.

Enron's nonqualified deferred compensation arrangements contained a variety of features which serve to blur the distinction between nonqualified deferred compensation and qualified plans. Enron's nonqualified deferred compensation plans included features that to some extent provided the advantages of a qualified plan, such as security for and access to benefits without current income inclusion, despite not meeting the qualified plan requirements. Because nonqualified arrangements have features like qualified plans, there may be less incentive from employers to adopt broad-based qualified retirement plans. If executives are able to fulfill their retirement needs through the use of nonqualified plans, for some employers there would be no incentive to offer qualified plans to rank and file employees.

While there are a number of reasons why nonqualified deferred compensation arrangements are adopted, a primary factor is the desire by the executive to defer payment of income tax. For example, a stated purpose of the 1994 Deferral Plan and Expat Deferral Plan was to allow executives to reduce current compensation and thereby reduce their current taxable income and earn returns on a tax-favored basis. Without the tax benefit of deferral, it is unlikely that nonqualified deferred compensation arrangements would exist, and certainly would not exist to the extent they do under present law.

Some argue that nonqualified deferred compensation is merely an avoidance of current income taxation, and that rules should be adopted to prevent inappropriate deferral. For

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[1920] EC 000769187 - EC 000769197. The election to defer was made August 4, 1999. Shares were credited to the Phantom Stock Account in the 1994 Deferral Plan in February 2000. The stock-for-stock exercises were done through attestation. Shares were withheld to pay Medicare taxes.

[1921] Mr. Lay's compensation generally would have been over the maximum amount subject to FICA and FUTA taxes (i.e., the taxable wage base); therefore, only Medicare (HI) taxes would apply to these amounts.

example, some have suggested rules that compensation should be includible in income when earned or, if later, when there is no substantial risk of forfeiture of the rights to such compensation.[1922] In the case of Enron executives, this would have resulted in earlier income inclusion, as amounts deferred would have been included in income when earned and vested. The Joint Committee staff believes that this approach would result in a better measure of income than under present-law rules in which an unfunded promise to pay, even if vested, is not currently taxable. However, this approach would represent a significant change in policy.

The Joint Committee staff believes that some changes to the present-law rules regarding the taxation of deferred compensation are appropriate. Following are some specific options relating to deferred compensation which would preserve the ability to obtain tax deferral, but would reduce the use of practices which give executives control over amounts deferred. This is not intended as an exhaustive list of possible alternatives. Other options should also be considered. The options mentioned here would affect current practices, but would have less impact on current practices than would a broad change in policy.

In evaluating changes to the rules relating to deferred compensation, one factor to keep in mind is that taxpayers are likely to change their behavior to adapt to any given set of rules. For example, if the law were changed to restrict the use of one particular practice, it is likely that, over time, taxpayers would develop other ways to achieve the intended result.

Section 132 of the Revenue Act of 1978

As discussed above, section 132 of the Revenue Act of 1978 was enacted in response to proposed Treasury regulation 1.61-16, and provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The restriction imposed by section 132 of the Revenue Act of 1978 may have prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law.

Section 132 of the Revenue Act of 1978 should be repealed. Repealing section 132 would allow Treasury to provide more guidance to taxpayers and may also help to stem abusive practices. Especially given the lack of statutory rules in this area, the lack of administrative guidance in this area allows taxpayers latitude to create and promote arrangements which push the limit of what is allowed under the law. Because of the lack of rules and guidance in this area, the current state of practice has, to a great extent, evolved from variations of private letters ruling issued by the IRS to various taxpayers. Because there are no clear rules or guidance, taxpayers continue to create new variations of arrangements that, in their basic form, are generally perceived as allowed by the IRS.

[1922] This would be similar to the rule under Code section 457(f) relating to deferred compensation of employees of tax-exempt organizations and governments. Another alternative would be to impose a tax on the investment income. *See* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986).

Accelerated distributions

Under present law, a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to preclude constructive receipt of income. The Joint Committee staff recommends that under nonqualified deferred compensation arrangements, plan provisions allowing accelerated distributions at the request of the participant, should trigger constructive receipt rather than resulting in deferral. Distributions made to executives in the period immediately preceding the bankruptcy drained Enron's cash by over $53 million that would have been available to the creditors and raises questions regarding whether, in fact, a substantial limitation existed.

As part of any specific proposal, consideration should be given to the circumstances under which withdrawals should be permitted without triggering constructive receipt. Distribution options under current arrangements include: financial hardship, death, disability, retirement, the passage of a period of time specified by the employee (e.g., three years), and change in control.

Rabbi trusts

Enron had a rabbi trust to provide some security with respect to deferred amounts. Rabbi trusts are common arrangements. Arrangements have developed which appear to fit within the technical guidelines for a valid rabbi trust, but which provide security to executives. For example, as discussed above, even though the trust document stated that participants' rights were not greater than those of general creditors, the fact that millions of dollars in distributions were made immediately before the bankruptcy supports the conclusion that the rights of participants were greater than those of general creditors. Consideration should be given as to whether rabbi trusts are appropriate for deferred compensation, or whether additional requirements should be imposed with respect to such trusts.

Participant-directed investment

Allowing participants to direct investment of amounts deferred gives participants control over the earnings on the amounts deferred. The Joint Committee staff recommends that the ability of participants to direct investments of amounts deferred should result in current inclusion of income.

Subsequent elections

While the rules regarding subsequent elections are not clear under present law, many taxpayers take the position that subsequent elections allowing participants to change the payout term of their deferred compensation do not result in constructive receipt.

The Joint Committee staff recommends that plan provisions allowing participants to make subsequent elections should trigger constructive receipt. Subsequent elections allow taxpayers to control the timing and amount of their distributions. Allowing participants to accelerate or postpone the payment of their accounts should result in constructive receipt.

Alternatively, limited opportunities to change elections could be provided for in the law. If limited opportunities to make subsequent elections are allowed, the time that such elections are allowed to be made should be specified.

Deferral of stock option gains and restricted stock

As described above, Enron provided opportunities for executives to defer gains that would otherwise have been taxable due to the exercise of stock options and the vesting of restricted stock. The deferral of stock option gains program can be viewed as a manipulation of the rules for deferred compensation and stock-for-stock exercise, which were not intended to be combined, thus resulting in an unintended and inappropriate result for taxpayers. The Joint Committee staff believes that it is inappropriate to allow deferral of stock option gains and restricted stock.

Reporting

Other than an initial plan filing with the Department of Labor, until amounts are includible in income, there is no required reporting of nonqualified deferred compensation. Requiring reporting of amounts deferred to the IRS, even if the taxpayer takes the position that such amounts are not currently includible in income, could provide the IRS greater information regarding such arrangements. In most cases, the IRS does not have any information regarding amounts deferred, and therefore, no indication that a particular arrangement should be examined.

2. Stock-based compensation

Present Law

General background

Stock-based compensation is a commonly used form of compensation for employees and may be also provided as compensation for service providers who are not employees, such as outside directors. Commonly used forms of stock-based compensation include stock options, restricted stock, stock appreciation rights, and phantom stock arrangements.

Similar to nonqualified deferred compensation arrangements, an employer may have a formal plan that provides stock-based compensation to employees on a regular basis. For example, the employer may have a plan under which stock or stock options are granted to employees annually. Alternatively, or in addition, an individual's employment contract may provide for stock-based compensation for that individual. In some cases, stock-based plans are a means of providing nonqualified deferred compensation.

Stock-based compensation is often used in connection with incentive compensation. For example, bonuses may be paid in the form of stock; grants of stock or stock options may depend on corporate performance; or the rate at which restrictions on stock lapse or the rate at which stock options become exercisable may be accelerated if certain corporate earnings targets are met.

Some argue that the use of stock-based compensation is an appropriate means of compensation because it aligns the interests of the shareholders and corporate executives and rewards performance. On the other hand, some argue that an increase in stock price or corporate earnings alone is not an appropriate measure of performance because such an increase may not be directly linked to an individual's performance and may encourage executives to inappropriately inflate earnings and focus on short-term earnings.

Compensatory stock (including restricted stock)

In general

Stock may be granted to an employee (or other service provider) without restrictions in the sense that the stock is fully vested and transferable. In some cases, the employee is granted "restricted" stock in the sense that the stock must be forfeited or sold back to the company in certain circumstances. For example, an employee may receive stock that is subject to a substantial risk of forfeiture because of a requirement that the stock be forfeited if the employee terminates employment within some stated number of years. As another example, restricted stock may be granted pursuant to a five-year vesting schedule, pursuant to which 20 percent of the stock granted becomes available to the employee for each year of service. In this example, if the employee were to leave after three years of service, 60 percent of the shares of restricted stock would have vested and 20 percent would be forfeited.

Restricted stock (i.e., stock that is subject to a substantial risk of forfeiture) is often referred to as nonvested stock; stock that is not (or is no longer) subject to a substantial risk of forfeiture is often referred to as vested stock. Restrictions that no longer apply are often said to have "lapsed." Shares that vest are sometimes referred to a being "released."

Tax treatment

Stock that is granted to an employee (or other service provider) is subject to the rules that apply under section 83 to transfers of property in connection with the performance of services. Accordingly, if vested stock is transferred to an employee, the excess of the fair market value of the stock, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

If nonvested stock is transferred to an employee, no amount is includible in income as a result of the transfer unless the employee elects to have income inclusion in the year of transfer.[1923] Otherwise, the excess of the fair market value of the stock at the time of vesting, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which vesting occurs.

In the case of an employee, the amount includible in income under section 83 is also subject to income tax withholding and to social security tax (subject to the social security wage

[1923] Sec. 83(b).

base) and Medicare tax and must be reported on a Form W-2.[1924] The amount includible in the income of the employee (or other service provider) is generally deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.[1925]

Compensatory stock options

In general

A stock option is the right to purchase stock at a specified price (or at a price determined under a specified formula) at a specified time or during a specified period. Stock options granted to employees or other service providers are considered to be compensation for services. There are two general types of compensation-related stock options under the Code: nonqualified options and statutory options.

Statutory options include incentive stock options[1926] and options provided under an employee stock purchase plan.[1927] Nonqualified options are any other options granted in connection with the performance of services.

Nonqualified options

The income taxation of a nonqualified option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value when granted. A nonqualified option has a readily ascertainable fair market value if (1) the option is actively traded on an established market, or (2) the option is transferable, it is immediately exercisable in full, the stock subject to the option is not subject to any restriction or condition that has a significant effect on the value of the option, and the fair market value of the option privilege is readily ascertainable. The option privilege is the opportunity to benefit from increases in the value of the stock during the option period without risking capital.

If an individual receives a nonqualified option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount, if any, paid for the option is includible in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or is not subject to a substantial risk of forfeiture (or, if the taxpayer elects, in the taxable year in which the option is

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[1924] Because there is no transfer of cash upon the vesting of the stock, the withholding requirements may present administrative issues. Enron utilized several methods for handling withholding in such cases, as described below.

[1925] The employer must comply with applicable reporting requirements in order to claim the deduction. Treas. Reg. sec. 1.83-6(a)(2). The amount of any deduction may also limited by the $1 million limitation on the deduction of compensation of the top-five executives. Sec. 162(m). This limitation is discussed in Part III.C.6., below.

[1926] Sec. 422.

[1927] Sec. 423.

granted). No amount is includible in the gross income of the option recipient due to the exercise of the option.

If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise. In most cases, compensatory stock options do not have a readily ascertainable fair market value.

In the case of an employee, the amount includible in income under section 83 with respect to nonqualified stock options is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2.

The amount includible in the income of the employee (or other service provider) is generally deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.[1928]

Statutory options

The Federal tax rules applicable to statutory options are not discussed in detail here because Enron did not utilize such options.[1929]

1928 The employer must comply with applicable reporting requirements in order to claim the deduction. Treas. Reg. sec. 1.83-6(a)(2). The amount of any deduction may also limited by the $1 million limitation on the deduction of compensation of the top-five executives. Sec. 162(m). This limitation is discussed in Part III.C.6., below.

1929 The following general rules apply to statutory options. No amount is includible in the gross income of the option recipient on the grant or exercise of a statutory option. No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a statutory option. If an employee disposes of stock acquired upon exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. For a detailed description of the rules relating to statutory options, *see* Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation,* JCX-29-02, at 41-44 (April 17, 2002).

Special techniques for exercising options

Cashless exercise of stock options

Stock option plans may allow employees to exercise their options through a cashless exercise program generally operated by a company-designated broker. In a cashless exercise, on behalf of the employee, the broker exercises the option and sells some of the stock acquired pursuant to the option in one transaction. The amount of stock sold generally is sufficient to generate cash in an amount needed to cover the exercise price and any taxes that the employer is required to withhold upon exercise of the option. The remaining stock is then transferred to the employee.[1930]

The funds required to exercise the options may be provided either by the issuer (e.g., by advancing shares to the broker) or by the broker (by making a loan to the option holder and then deducting the amount loaned from the proceeds of the sale). If the funds for the exercise of the options are provided by the issuer, the broker transfers the exercise price along with tax withholdings back to the issuer.[1931]

Stock-for-stock exercise of stock options

Employers often allow optionees to pay the amount due on the exercise of an option with already owned stock of the employer (a "stock-for-stock" exercise) rather than requiring executives to pay cash. An IRS revenue ruling,[1932] addresses the use of employer stock to exercise stock options. Under the ruling, if stock of a corporation is exchanged for similar stock in the same corporation, the transfer qualifies as a nontaxable transaction and the taxpayer is not required to recognize the gain realized in the exchange.[1933] Instead, the taxpayer's basis in the stock exchanged is transferred to an equal amount of new shares.[1934] Shares received by the employee that are in addition to the number of shares exchanged are treated as compensation for

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[1930] For purposes of section 83, in a cashless exercise, the employee is treated as having received all the stock subject to the option, followed by a separate sale of stock. The amount includible in the gross income of an employee as a result of the exercise of the option is not affected by a cashless exercise.

[1931] Some have suggested that cashless exercise programs may be affected by the prohibition on loans to executives in the Sarbanes-Oxley Act of 2002, because such programs involve the extension of credit (or the arranging of credit) by the employer. Pub. L. No. 107-204, sec. 402 (2002).

[1932] Rev. Rul. 80-244, 1980-2 C.B. 234.

[1933] Sec. 1036.

[1934] Sec. 1031.

services under section 83(a).[1935] The employee is required to include in gross income the fair market value of the additional shares received.

The stock-for-stock exercise effectively allows an employee to use the untaxed appreciation in already owned shares on a tax-free basis to purchase new shares. Upon a stock-for-stock exercise, taxes can be satisfied with already-owned shares or cash. The participant does not incur a brokerage fee because the swap does not involve a sale on the open market. A plan may provide that the employee does not have to physically surrender the previously owned shares. Delivery of the shares may be accomplished through "attestation," in which case the executive provides an affidavit of ownership of the shares.

A stock-for-stock exercise can be illustrated by the following example:

> An employee exercises an option to purchase 200 shares of stock with a fair market value of $100 per share at an exercise price of $50 per share. To pay for the exercise price, the employee exchanges 100 previously-owned shares, with a fair market value of $100 per share, and a basis of $30 per share. The basis in the previously-owned 100 shares would transfer to 100 new shares. The fair market value of the additional 100 shares received ($10,000) is includible in income.

The use of a stock-for-stock exercise provides more favorable tax results to the executive than would be the case if the executive first sold previously owned shares and then used the cash to pay the purchase price. With a stock-for-stock exercise, the executive can postpone the recognition of gain on the previously-owned shares.[1936]

<u>Gifting of stock options</u>

Some employer plans permit the executive to transfer options to family members or others as a gift. The IRS issued guidance on the gifting of options in 1998, which concludes that the gratuitous transfer of a stock option is a completed gift at the later of: (1) the date of transfer, or (2) when the right to exercise the option is no longer conditioned on the performance of services by the transferor.[1937] Upon exercise of the option by the transferee, the income tax is generally required to be paid by the transferor.

The IRS guidance describes how an unexercised compensatory stock option is valued for gift or estate tax purposes.[1938]

1935 Rev. Rul. 80-244.

1936 In a stock-for-stock exercise, the amount includible income is the same amount that would be includible in income if the employee paid the exercise price with cash, although the amounts are arrived through different analyses.

1937 Rev. Rul. 98-21, 1998-18 I.R.B. 7.

1938 Rev. Proc. 98-34, 1998-18 I.R.B. 34.

Accounting for stock options

In general

The accounting rules for treatment of stock based compensation generally are governed by Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, ("APB 25") and Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ("FAS 123"). FAS 123 is the preferred accounting method, but is not mandatory. If a company accounts for options using APB 25, disclosure of the impact of FAS 123 on the income statement is required.

APB 25 treatment of stock options

APB 25 requires compensation costs for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. No increase in value is ascribed to the right to purchase the stock at a fixed price for a period of years. Correspondingly, no decrease in value is ascribed to restrictions on the option. The comparison of the market price to the exercise price is generally done on the grant date.[1939] The approach is effectively a snapshot of the difference between the market price and exercise price at a specific date.

As a result of these rules, under APB 25, generally no compensation cost is recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date.

FAS 123 treatment of stock options

FAS 123, issued in 1995, defines a fair value method of accounting for employee stock options. Under FAS 123, except in extremely rare situations, the fair value determination of an option is made on the grant date.

The fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. The fair value of an option estimated at the grant date is not subsequently adjusted for changes, such as in the price of the underlying stock, its volatility, or the life of the option.

The total amount of compensation cost recognized for an award of stock options is based on the number of options that eventually vest. No compensation cost is recorded for options that do not vest. If compensation cost has been recorded in a prior period and the employee does not vest, such cost is reversed in the current period. Once an option vests no reversal of cost is permitted if the option is forfeited or expires.

[1939] An exception applies to certain variable plans, a type of stock option plan that is not very common.

Other types of stock-based compensation

Stock appreciation rights

A stock appreciation right ("SAR") is an arrangement under which the employee has the right to receive the amount of the increase in the value of stock of the employer during a specified period. The employee receives the increase in value by cashing out or exercising the SAR. For example, the employee may be granted stock appreciation rights with respect to 1,000 shares of employer stock at a time when the stock is valued at $100 a share, and the SAR may be exercisable for three years. As a result, the employee has the right at any time during the three years to receive cash in the amount of the increase in value of 1000 shares of stock since the time the SAR was granted. Variations in the terms of an SAR may include limitations on the exercisability of the SAR until (or unless) certain stock value goals are met or allowing the proceeds of the SAR to be paid in the form of stock rather than cash.

Because the employee has the right to receive on request the increase in stock value that has already occurred (i.e., the current increase in stock value), SARs raise constructive receipt issues. However, under IRS revenue rulings, a substantial limitation on the employee's ability to receive the current increase in stock value results from the fact that the employee must forego the right to benefit from additional increases in stock value during the SAR period (i.e., the employee must surrender a valuable right) in order to exercise the SAR.[1940] Therefore, the current increase in stock value is not considered constructively received. The amount received on exercise of the SAR is includible in income and wages for employment tax purposes at that time.

Phantom stock

A phantom stock unit is a contractual obligation of the company equal in value to one share of the company which, until paid, is an unfunded bookkeeping credit on the records of the company. Upon the vesting of phantom stock units, the holder is generally entitled to payment in cash or in shares of common stock at the rate of one share of common stock for each phantom stock unit, plus dividends that have accrued from the grant date until vesting. Payments made in cash under a phantom stock plan are includible in gross income and wages when received. Payments made in the form of stock are includible in income as provided under section 83.

Factual Background

In general

Enron utilized various types of programs to provide its employees with compensation tied to the equity or long-term performance of the company. Included in these programs were stock-based plans such as the 1991, 1994 and 1999 Stock Plans,[1941] as well as one-time stock or option

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[1940] Rev. Rul. 80-300, 1980-2 C.B. 165.

[1941] Other stock-based plans, such as the 1978, 1984 and 1988 Stock Option Plans were no longer active during the 1990s.

grants such as the All-Employee Stock Option Program, the 2001 Special Stock Grant, and "Project 50." Long-term compensation programs that were not based on Enron stock included the Performance Unit Plan, which was terminated in 1999.

In recent years, Enron used stock options and restricted stock as the long-term component for executive compensation.[1942] Various documents provided by Enron show that participation in the long-term incentive program was limited to employees in the vice president job group and above.[1943] An employee involved in compensation matters interviewed by Joint Committee staff stated that restricted stock was limited to executives. The Joint Committee staff asked Enron whether nonexecutive level employees (i.e., employees below the vice president level) were granted stock options and restricted stock other than through all-employee programs. Enron responded that stock options and restricted stock/phantom stock were also granted to nonexecutive level employees.[1944]

As part of its compensation package, Enron provided its executives with long-term incentives designed to "encourage and reward...the enhancement of stockholder wealth."[1945] According to the proxy statements, the value of the long-term incentives, like base salary and annual incentives, was targeted at the 75th percentile of Enron's industry peer group.

Prior to 1999, long-term incentive grants were given in performance units under the Performance Unit Plan[1946] and in stock options.[1947] Occasionally, restricted stock was granted for specific reasons, such as: (1) individual performance; (2) company performance; (3) to accommodate special situations such as promotions; (4) in lieu of other benefits; or (5) to remain

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[1942] According to Enron, options were never repriced.

[1943] *See, e.g.*, Enron Corp. Executive Compensation program brochure. EC 002634796.

[1944] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002. Joint Committee staff asked Enron for data regarding stock options and restricted stock granted to nonexecutives. In providing the data, Enron stated that there is some overlap in grants to executives, so that data does not clearly indicate the amount of options and restricted stock provided to nonexecutives. Because the data provided does not provide the requested information, it is not included here.

[1945] 1992 Enron Corp. Proxy Statement.

[1946] See the discussion below for an explanation of this long-term incentive program.

[1947] According to the proxy statements, the value of an Enron stock option was based upon the value of Enron stock at the time of the grant and other factors, including stock price volatility, dividend rate, option term, vesting schedule, termination provisions and long-term interest rates. In 2000, stock options were granted with a seven-year term, 25 percent vesting on date of grant and 25 percent vesting each anniversary date thereafter. In 2001, the term of stock options was changed to five years and the portion of the grant vesting each year was increased to 30 percent.

market competitive.[1948] Aggregate stock holdings of the executives had no bearing on the size of long-term incentive grants.

In 1999, citing difficulties in identifying an appropriate peer group for comparison and the tenuous connection between peer group performance and executive management, Enron ceased giving long-term incentive grants under the Performance Unit Plan. Consequently, for the years 1999 to 2001, long-term grants to executives consisted of fifty percent nonqualified stock options and fifty percent performance-based restricted stock with a performance accelerated vesting feature.[1949] According to the 1999 proxy statement, the ultimate value of the performance based restricted stock awards made to executives was to depend upon the achievement of recurring after-tax net income targets established by the Compensation Committee for the years 1999, 2000, and 2001 and Enron's stock price.

During the 1990s, Enron had two principal stock plans: the 1991 Stock Plan and the 1994 Stock Plan. In 1999, Enron approved the 1999 Stock Plan as a funding mechanism for the issuance of common stock in connection with special circumstances. The plans are described below.

1991 Stock Plan

History

The 1991 Stock Plan was created in 1991 as an unfunded plan with the purpose of encouraging Enron employees and other eligible persons to "develop a proprietary interest in the growth and performance of the Company . . . generate an increased incentive to contribute to the Company's future success and prosperity . . . and enhance the ability of the Company to retain key individuals."[1950] The Plan was restated and approved by the shareholders in 1994, 1997, 1999, and 2001. Various amendments that did not require shareholder approval were approved throughout the years.

Eligibility

When the 1991 Stock Plan was created in 1991, eligible participants included all employees of Enron Corp. and its affiliates as well as nonemployee directors of Enron Corp. or an affiliate.[1951] Nonemployee contractors were added as eligible participants in 1994. In 1999,

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[1948] 1998 Enron Corp. Proxy Statement.

[1949] 2000 Enron Corp. Proxy Statement. According to the proxy statement, restricted stock was subject to four-year cliff vesting from the date of grant. However, vesting could be accelerated based upon Enron's annual cumulative shareholder return relative to the S&P 500. For example, if Enron's cumulative shareholder return exceeded the 90^{th} percentile, 100 percent would vest on the date of grant.

[1950] 1991 Stock Plan, section 1.

[1951] 1994 Enron Corp. Proxy Statement.

however, the entire class of eligible participants in the 1991 Stock Plan was changed to include only employees who were residents of the United Kingdom or members of the Management Committee of Enron, and nonemployee directors. The change in eligibility decreased the number of individuals eligible to receive benefits under the 1991 Stock Plan from approximately 7,000[1952] to 500.[1953]

Grants under the 1991 Stock Plan

Initially, the 1991 Stock Plan provided for grants of (1) stock options,[1954] including incentive stock options meeting the requirements of section 422 of the Code,[1955] and stock options with a grant price that is discounted from the fair market value to be used only in lieu of cash bonus payments, (2) stock appreciation rights ("SARs"), and (3) restricted stock.[1956]

In 1996, the 1991 Stock Plan was amended to provide that phantom stock units would be given to Enron directors in lieu of restricted stock and to permit the grant of phantom stock units interchangeably with restricted stock to eligible persons other than directors.[1957] According to documents provided by Enron, the decision to grant phantom stock units in lieu of restricted stock was motivated by the desire to avoid constructive receipt for employees who met the 1991 Stock Plan's definition of retirement.[1958] Under the 1991 Stock Plan, vesting of restricted stock was to be accelerated when an employee met the plan's definition of retirement. Employees who

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[1952] 1997 Enron Corp. Proxy Statement.

[1953] 1999 Enron Corp. Proxy Statement.

[1954] The 1991 Stock Plan provided that exercise price of a stock option could not be less than the fair market value of the stock on the date of grant.

[1955] Although the 1991 Stock Plan provided for incentive stock options, Enron did not grant such options.

[1956] The 1991 Stock Plan provided that restrictions placed on restricted stock would remain in place for at least three years in the case of restricted stock and, in the case of performance-based restricted stock, for least one year. Dividends or credits associated with the restricted stock were to be withheld during that period but credited to the participant's account. When shares became vested, all accumulated credits and dividends were to be distributed to the participant. The Plan provided that non-vested restricted stock would be forfeited if the participant terminated service for any reason other than death, disability, retirement, or involuntary termination. On the occurrence of certain events such as such as a merger, dissolution, sale of assets and consolidation, the Plan provided for the accelerated vesting of restricted stock and stock options.

[1957] Minutes of the meeting of the Compensation Committee (May 6, 1996).

[1958] EC 000102953. While documents provided by Enron state that there was an issue of constructive receipt, the actual issue appears to be a section 83 issue regarding a transfer of property.

met the definition of retirement but who remained employed with Enron would be vested in restricted stock and could be subject to taxation before actual receipt of the shares. To defer taxation until the payout of the shares, the plan was amended to grant phantom stock units instead of restricted stock, on the theory that phantom stock is considered an unfunded promise to pay stock which would be taxable when actually or constructively received, rather than section 83 property, which would be taxed upon vesting.

In 1997, Enron eliminated the availability of discounted options under the 1991 Stock Plan, and the plan was amended to provide that the exercise price of options would not be less than fair market value of the stock on the date of grant. In 1999, stock appreciation rights were eliminated from constituting an option for award under the 1991 Stock Plan.

Performance-based compensation

In 1994, in order for awards under the 1991 Stock Plan to qualify as performance-based compensation for purposes of the $1 million limitation on the deduction of certain executive compensation,[1959] the 1991 Stock Plan was amended to provide that: (1) the issuance of awards was contingent upon attainment of preestablished performance criteria: (2) restrictions would lapse contingent upon attainment of preestablished performance criteria, and (3) the issuance was in lieu of cash payments under the Annual Incentive Plan or Performance Unit Plan, based upon attainment of the performance criteria established under the terms of those stockholder approved plan. Likewise, limitations were placed on the number of options, stock appreciation rights and performance-based restricted stock that could be given to any one individual during a calendar year. The limit on options and stock appreciation rights was set at one million, while the number of performance-based restricted stock was capped at 100,000.[1960]

Shares available

When the 1991 Stock Plan was first approved in 1991, the number of shares available for grant under the plan was 11 million.[1961] The number of shares authorized for granting awards under the 1991 Stock Plan was increased by 10 million in each of the years 1994, 1997, and 1999. In 2001, an additional 21 million shares (reflecting a two-for-one stock split that took place in 1999) were added to the 1991 Stock Plan. No more than an aggregate of 25 percent of the shares available under the 1991 Stock Plan could be granted as restricted stock or phantom stock units.[1962]

[1959] This limitation is discussed in Part III.C.6., below.

[1960] As a result of the stock split, the caps were set at 2 million for both restricted stock and stock appreciation rights and at 200,000 for performance-based restricted stock.

[1961] This is equal to 2.75 million shares, adjusted for stock splits in December 1991 and August 1993.

[1962] 1996 Enron Corp. Proxy Statement.

Assignability and transferability of awards

Originally, the 1991 Stock Plan contained an antialienation provision prohibiting the assignment or transfer of awards (with the exception of transfer pursuant to a qualified domestic relations order.) In 1996, the 1991 Stock Plan was amended to allow the transfer of stock options to immediate family members, family trusts, and family partnerships.[1963] This transfer program is discussed in more detail, below.

On October 9, 2000, the 1991 Stock Plan was amended to allow the transfer by an eligible participant of options to a private charitable foundation described in 501(c)(3), the assets of which are controlled by the participant and one or more members of his or her immediate family.[1964]

Nonemployee directors

Nonemployee directors were eligible to receive awards under the 1991 Stock Plan, except for incentive stock options. Under the 1991 Stock Plan, nonemployee directors were to receive each year an amount equal to half of their retainer fee in restricted stock or stock options.[1965] In 1994, the 1991 Stock Plan was amended to allow non-employee directors to elect to receive a portion or all of their retainer fees in restricted stock and stock options.

Pursuant to the terms of the 1991 Stock Plan, nonemployee directors were required to defer fifty percent of their annual retainer fee into the 1994 Deferral Plan. On August 11, 1999, the 1991 Stock Plan was amended to allow nonresident, nonemployee directors whose deferral was regarded as the receipt of taxable income in their country of residence, to elect to waive the portion of the retainer fee required to be deferred and receive an award of phantom stock units under the 1991 Stock Plan.[1966]

On August 14, 2001, the 1991 Stock Plan was amended to provide that if a nonemployee director resigned with the approval of the board, the Compensation Committee could fully vest

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[1963] 1997 Enron Corp. Proxy Statement. This change followed the 1996 amendments to the short-swing profit liability rules under section 16(b) of the Securities Exchange Act of 1934, which eliminated the requirement that stock options be nontransferable.

[1964] Sixth amendment to the 1991 Stock Plan (as amended and restated May 4, 1999). According to documents provided by Enron, the change would allow employees to claim charitable contribution deductions on the transfers to private charities.

[1965] Only 20 percent of the options granted could be exercised on the date of grant, with an additional 20 percent becoming exercisable in each of the following four years. On May 2, 2000, the 1991 Stock Plan was amended to provide that the 20 percent portions of the options granted were to become exercisable only upon the completion of a full term of service by the nonemployee director. Fourth Amendment to the 1991 Stock Plan, as amended and restated May 4, 1999.

[1966] First Amendment to the 1991 Stock Plan (as amended and restated May 4, 1999).

grants of restricted stock made to the director and extend the time in which he or she could exercise options after resignation.[1967]

Other provisions

The 1991 Stock Plan was amended to allow for broker cashless exercise of stock options. As mentioned above, in a cashless exercise, the broker loans money to exercise the options, sells the shares, deducts taxes and commissions from the sales proceeds, and sends the participant the remaining proceeds.

Under the 1991 Stock Plan, the payment of the exercise price and applicable tax withholding amounts was required to be made at the time of option exercise and could be made by delivery of cashier's checks, shares of stock, or other property, which allowed participants to use stock-for-stock exercises. Prior to 1996, shares could not be used to satisfy tax withholding obligations.

1994 Stock Plan

History

The 1994 Stock Plan was created in 1994 to provide long-term incentives to employees in a similar way to the 1991 Stock Plan. The purpose of the 1994 Stock Plan was "to enable all employees employed by Enron Corp. . . . and its Affiliates and other eligible persons to develop a proprietary interest in the growth and performance of the Company, to generate an increased incentive to contribute to the Company's future success and prosperity, thus enhancing the value of the Company for the benefit of its stockholders, and to enhance the ability of Enron and its Affiliates to attract and retain employees who are essential to the progress, growth and profitability of Enron."[1968] The 1994 Stock Plan was amended several times and restated on October 12, 1999.

Eligibility

Eligible participants in the 1994 Stock Plan included any employee of Enron or of an affiliate, any nonemployee director of an affiliate, and any nonemployee contractor performing services for Enron. Originally, any person who was subject to section 16(b) of the Securities Exchange Act of 1934 or any officer or director of Enron who was covered by the New York Stock Exchange listing requirements was not eligible to be designated a participant. This participation restriction was subsequently removed.[1969]

1967 First Amendment to 1991 Stock Plan (as amended and restated May 1, 2001).

1968 Enron Corp. 1994 Stock Plan.

1969 June 28, 1999.

Grants

When originally enacted, stock options and restricted stock could be awarded under the 1994 Stock Plan. The 1994 Stock Plan was later amended to allow the grant of phantom stock units.[1970] Grants of incentive stock options could not be made under the 1994 Stock Plan.[1971] The number of shares of restricted stock available for grant under the 1994 Stock Plan was limited to not more than 25 percent of the total number of shares available under the 1994 Stock Plan.

On February 7, 2000, the 1994 Stock Plan was amended to provide that bookkeeping credit for phantom stock units given to individuals who were subject to the tax laws of specified countries would be made in cash rather than Enron stock.[1972]

Shares available

When the 1994 Stock Plan was created, the number of shares approved for awards was three million. On May 3, 1994, the number of shares under the Plan was increased to 11 million.[1973] The number of shares was further increased to 18 million, 26.5 million and then to 30 million between the years 1994 and 1997. In June of 1999, additional shares were added for a total of 45 million (updated to 90 million after the 1999 two-for-one stock split). Finally, in February and December of 2000, the number of shares available was increased to 104 million and 124 million, respectively.[1974]

Antialienation provisions

Under the 1994 Stock Plan as originally enacted, no rights under the 1994 Stock Plan could be pledged, alienated, attached or encumbered, except pursuant to a domestic relations order.

On August 8, 2000, the antialienation provision was amended to allow for the transfer of awards under the 1994 Stock Plan by a participant to: (1) a member of his or her immediate family; (2) a trust solely for the benefit of the participant and his or her immediate family; or (3)

[1970] December 12, 1997.

[1971] Enron Corp. 1994 Stock Plan (as amended and restated in October, 1999).

[1972] The change was made in response to the tax laws of China. Second Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

[1973] First amendment to 1994 Stock Plan.

[1974] Second and Fifth Amendments to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

a partnership or limited liability company whose only partners are the participant and his or her immediate family.[1975] This transfer program is discussed in more detail, below.

On October 9, 2000, the provisions were further amended to allow transfers of awarded options by a participant to a section 501(c)(3) charitable foundation the assets of which are controlled by the participant and/or one or more of his or her immediate family members.[1976]

Other provisions

The 1994 Stock Plan was amended to allow for broker cashless exercise of stock options. As mentioned above, in a cashless exercise, the broker loans the money to exercise the options, sells the shares, deducts taxes and commissions from the sales proceeds, and sends the participant the remaining proceeds.

Under the 1994 Stock Plan, the payment of the exercise price and applicable tax withholding amounts was required to be made at the time of exercise and could be by delivery of cashier's checks, shares of stock, or other property, which allowed participants to use stock-for-stock exercises. Prior to 1996, shares could not be used to satisfy tax withholding obligations.

1999 Stock Plan

The 1999 Stock Plan was created to "provide a funding source for the issuance of common stock of Enron Corp. in connection with special situations, including, but not limited to divestitures, outsourcing, remuneration payable under compensatory programs sponsored by Enron and its affiliates, and any other circumstance deemed, by the Compensation Committee of the Board of Directors as such a special situation."

Eligible participants included all employees of Enron Corp. and its affiliates, nonemployee directors, nonemployee contractors, and any individual who had accepted an offer of employment with Enron Corp. or an affiliate.

Under the 1999 Stock Plan, awards could be given in restricted stock, stock options, or phantom stock units. No grants of incentive stock options could be made under the 1999 Stock Plan. The number of shares available for grant under the 1999 Stock Plan was initially 3 million. Awards granted were inalienable with the exception of a transfer pursuant to a qualified domestic relations order.

Under the 1999 Stock Plan, the payment of the exercise price and applicable tax withholding amounts were required to be made at the time of exercise by delivery of cashier's checks, shares of stock, or other property, thus allowing stock-for-stock exercises.

[1975] Third Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

[1976] Fourth Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

Stock option transfer program

After amending the 1991 and 1994 Stock Plans to allow for the transfer of options to family members or family controlled entities, Enron instituted the stock option transfer program. In 2000, the 1991 and 1994 Stock Plans were amended to allow transfers to private charitable foundations controlled by participants or their immediate family members. Originally, eligibility for participation in the program was limited to nonemployee directors and Management Committee members. In August 2000, eligibility was expanded to include all employees who received grants from the 1991 or 1994 Stock Plans.

Pursuant to the stock option transfer program, employees could irrevocably gift stock options granted under the 1991 and 1994 Stock Plans to family members or certain family-controlled entities.[1977] Transfers could be made to immediate family members, to a trust for the exclusive benefit of immediate family members, or to a partnership in which immediate family members are the only partners. As mentioned above, the plans were later amended to allow transfers to private charitable foundations controlled by a participant or his or her immediate family.[1978] The employee would pay gift tax on the present value of the options, subject to the annual gift-tax exclusion or the lifetime unified tax credit. Enron advised employees against gifting unvested stock options given the IRS' position[1979] that the transfer of unvested options would not be considered a completed gift, the result being that gift tax would be assessed on the value of the options on the date of vesting rather than the date of the gift.

When the transferee exercised the options, the employee would be responsible for income tax payments on the gains realized.[1980] No additional payment of gift tax or estate tax would be required on the death of the employee since the options were already removed from the employee's estate by the transfer.

As stated in materials given to employees explaining the program "[t]he gifting technique allows you, with little or no additional tax, to pass on stock option gains that would have been in the estate and subject to estate rates of up to 55 percent."[1981] In addition, for transfers to family charitable foundations, the employee could be eligible for a charitable deduction.

[1977] In February 2001, the Compensation Committee approved administrative procedures to be followed under the stock option transfer program.

[1978] Even though allowed by the plans, program information given to participants does not include transfers to private charitable foundations as a permissible under the program.

[1979] Rev. Rul. 98-21, 1998-18 I.R.B. 7.

[1980] Documents provided to participants state that upon exercise of an option by the transferee, Federal income tax withholding was required to be paid to the Company by the executive for the amount of withholding tax imputed to the executive.

[1981] Memorandum to Executive Committee Members regarding the stock option transfer program. EC2 000019353.

Enron used the Black-Scholes option pricing method to value options transferred.[1982] Employees were advised that more recent grants would have the lowest estimated value and would create the lowest gift tax liability and the greatest benefit.

As stated in employee materials provided by Enron, benefits to the transferor included: (1) the ability to pass on stock options that would have otherwise been in the estate and subject to estate taxes; (2) the ability to gift vested stock options immediately after vesting at a discounted theoretical value which reduces the gift tax when the gifting occurs; (3) the ability to provide a benefit that appreciates over time and is tax free to heirs upon exercise; and (4) the ability to maximize the benefits to heirs by utilizing the $10,000 per recipient annual gift tax exclusion and/or the $675,000 lifetime unified tax credit.[1983]

The Compensation Committee was required to be notified of the terms and conditions of any transfer and was required to determine that the transfer complied with the requirements of the applicable plan. Documents provided by Enron indicate that transfers by at least five persons, including Ken Lay and two members of the Board of Directors, were approved by the Compensation Committee.[1984]

Stock option tax shelter

The materials provided in response to the Joint Committee staff's general request for information regarding Enron compensation arrangements included documents describing a technique purporting to defer inclusion of income upon the exercise of an employee's stock options.[1985] The documents indicate that Enron apparently considered whether to have a role in facilitating the technique and in letting Arthur Andersen show the technique to employees. The

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[1982] Documents provided by Enron show that in some years, multiple valuations were considered. For an assumed transfer date of November 15, 2000, one set of valuations that conforms strictly to Revenue Procedure 98-34 and qualified for safe harbor treatment was considered, as was another set of valuations which Enron believed conformed to Revenue Procedure 98-34, but took a more aggressive approach.

[1983] Enron informed participants that the possible drawbacks are: the inability to control the timing of the exercise, which must be relinquished to the transferee; the income tax that the executive must pay; income tax consequences to the transferee if the executive dies before the options are exercised; and if the executive pays gift tax upon the transfer and the stock does not appreciate, tax would be paid on income never realized.

[1984] The documents indicate that the Compensation Committee approved transfers during 1997-1998 to family members, family partnerships, and trusts of executives. EC 000104417; EC 000102332; EC2 000019444 - EC2 000019470; EC 002634789.

[1985] Sale of Executive Options Techniques, EC 000770979 – EC 000770981, and Sale of Executive Options Technique – Advantages and Disadvantages, EC 000770978. Enron also received a draft opinion letter for employees from Arthur Andersen (1999) (EC2 000038589 – EC2 000038616), but it is not known whether Enron ever supplied the letter to any employees. These materials are included in Appendix D of this Report.

technique involves the purported sale of the option to a partnership consisting of the employee's family members, followed by the partnership's exercise of the option and possible sale of the stock. In order for the technique to be effective, it would require Enron not to report gain on the exercise of the stock option on the employee's W-2 statement.[1986]

In an interview with Joint Committee staff, Mr. Hermann indicated that he understood that the technique was considered to be of interest to one employee. He declined to name this individual. He also told the Joint Committee staff that the tax department had reviewed the technique and had advised that Enron was required to withhold. Thus, the technique would not achieve the intended result. Mr. Hermann stated that he believed that Enron had not facilitated this type of transaction. From the materials received by the Joint Committee staff, it is not clear whether or not any Enron executives entered into a transaction of this type.

Performance Unit Plan

The Performance Unit Plan was created to provide long-term incentive compensation tied to increases in stockholder value to key Enron executive employees.[1987] According to the Performance Unit Plan, eligible participants included employees of Enron Corp. and its subsidiaries who participated in the Enron Executive Compensation Program. Dr. Charles LeMaistre, the Chairman of the Compensation Committee, submitted written testimony to the Permanent Subcommittee on Investigations on May 7, 2002, regarding, among other things, the Performance Unit Plan.[1988] In his statement, Dr. LeMaistre stated that Enron granted performance units to corporate and certain operating company executives who were not in an Enron long-term incentive plan. These operating company executives were, for the most part, in commercial support and pipeline businesses. Dr. LeMaistre stated that he believed that performance unit awards were granted pursuant to the Performance Unit Plan between 1987 and 1998.

Prior to the beginning of each calendar year, the Compensation Committee would designate the employees that were eligible to receive performance units during that year and the number of performance units to be given to each individual. Each performance unit had a value at the time of grant of $1. No single individual could be granted more than 3 million performance units in one calendar year.

Pursuant to the Performance Unit Plan, the total shareholder return of Enron was compared to that of a selected peer group comprised of 11 publicly held companies over a four-

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[1986] Sale of Executive Options Technique – Advantages and Disadvantages, EC 000770978. This document states, "Enron will require guidance from Arthur Andersen as the executive's tax advisor to operationalize manually overriding the payroll system to legally keep income off of the executive's W-2 statement."

[1987] 1994 Enron Corp. Proxy Statement.

[1988] *Hearing on The Role of the Board of Directors in Enron's Collapse before the Permanent Subcommittee on Investigations of the Committee on Government Affairs*, 107th Cong. (May 7, 2002) (testimony of Dr. Charles LeMaistre).

year period. The value of the performance units was then determined with reference to the ranking of Enron's shareholder return relative to its peer group as shown in Table 22, below.

Table 22.–Performance Unit Adjusted Values

Enron's Total Shareholder Return Ranking Position	Adjusted Value
1	$2.00
2	$1.50
3	$1.00
4	$0.75
5	$0.50
6	$0.25
7 through 12	$0.00

Additionally, irrespective of the ranking position of Enron's shareholder return, if the total return for the period did not exceed the cumulative percentage return for 90-day U.S. treasury bills, the performance unit would have no value.

In 1995, the Plan was restated and approved by shareholders to comply with the requirements of section 162(m) for deductions of performance-based compensation.[1989]

All-employee stock option arrangements

In general

Enron periodically made stock option grants to all employees. These grants were made to allow all employees to become shareholders of Enron.

All-Employee Stock Option Program

Under the All-Employee Stock Option Program, participants were entitled to receive a one-time up-front grant of Enron stock options. The six-year program was created in 1994 and was offered to all full-time Enron employees and part-time employees who completed at least 1,000 hours of service. The grants were made under the 1991 Stock Plan for Section 16 officers and under the 1994 Stock Plan for all other employees.

Initial grants under the program were made in 1994 and were equal in value to 30 percent of the annual base salary of each employee. For those joining the All-Employee Stock Option Program in subsequent years, the benefit was reduced by five percent for each year. For example, so that those joining in 1999 received a grant equal to five percent of their annual benefits. The grant was awarded on the last business day of the calendar year in which the employee was hired. Stock options awarded under the All-Employee Stock Option Program vested ratably over five years or over the remaining years of the program, whichever was shorter.

[1989] 1995 Enron Corp. Proxy Statement.

Enron documents indicate that the program was implemented in lieu of a company match under the Enron Savings Plan because of the cost savings that could be achieved by Enron. Documents provided by Enron show that a 401(k) match would have cost the Enron $43.9 million more than the All-Employee Stock Option Program.[1990] Documents provided by Enron show that if options would have been held to a $75 stock price, they would have delivered $1.77 billion in option value, while a 401(k) match, if implemented, would have delivered only $359.2 million in value.[1991] The Compensation Committee decided to repeat the program in 2000 through 2005.

One Enron - "Project 50" Stock Option Program

Eligible employees on the payroll as of December 31, 1999, participated in "Project 50." Under the program, employees were given a one-time grant of 50 stock options on January 18, 2000, in recognition of Enron's stock price reaching $50 after the 1999 two-for-one stock-split. Included in the Project 50 informational materials provided by Enron to participants is a message from Mr. Lay thanking the employees' contributions to Enron's success. In his words, "I look forward to working with you as we continue to make Enron a successful global energy and communications company. And it would not surprise me if our stock continued to $50 milestones after two-for-one splits on an even more frequent basis. In fact, anything is possible, if we are focused, if we work together, as a team, as One Enron."[1992]

EnronOptions

In May 2000, Enron approved a new all-employee stock option program called "EnronOptions - Your Stock Option Program" which was to commence in 2001 and continue for a five-year period. Pursuant to the program, all full-time and part-time employees on the payroll of Enron as of December 29, 2000, were awarded a one-time grant of stock options equal in value to 25 percent of their annual base salary.[1993] Employees joining after 2001 were to receive the annual grant in the year they were hired equal in value to five percent of their annual base salary multiplied by the number years remaining in the program. Stock options awarded under the program were to vest ratably on June 30 of each year remaining in the program.

Pursuant to bankruptcy rules, the EnronOptions program was terminated effective with the December 20, 2001, Compensation Committee meeting.[1994]

[1990] EC 000101777.

[1991] EC 000101777.

[1992] EC2 000019565.

[1993] 2001 Enron Corp. Proxy Statement.

[1994] Compensation Committee Meeting Minutes, December 20, 2001.

2001 Special Stock Grant

In the summer of 2001, when Enron's financial problems were getting much attention, Enron made an all-employee stock grant. The 2001 Special Stock Grant was made to most eligible Enron employees; some Enron companies' employees were not eligible due to legal, accounting, tax, labor or business issues.[1995] Grants were made to eligible employees who were active, regular employees of participating companies on August 13, 2001. Such employees received options equal to five percent of their annual base salary, as of August 13, 2001. Most employees were granted options on August 21, 2001, with an exercise price equal to the closing price of Enron stock ($36.88) on that date. The number of options that an eligible employee would receive was based on five percent of an employee's annualized base salary, as of August 13, 2001, and a theoretical stock option value of $15 (the Black-Scholes value for Enron stock on the grant date). The grant date for some non-U.S. locations was made at a later time due to pending legal/business issues. The grant price for grants made to eligible employees after August 21, 2001, was determined on the date of grant.

Options granted through the 2001 Special Stock Option Grant were 100 percent vested on the date of grant. Eligible employees who received the grant had five years to exercise the stock options unless they terminated employment. Although examples in employee communications assumed that the stock price would increase, Enron noted that there was no assurance that Enron common stock would increase in value.

Enron employees interviewed Joint Committee staff stated that the grant was done for goodwill and morale reasons on account of concerns that the stock price continued to decline. In connection with the 2001 Special Stock Grant, Mr. Lay circulated an electronic mail message to employees stating "one of my highest priorities is to restore investor confidence in Enron. This should result in a significantly higher stock price . . . I ask for your continued help and support as we work together to achieve this goal."[1996]

Miscellaneous

As discussed in Part III.B.2., above, Enron had two bonus deferral programs. Under the Bonus Phantom Stock Program and the Bonus Stock Option Program, participants were given the opportunity to receive stock options and/or phantom stock in lieu of cash bonus.

In addition, Enron offered the deferral of stock options gains and deferral of restricted stock programs in which participants could defer taxation attributable to such compensation. The deferral of stock option gains program allowed executives to exercise options without outlaying cash or incurring any current income tax liability. The program would be particularly useful for options due to expire. These programs are discussed in Part III.C.1.

Before Enron revised its compensation system in 1999, many other stock/equity plans existed throughout the various business units. These included the: Enron Capital & Trade

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[1995] EC2 000019566.

[1996] EC 000851236.

Resources Corp. Phantom Stock Unit Plan; Enron Energy Services, LLC Phantom Equity Plan; Enron Power Corp. Phantom Equity Plan, Enron International Stock Plan; Enron Renewable Energy Corp. Tandem Option Program; Northern Plains Natural Gas Company Phantom Stock Unit Plan; and Azurix Corp. Stock Option Plan. Miscellaneous stock-related programs may have also existed for various groups of employees or business units.[1997]

Discussion of Issues

In general

Enron used considerable amounts of stock-based compensation, and the amount of compensation generated from such arrangements increased dramatically in the years immediately preceding the bankruptcy, particularly in 2000.

Table 23, below, shows the Enron's deduction attributable to stock options for 1998 through 2000.[1998]

Table 23.–Enron Deduction Attributable to Stock Options 1998-2000

Year	Amount of Deduction
1998	$125,343,000
1999	$585,000 as filed $367,798,000 as amended
2000	$1,549,748,000

Table 24, below, shows the amount of income attributable to stock options for the highest paid 200 employees for 1998, 1999, and 2000. This is summary information provided by the IRS, based on information provided by Enron to the IRS.

Table 24.–Income Attributable to Stock Options for Top-200 Most Highly Paid Enron Employees (1998-2000)

Year	Amount of Compensation
1998	$61,978,000
1999	$244,579,000
2000	$1,063,567,000

Table 25, below, shows the income generated from the release, i.e., vesting, of stock options for the top-200 most highly paid Enron employees for 1998-2000. This information is also summary information provided by the IRS based on information provided by Enron to the IRS.

[1997] Minutes of the Compensation Committee show that the committee approved two other miscellaneous programs, the Key Performer Stock Option Retention Program and the NationsBank OptionPlus Program. It is unclear whether such programs were implemented.

[1998] Information from Schedule M1.

Table 25.–Income Attributable to the Vesting of Restricted Stock for Top-200 Most Highly Paid Enron Employees (1998-2000)

Year	Amount of Compensation
1998	$23,966,000
1999	$21,943,000
2000	$131,701,000

Enron's stock-based compensation programs can be analyzed both from a Federal tax perspective and from a nontax perspective. As discussed below, while Enron took advantage of tax planning opportunities in implementing its stock-based compensation programs, with two exceptions, the issues raised by these programs are not primarily tax-related.

Federal tax issues, in general

From a Federal tax perspective, Enron structured its stock-based compensation arrangements with an eye toward tax planning, sometimes from the point of view of Enron, sometimes from the point of view of the executive. For example, the use of nonqualified stock options resulted in tax deductions for Enron that would not have been available if Enron had used qualified stock options.[1999]

Enron also made use of techniques that benefited the executives from a tax perspective. For example, the use of stock-for-stock exercises provided a more favorable tax result for the executive than would have resulted if the executive sold Enron stock and used the cash proceeds to exercise options. In addition, the stock option transfer program, which allowed the gifting of stock options to family members and certain other persons, was clearly an estate planning device and was described to employees as such. However, both of these programs appeared to operate in accordance with published IRS rulings.[2000] In these cases, Enron appeared to do little more than take advantage of tax planning opportunities provided clear IRS authority.

There are two aspects of Enron's stock-based compensation programs that raise Federal tax issues. The first is the ability to defer gain on the exercise of options and restricted stock, which is discussed in Part III.C.1., above. The second is the sale of executive stock options tax shelter technique, which, if utilized by Enron executives, would raise signification tax issues. As mentioned above, it is unclear whether Enron executives engaged in this transaction. Issues with respect to this technique are discussed below.

[1999] There may be other reasons Enron did not use qualified options, including the restrictions placed on those options under applicable Code requirements.

[2000] It also appears that Enron attempted to comply with withholding requirements for stock-based compensation.

Stock option tax shelter technique

Recent news articles have drawn attention to attempts to defer inclusion of income upon the exercise of employees' stock options.[2001] Publicity has focused on the question of whether the sale of the option to the partnership can be an arm's length transaction.[2002]

Enron received a copy of a draft opinion letter (not addressed to any particular individual) from Arthur Andersen that could be provided to individuals who utilize the technique.[2003] In the transaction contemplated in the draft Arthur Andersen opinion letter, an employee who holds stock options sells the options to a family partnership owned 79 percent by himself, 17 percent by his wife, and one percent by each of his two sons. The partnership is capitalized with cash contributed by the option holder and his family ($180,000 by the employee, and $20,000 by the other family members). The purchase price of the options is set at $2 million as determined by an appraisal performed by Arthur Andersen. Upon the sale of the stock options to the partnership, the option holder takes back an unfunded and unsecured promissory obligation to repay the purchase price after 20 years, at 8 percent interest. The terms of the purchase agreement are described as "designed to be comparable to similar commercial transactions."[2004]

The draft opinion letter concludes it is more likely than not that: (1) the partnership will be recognized as a valid partnership for Federal income tax purposes; (2) the sale of options to the partnership will be respected as a valid sale between two separate taxable entities; (3) the assignment of income doctrine will not apply to the sale; (4) a disposition of options at fair market value under commercially reasonable terms satisfies the arm's length standard of section 83; (5) once the options are disposed of at arm's length under section 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by the partnership does not invoke the re-application of section 83; (6) the transferor's receipt of the partnership's unfunded and unsecured promise to pay the appraised value of the options plus interest will not constitute the "receipt of property" for purposes of section 83, so recognition of compensatory ordinary income should be delayed until the transferor receives principal payments under the promissory obligation; and (7) the timing and amount of the grantor corporation's deduction for compensation paid correspond to the timing and amount of compensation included in the transferor's gross income.

[2001] Johnston, *Costly Questions Arise on Legal Opinions for Tax Shelters*, N.Y. Times, Feb. 9, 2003, at A15; Glater and Labaton, *Auditor Role in Working for Executives is Questioned*, N.Y. Times, Feb. 8, 2003, at B1; Johnston and Glater, *Tax Shelter Is Worrying Sprint's Chief*, N.Y. Times, Feb. 6, 2003, at C1; Blumenstein, Lublin and Young, *Sprint Forced Out Top Executives Over Questionable Tax Shelter*, Wall St. J., Feb. 5, 2003, at A1.

[2002] *Id.*

[2003] Draft opinion letter to Mr. Client from Arthur Andersen, dated 1999 (EC2 000038589 – EC2 000038616). Appendix D contains this document.

[2004] EC2 000038591.

One element of the draft opinion letter is the conclusion that, more likely than not, the note received from the partnership does not constitute property for purposes of section 83, because the note is unfunded and unsecured. The opinion letter relies on the regulations under section 83 providing that an "unfunded and unsecured promise to pay" is not "property."[2005]

The conclusion that the partnership's obligation is "unfunded and unsecured" is arguably not directly contrary to the conclusion that the obligation is at "arm's length," as discussed below. However, whether this obligation is unfunded and unsecured could be challenged based on the practical meaning and application of the "unsecured and unfunded" language of the section 83 regulation in the context of a third party note as opposed to an obligation of an employer.

The draft opinion letter concludes that it is more likely than not that sale of options to the partnership will be respected as being at arm's length. In discussing this issue, the draft opinion letter relies on the assumed facts that the partnership may not make distributions other than to meet its partners' tax obligations, which is similar to security arrangements required by commercial lenders; this restriction helps to assure that the partnership will be able to meet its obligation to pay after 20 years. The draft opinion letter also relies on the fact that the partnership's primary activity is investing, so its exposure to liabilities or creditors' claims is likely to be small.

The draft opinion letter does not mention or alert the transferor to any possible economic risk of the transfer. For example, if the payments are in fact unsecured and unfunded, then it is possible that the value of the options (or of the optioned stock) in the hands of the partnership could decline. To the extent this can occur and the transferor is not protected except by the value of the options (or stock, if the options are exercised) in the partnership and by the cash contribution largely funded by the transferor, it could be argued that he did not in fact transfer the risk of loss of value of the options or underlying stock to the partnership, a key element of a "sale." Thus, it could be the conclusion that the transaction would be a contribution to capital rather than a sale, or perhaps even a "sham" transaction that did not actually shift the benefits and burdens of option ownership significantly to the partnership.[2006]

[2005] The draft opinion letter refers to Treas. Reg. Sec. 1.83-3(e). The draft opinion letter recognizes that the authorities it cites interpreting that regulation involve a promissory obligation of an employer rather than a third party, but concludes that there is no special rule limited the provision to employers and that the theoretical support should apply equally to a third party. EC2 000038611.

[2006] Although the draft opinion letter does make reference to concepts such as the common law "sham transaction" and "substance over form" doctrines, it relies in large part on its conclusion that the transfer is more likely than not an "arm's length" sale to distinguish cases in which such doctrines have been applied. EC 000038599.

For detailed information on the present law rules and judicial doctrines applicable to tax avoidance transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), The draft opinion letter also takes the position that the sale of the options is at arm's length, even though the transaction is between an individual and a partnership whose partners are the members of his immediate family. In discussing the issue, the draft opinion letter concludes that the state of the law is merely ambiguous, and that the sale between related parties can be considered at arm's length. This conclusion fails to take into account the absence of any adverse interest between the parties.

The draft opinion letter relies entirely upon the application of specific regulations under section 83, and does not consider whether any other provisions of the tax law might apply. For example, the letter does not mention section 453(e), generally applicable to installment sales between parties that are related but otherwise respected as independent. Section 453(e) provides that if a sale of property occurs between related parties and, within two years of the first sale, the transferee makes a second disposition of the transferred property, then the original transferor is not entitled to use the installment method of reporting income to defer recognition of income from the sale until payments are received, but rather must include all gain in income at the time of the second disposition. The opinion letter does not address whether this provision might have relevance to the transaction, or whether an exercise of the option (or a sale of the optioned stock) by the partnership might invoke this section.[2007]

__Nontax issues__

A noticeable aspect of Enron's stock-based compensation programs is the emphasis placed on stock as a form of compensation. Enron used stock-based compensation as a principle form of compensation for executives. Management believed that executive compensation should be tied to company performance. There was a stock ownership requirement for certain executives, the stated purpose of which was to align the interests of executives and stockholders. A stated focus of the Compensation Committee was ensuring that there was a strong link between the success of the shareholder and the rewards of the executive. The Compensation Committee believed that a great deal of executive compensation should be dependent on company performance.

March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters*, 54 SMU L. Rev. 1 (2001).

[2007] Some published discussion of similar structures has discussed section 453, both by way of exploring possible beneficial capital gain treatment of a sale of options and also by way of exploring whether there might be risks in the case of transfers to related parties. *See, e.g.*, Hammill and Lusby, *Intrafamily Installment Sales of Nonqualified Stock Options*, 31 Tax Advisor 494 (July 2000).

As noted elsewhere, the Enron culture also Enron stock ownership by employees. For example, Joint Committee staff were told that there was a monitor in the lobby of the Enron headquarters in Houston so that the performance of Enron stock could be viewed by all who entered the building. Even up to the months immediately preceding the bankruptcy, employees were encouraged that the company was in strong financial shape. Stock-based compensation for was used for all employees in a variety of forms, including as an investment in the Enron Savings Plan and Enron ESOP, in addition to the all-employee stock option programs. Stock was used as a form of compensation for nonemployee directors.

While some argue that linking shareholder and executive success is beneficial for shareholders, conflicts may arise. Linking compensation of executives to the performance of the company can result in executives taking measures to increase short-term earnings instead of focusing on longer-term interests.

The use of stock options by Enron brings renewed attention to discussions regarding the proper treatment of stock options for accounting purposes, and the difference between the treatment of options for tax and accounting purposes. As discussed above, under APB 25, which Enron followed, generally no compensation cost is required to be recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date. FAS 125, the "preferred," but optional, approach, would require stock option costs to be taken into account when options are granted, based on a determination of the value of the option.

Because of the differences between accounting rules and tax rules, the amount shown on financial statements as a cost attributable to stock options, even under FAS 125, can be substantially less than a company's tax deduction for stock options. Accounting rules and tax rules have somewhat different purposes, and it may be appropriate for different rules to apply in order to achieve the differing purposes. For example, under the tax laws, one principle is the proper matching of income and deductions; in the case of stock options, the corporation is not allowed a deduction until an amount is includible in gross income, which is generally upon exercise. This is an appropriate rule from a tax perspective; however, accounting rules might reasonably take the approach that options should be recorded earlier for financial reporting purposes.

Nevertheless, the sheer magnitude of the amount of corporate deductions and executive income generated by the exercise of stock options in some cases, such as Enron's, may appropriately focus attention on whether proxy disclosure rules and accounting rules are sufficient to properly inform shareholders.

3. Employee loans

Present Law

Overview

It is not uncommon for employers to make loans to some employees, particularly executives. From a Federal income tax perspective, a question that may arise is whether the arrangement is in fact a loan or a payment of compensation.

The tax treatment of loans is different from the tax treatment of compensation for both the employer and the employee. Compensation is generally currently includible in the gross income of the employee, and includible in wages for employment tax purposes. Compensation is generally deductible by the employer as an ordinary and necessary business expense,[2008] subject to the $1 million limitation on the deduction of compensation for certain executives.[2009]

On the other hand, a loan is not includible in the gross income of the employee (or in wages for employment tax purposes). Similarly, no deduction is allowed the employer with respect to the making of a loan to an employee. Interest payments may in some circumstances be deductible by the employee;[2010] accrued interest is includible in the gross income of the employer.

Under present law, a loan that provides for the payment of interest at a rate below the applicable Federal rate (a "below-market-rate loan") between certain parties is recharacterized as a transaction in which the lender made a loan to the borrower is exchange for a note requiring the payment of interest at the applicable Federal rate. In the case of loans in the employment context, the rule results in the parties being treated as if: (1) the borrower paid interest to the lender at the applicable Federal rate which is includible in income by the lender; and (2) the lender paid compensation to the employee in the amount of imputed interest.[2011] Because of these rules, the stated interest rate on loans to executives is often the applicable Federal rate.

If an employer makes a bona fide loan to an employee and subsequently forgives any outstanding debt, the amount forgiven is includible in gross income as compensation in the year forgiven and subject to employment taxes. The employer is generally entitled to a compensation deduction upon such forgiveness, subject to the general rules applicable to deduction of compensation expenses.

[2008] Sec. 162.

[2009] Sec. 162(m). This limitation is discussed in Part III.C.6., below.

[2010] Sec. 163.

[2011] Sec. 7872.

Determining whether an arrangement is a loan to an employee or compensation is generally based on all the facts and circumstances. Present-law rules applicable in making this determination are discussed below.

Laws other than tax laws may also affect the structure of employee loan transactions. Federal securities laws regarding reporting of stock transactions by corporate executives have influenced the decision of whether to use stock of the company to repay a loan. These rules are discussed in brief, below.

Definition of a bona fide loan

In general

A transfer of funds from one taxpayer to another may constitute a loan, a gift, compensation for services, a contribution to capital, or something else.[2012] Whether the transfer will be treated as a loan for tax purposes depends on the intentions of the parties as well as the objective facts and circumstances of the transaction.[2013]

In general, in order for a loan to exist, at the time the transfer of funds takes place, there must be an unconditional obligation on the part of the transferee to repay the funds coupled with an unconditional intention on the part of the transferor to secure repayment.[2014] In analyzing whether there is an unconditional obligation to repay on the part of the payee, courts have examined whether, under the loan agreement, the obligation to repay the loan is contingent upon a future event.[2015] If the obligation to repay is conditional if the condition of repayment may be easily satisfied by the borrower[2016]or is under the borrower's control, the transfer of funds generally will not be regarded as a bona fide loan.[2017]

[2012] For example, a transfer by a corporation to a shareholder employee may be a dividend.

[2013] *Haber v. Commissioner*, 52 T.C. 255, 266 (1969) *aff'd*, 422 F.2d 198 (5th Cir. 1970).

[2014] *Id.; Haag v. Commissioner*, 88 T.C. 604, 615-616 (1987), *aff'd* 855 F.2d 855 (8th Cir. 1988).

[2015] *See, e.g., Frierdich v. Commissioner*, T.C. Memo 1989-103, *aff'd*, 925 F.2d 180 (7th Cir. 1991); *also see Bouchard v. Commissioner*, T.C. Memo 1954-243, *aff'd*, 229 F.2d 703 (7th Cir. 1956)

[2016] *Saunders v. Commissioner*, 720 F.2d 871, 874 (5th Cir. 1983) (holding that where agreement contained "exceedingly generous" forgiveness clauses and the recipients of the loans could easily qualify for cancellation of the loan, no creditor-debtor relationship was established).

[2017] *Milenbach v. Commissioner*, 106 T.C. 184, 197 (1996). In *Milenbach*, repayment was to be made out of future profits generated from residential suites the borrower was to construct at a time in its "reasonable discretion." The borrower never constructed the suites and thus never repaid the loan. The Tax Court held that because the agreement provided for only a

Courts have often looked beyond the intentions of the parties to objective factors that may indicate whether a creditor-debtor relationship has been created.[2018] Frequently cited factors include (1) the existence of a promissory note or other evidence of indebtedness, (2) the existence of a specified repayment schedule including interest, (3) the presence of a collateral or security for the loan, and (4) the payee's ability to repay.[2019] Additional factors include whether repayments were made, and the manner in which the loan was treated in the taxpayers' books.[2020]

Loans in the employment context

Loans to employees may be subject to challenge on the ground that they constitute compensation for services rather than a true debt. Two factors, in addition to the general rules for determining whether a bona fide loan exists, have been applied in the employment context.

First, the manner in which the loan is to be repaid--whether through the provision of services or monetary payments--has been a significant indicator of whether a bona fide loan exists in the employment context. Generally, loans made with the expectation that they would be repaid through the provision of future services have been held not to create a creditor-debtor relationship between the employer and the employee and to constitute advance compensation rather than loans.[2021] The same result has been reached even if employment was ultimately terminated and monetary repayment ensued.[2022]

Second, if under the loan agreement repayment is to be satisfied with monetary payments, the focus has been on whether the repayment is to be satisfied solely from the future

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conditional obligation to repay the loan, the satisfaction of which was under the sole control of the borrower, it did not constitute a true loan.

[2018] *Geftamn v. Commissioner*, 154 F.3d 61, 68 (3rd Cir. 1998); *Haag*, 88 T.C. at 616; *Morgan v. Commissioner*, T.C. Memo 1997-132.

[2019] *Geftamn*, 154 F.3d at 68; *Morgan*, T.C. Memo 1997-132.

[2020] *Haag*, 88 T.C. at 616.

[2021] *Beaver v. Commissioner*, 55 T.C. 85, 91 (1970) ("in the case of a loan, satisfaction is to be made by making monetary payments pursuant to the parties' agreement. In such case a debtor-creditor relationship is established at the outset. In the case of compensation for future services, satisfaction is to be made by actually performing such services. Only when such services are not rendered does there arise a debtor-creditor relationship requiring satisfaction by monetary repayment."); *see also Morgan*, T.C. Memo 1997-132 ("an intent to repay a purported loan by the performance of services...[renders the loan] nothing more than an advance salary or other payment for services"); and *Frierdich*, T.C. Memo 1989-103 (holding that a loan to an attorney by his client, the repayment of which was due upon the occurrence of a future event and which could be offset by legal fees owed to the attorney, was not a loan but advance payment for legal services).

[2022] *See Beaver, supra.*

earnings of the employee during the period of employment or whether the obligation to repay continues after the employment relationship is terminated. Thus, in cases in which the loan agreement provided that repayment was to be made out of the future earnings of the employee but that the obligation would continue to exist after termination of employment, the transfer was treated as a true loan.[2023] Conversely, when repayment of the loan was limited to the future earnings of the employee during employment and could not be enforced against the employee after termination, the transfer was deemed to constitute compensation rather than a loan.[2024] Further, if there existed a high probability that, in fact, repayment would not be enforced against the employee or would be forgiven by the employer the transfer was not regarded as a loan but as compensation for services.[2025]

In a private letter ruling, the IRS ruled that advances made pursuant to an arrangement whereby they had to be repaid, in effect, only if the employee left the employment prior to the end of a required period of service constituted advance compensation for services rather than true loans.[2026] Under the loan agreement in the ruling, the employees had to work five years throughout which portions of the debt were forgiven on a yearly basis. The IRS reasoned that the fact that the obligation to repay would only arise if the employee's employment terminated prematurely rendered the repayment a conditional obligation "not sufficient to characterize the transfer as a loan." Any repayment obligation that would arise would be, according to the IRS, "liquidated damages for breach of the employment contract."[2027]

[2023] Rev. Rul. 68-337, 1968-1 C.B. 417 (holding that advance payments made to employees which were to be repaid out of future earnings, but which included an acknowledgment of the debt and had to be repaid even if employment was terminated, were true loans rather than compensation); *see also Rosario v. Commissioner*, T.C. Memo 2002-70 (holding that payments made pursuant to an income guarantee agreement which were to be repaid during the term of employment from excess earnings were loans rather than compensation, if any balance remaining after termination of employment was to be repaid to the employer).

[2024] Rev. Rul. 68-239, 1968-1 C.B. 414 (holding that loans made to employees to be paid out of future earnings but which would not be enforced if employment were terminated were "wages" for income tax purposes); *see also Kinzy v. United States*, 87-2 USTC ¶ 9520, 60 AFTR 2d 5770 (N.D. Ga. 1987), (holding that when an employee received an advance payment which would be charged off as long as he remained employed and which had to be repaid only if employment terminated prior to the discharge and even then only out of earned commissions, the liability was contingent rather than an unconditional obligation to pay the advances and, therefore, the payment was compensation rather than a loan).

[2025] Rev. Rul. 83-12, 1983-1 C.B. 99 (holding that advance payments made to insurance agents which were to be repaid out of earned commissions and for which the agent was personally liable beyond the employment relationship, did not constitute true loans where the employer had a practice of forgiving and not enforcing the debt).

[2026] Priv. Ltr. Rul. 200040004 (June 12, 2000).

[2027] *Id.*

Nontax laws relating to employee loans

SEC reporting requirements regarding insider sales of securities

In some cases, Enron executives used stock to repay loans from Enron. Such transactions are affected by SEC reporting rules. Generally, any sale or purchase of the stock of a publicly held by its officers and directors is subject to reporting requirements under the Securities Exchange Act of 1934.[2028] In general, these rules require that purchases or sales of a company's stock in public markets must be reported within 10 days of the close of the month in which the transaction occurs.

However, during the time period covered by the Joint Committee staff review, in the case of transactions between officers and directors and the company itself, if certain requirements were satisfied, the transaction did not have to be disclosed until 45 days after the close of the company's fiscal year.[2029] Among the requirements that may apply in order for a transaction to qualify for delayed reporting is a requirement that the transaction be approved by the Board of Directors of the company or a committee of the Board consisting solely of two or more nonemployee directors. For example, if the applicable requirements are met, then transfers of stock by a corporate insider to the company in order to make payments on a loan from the company would qualify for delayed reporting.

Following the recent exposures of significant volumes of undisclosed insider-issuer dispositions and pursuant to section 403 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission has adopted new disclosure rules relating to transactions between the issuer and its officers and directors.

Prohibition on loans to executives

The Sarbanes-Oxley Act of 2002,[2030] enacted in the aftermath of the Enron bankruptcy, contains a prohibition on the provision of personal loans to executives of companies with securities registered under the Securities Exchange Act of 1934.[2031] Subject to certain exceptions, the provision prohibits such a company from directly or indirectly (including through a subsidiary) extending or maintaining credit, arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the company.

If certain requirements are satisfied, the prohibition on loans does not apply to:

[2028] 15 U.S.C. sec. 78p(a).

[2029] *See* Rule 16b-3 of the Securities Exchange Act of 1934; 17 CFR § 240.16b-3 which exempted transaction with the issuer from Rule 16(b).

[2030] Pub. L. No. 107-204 (2002).

[2031] Sec. 402(a) of the Sarbanes-Oxley Act of 2002.

- Home improvement and manufactured home loans as defined in the Home Owners' Loan Act,[2032]
- Consumer credit as defined in the Truth in Lending Act,[2033]
- any extension of credit under an open end credit plan or a charge card,[2034] or
- certain extensions of credit by a broker or dealer registered under the Securities Exchange Act of 1934 to any employee of that broker or dealer to buy, trade, or carry securities.

In order for one of these exceptions to apply, the following requirements must be satisfied. The loan must be:

- made or provided in the ordinary course of the consumer credit business of the company,
- of a type that is generally made available by the company to the public, and
- made by the company on market terms, or terms that are no more favorable than those offered by the company to the general public for such extensions of credit.

The prohibition also does not apply to loans made or maintained by an insured depository institution if the loan is subject to the insider lending restrictions of the Federal Reserve Act.

The provision is generally effective on the date of enactment of the Sarbanes-Oxley Act (July 30, 2002), but does not apply to extensions of credit maintained on that date if there is no material modification to any term of the arrangement or any renewal of the arrangement on or after that date.

Factual Background

In general

Enron did not have a general policy or program relating to executive loans. However, from time to time Enron extended loans to various executives. These loans were individually designed arrangements, and varied considerably. In Enron documents, most of the loans are described as personal loans. Interviews with current and former Enron personnel indicate that there was no single person or department that kept track of loan information, and that in some cases only one or two people within Enron may have been aware of the loan arrangements. Some of these arrangements have received considerable media attention, particularly the loans extended to Kenneth L. Lay.

[2032] 12 U.S.C. 1464(c)(1)(J).

[2033] 15 U.S.C. 1602.

[2034] These terms are as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602) and section 127(c)(4)(e) of the Truth in Lending Act (15 U.S.C. 1637(c)(4)(e), respectively).

In repose to requests for information, Enron provided to the Joint Committee staff account reconciliation statements regarding executive loans. These statements show the amount of loans, payments made, and interest accrued with respect to loans to Mr. Lay, Jeffrey Skilling, Rebecca Mark, Rodney Gray, Clifford Baxter, and Mark Frevert. These account reconciliation statements are included in Appendix D to this Report. Other documents provided by Enron describe loans to Mark Pickering, and David Oxley. The loans to each of these individuals are discussed below.[2035] The loan arrangements of Mr. Lay and Mr. Skilling are highlighted, due to the amounts involved, the position they held within Enron (both served as Chief Executive Officer at different times), and the attention garnered by the these particular arrangements. All of these arrangements were treated by Enron as loans for Federal tax purposes.

Kenneth L. Lay

On September 1, 1989, Mr. Lay entered into a loan agreement with Enron. Under the agreement, Enron provided him with a revolving line of credit in the amount of $2.5 million.[2036] Mr. Lay also received an advance of $5 million to be used to purchase shares of Enron common stock, which were used as collateral.[2037] Mr. Lay signed a promissory note and pledged as collateral certain deferral benefits under the Deferral Plan, death benefits, Enron stock granted under the 1988 Stock Plan, financed stock held by Enron, and any severance remuneration payable.[2038] Mr. Lay was responsible for paying the full amount of interest which was to accrue at the applicable Federal rate. Mr. Lay repaid the entire principal of the $2.5 million loan and the $5 million advance, plus accrued interest, in 1994.[2039]

On March 25, 1994, Mr. Lay's employment agreement was renewed to provide him with a noncollateralized,[2040] interest-bearing revolving line of credit in the amount of $4 million.[2041]

On May 3, 1999, the Compensation Committee approved an amendment to the loan agreement that allowed Mr. Lay to repay his loans with Enron stock, and the loan agreement was accordingly amended. Compensation Committee minutes indicate that the approval of the new

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2035 All of these loan arrangements are also described in proxy materials, except those to Mr. Frevert, Mr. Pickering, and Mr. Oxley.

2036 The 1996 proxy characterizes the line of credit as a one-time loan. The loan agreement, however, suggests that the loan was in the form of a line of credit.

2037 The shares were pledged as collateral.

2038 *See* Loan Commitment Agreement, September 1, 1989 (EC000752817).

2039 The renewed employment agreement signed in 1994 provided that Mr. Lay had to pay all outstanding balances within 30 days of its execution.

2040 The proxy statements indicate that the loan was not collateralized.

2041 1996 Enron Corp. Proxy Statement.

repayment option was intended as evidence of compliance with the exemption from reporting under applicable securities laws.[2042]

On August 13, 2001, the amount available to Mr. Lay under the line of credit was increased to $7.5 million.[2043] Mr. Lay resigned on January 23, 2002, with a remaining unpaid principal balance of $7.5 million. According to Enron, the total outstanding amount, plus accrued interest, is $7.794 million.[2044]

The account reconciliation statements for Mr. Lay's loans show that the aggregate amounts withdrawn pursuant to his line of credit from 1997 through 2001, was over $106 million.[2045] In 2001 alone, Mr. Lay engaged in a series of 25 transactions involving withdrawals under the line of credit. The total amount of withdrawals for 2001 was $77.525 million (of which all but $7.5 million was repaid). The account reconciliation statements also show that during 1997 through 2001, Mr. Lay repaid principal amounts of $99.3 million. Over $94 million of this amount was repaid with 2.1 million shares of Enron stock.[2046]

The Joint Committee staff sent a series of written questions to Mr. Lay's counsel, Piper Rudnick, regarding Mr. Lay's compensation arrangements. In response to a question regarding Mr. Lay's use of stock to repay loans, Mr. Lay's counsel stated that it was their understanding that in 2001 Mr. Lay drew down on the Enron line of credit and then repaid it with stock principally because he needed funds to avoid or, if unavoidable, to pay margin calls on secured lines of credit Mr. Lay had established with certain banks and brokerage firms. These lines were secured primarily by Enron stock, the price of which was falling. Mr. Lay's counsel also stated it was their understanding that, because Mr. Lay's holdings in Enron stock represented a high percentage of his liquid assets, he used Enron stock to repay the Enron loan.

[2042] Minutes of the Meeting of the Compensation Committee, at 10 (May 3, 1999).

[2043] EC2000026955.

[2044] EC002679852.

[2045] *See* Appendix D to this Report. The total outstanding principal amount at any one time varied, but did not exceed $7.5 million.

[2046] In the account reconciliation statements, the use of Enron stock to repay an outstanding loan is referred to as "swapping in" Enron stock. *See, e.g.*, EC002680500 in Appendix D.

Jeffrey K. Skilling[2047]

On October 13, 1997, Mr. Skilling's employment agreement was amended to incorporate a loan provision, allowing Mr. Skilling to borrow $4 million. Interest was to accrue at the applicable Federal rate until maturity on December 31, 2001. Under the agreement, Mr. Skilling was responsible for paying the interest. The loan agreement further provided that if Mr. Skilling remained in the employ of Enron until December 31, 2001, 50 percent of the loan principal would be forgiven. If, however, he voluntarily terminated his employment prior to that or was terminated for cause, the entire amount of the loan would become due. As collateral, Mr. Skilling pledged his Enron restricted stock and the right to receive certain deferral benefits under the 1994 Deferral Plan.[2048]

Mr. Skilling borrowed $4 million from Enron on October 23, 1997, and signed a promissory note. On May 3, 1999, the Compensation Committee approved an amendment to the loan agreement that allowed him to repay his loans with Enron stock and, on that date, he made a partial repayment in the form of $2 million worth of Enron shares.[2049] Compensation Committee minutes indicate that the approval of the new repayment option was intended as evidence of compliance with the exemption from reporting under applicable securities laws.[2050] Mr. Skilling resigned from his position (then as Chief Executive Officer of Enron) on August 14, 2001. On September 15, 2001, he repaid in cash the remaining $2 million balance due on the loan.[2051] Mr. Skilling recalled that he paid accrued interest on the loan. According to Enron, Mr. Skilling still owes $88,679 of accrued interest and payment has been requested.[2052]

[2047] Jeffrey K. Skilling was appointed President and Chief Operating Officer of Enron Corp. on December 10, 1996. Prior to his appointment as Chief Operating Officer of Enron, Mr. Skilling served as the Chairman and Chief Executive Officer of Enron Gas Services Corp. Mr. Skilling entered into several loan transactions with Enron during that time: he received a $1.4 million loan in 1991 and another $100,000 loan in 1992. The 1991 loan was collateralized with pledged personal property. In 1993, Mr. Skilling repaid the principal and interest of both loans with the proceeds of a newly-issued nonrecourse debt in the amount of $1,606,719, which was collateralized with Enron stock options and phantom equity in Enron Gas Services. The loan was repaid in full on July 1, 1993. *See* 1993 and 1994 Enron Corp. Proxy Statements.

[2048] The 1999 Enron Corp. Proxy Statement indicates that the collateral given included Enron common stock, EOG stock and 1994 Deferral Plan benefits.

[2049] EC002680500. The 1999 Enron Corp. Proxy Statement indicates that he had paid the total amount of interest that accrued until September 1998 for a total of $215,664. According to the 2000 Enron Corp. Proxy Statement, the total accrued interest for 2000 was $126,747, which was paid by Mr. Skilling.

[2050] Minutes of the Meeting of the Compensation Committee, at 9 (May 3, 1999).

[2051] Enron Corp. Account Reconciliation Officers' Loans as of September 30, 2001, EC002680504.

[2052] EC002679852.

Other executive loans

Rebecca Mark

Rebecca Mark held numerous positions with Enron, including chairman and Chief Executive Officer of Enron International, Chairman and Chief Executive Officer of Azurix, and Chairman and Chief Executive Officer of Enron Development Corp.

Ms. Mark received two loans from Enron. First, Ms. Mark received a loan in the amount of $900,000 on May 7, 1997. The loan bore interest at the mid-term applicable Federal rate and was collateralized with 24,899 shares of Enron common stock.[2053] In May 1998, the entire principal of the loan plus the accrued interest, totaling $955,343, were forgiven.[2054] The 1999 proxy statement states that the loan forgiveness was "in consideration of Ms. Mark's increased responsibilities."[2055] The precise nature of these increased duties are not described.[2056]

Second, on May 4, 1998, Ms. Mark received a loan in the amount of $2.5 million.[2057] The loan bore interest at the short-term applicable Federal rate and was collateralized with Enron stock. In the beginning of 1999, $700,000 of the principal amount was forgiven due to Ms. Mark's performance in 1998. In February 1999, Ms. Mark repaid $550,000 on the loan.[2058] The remaining amount of $1.25 million as well as the accrued interest (in the amount of $171,099) was repaid by February 25, 2000.[2059]

[2053] 1998 Enron Corp. Proxy Statement, at 26. As of December 1997, accrued interest totaled $37,367. *Id.*

[2054] 1999 Enron Corp. Proxy Statement, at 25.

[2055] *Id.*

[2056] *Id.* Enron Corp. billed $450,000 of the loan amount to Enron International and amortized the remaining $450,000 plus the relevant portion of the accrued interest during 2000. *See* Account Reconciliation of Officer's Loans Chart as of December 31,2000 (EC001709350). It is noted on the chart that Enron Corp. would attempt to shift the remaining $450,000 to Water Co., and would write it off before year-end if it did not succeed.

[2057] According to the 1999 proxy statement, the loan was issued "due to revised vesting provisions that triggered constructive receipt for tax purposes." 1999 Enron Corp. Proxy Statement, at 25.

[2058] According to Enron, on the same date Ms. Mark paid $206,150 representing taxes on the $700,000 that was forgiven. EC002679704.

[2059] 1999 Enron Corp. Proxy Statement, at 25. (EC001709350).

Enron said that it reported both amounts forgiven as income on Ms. Mark's Form W-2.[2060]

Richard Kinder

Pursuant to his 1989 employment agreement, Richard Kinder received an advance of $3 million to purchase shares of Enron Corp. common stock,[2061] and a loan in the amount of $1.5 million. The loan and advance were to mature on February 8, 1999.[2062] In February of 1994, Mr. Kinder's employment agreement was renewed to provide that if he and Enron would "not be able to reach mutually satisfactory terms relating to his future employment," the loan and the advance would be forgiven.[2063] In November of 1996, Mr. Kinder entered into an agreement with Enron whereby he would resign from his position as an officer and director of Enron effective December 31, 1996, and would terminate his employment with Enron effective February 15, 1997. The outstanding principal and interest balances on his loan and advance -- totaling $3.8 million -- were forgiven as of February 7, 1997.[2064]

Rodney Gray

Rodney Gray received a loan from Enron in the amount of $250,000 on August 1, 1994. Enron Corp. common stock was pledged as collateral and Mr. Gray was responsible for payment of interest, which accrued at the applicable Federal rate.[2065] Mr. Gray terminated employment as an executive officer with Enron in November 1997. According to documents provided by Enron, Mr. Gray repaid the loan on August 24, 1999.[2066]

Clifford Baxter

Clifford Baxter received a loan from Enron in the amount of $200,000 on September 15, 1995. The loan bore interest at the short-term applicable Federal rate. According to the terms of the loan agreement as described in proxy materials, if Mr. Baxter remained employed by Enron

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2060 EC002680476.

2061 The stock was pledged as collateral. 1996 Enron Corp. Proxy Statement, at 21.

2062 *Id.* at 21-22.

2063 *Id.*

2064 1997 Enron Corp. Proxy Statement, at 25. A former member of the Board of Directors of Enron told the Joint Committee staff that Mr. Kinder had anticipated succeeding Mr. Lay as Chief Executive Officer, and that when that failed to occur, Mr. Kinder resigned.

2065 *Id.* at 24.

2066 EC002680449. According to the 1997 and 1998 proxy statements, Mr. Gray made interest payments of $15,426 in 1996 and $15,874 in 1997. 1997 Enron Corp. Proxy Statement, at 24; 1998 Enron Corp. Proxy Statement, at 26.

during March 15, 1996, and March 15, 1997, 50 percent of the loan would be forgiven on each date. In 1996, $100,000 of the principal was forgiven[2067] and in 1997 the remaining balance was forgiven.[2068]

Mark Frevert

Enron filings with the bankruptcy court indicate that Enron made a $2 million loan to Mark Frevert.[2069] Documents provided by Enron indicate that this loan was made in October 2001, the loan bore interest at the applicable Federal.[2070] According to Enron, the loan is still outstanding and repayment has been requested. The outstanding amount, including principal and interest is $2.093 million.

Mark Pickering

According to documents provided by Enron as well as interviews with Enron employees, Enron made a loan to Mark Pickering in connection with his relocation to the United States. It was explained that because Mr. Pickering had no credit in the United States, he was required to pay a substantial down payment on the purchase of a home and that Enron loaned him the money for this reason. The loan was made on June 13, 2001, for $400,000 and, according to Enron, is still outstanding.[2071]

David Oxley

According to information provided by Enron, a loan was made to David Oxley[2072] on August 15, 2001, in the amount of $500,000. The loan agreement provided that the loan was to

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2067 1997 Enron Corp. Proxy Statement, at 24-25.

2068 1998 Enron Corp. Proxy Statement, at 26-27. According to the 1997 and 1998 proxy statements, Mr. Baxter paid the accrued interest on the loan, totaling $6,000 in 1996 and $5,788 in 1997. 1997 Enron Corp. Proxy Statement, at 25; 1998 Enron Corp. Proxy Statement, at 27. While a loan to Mr. Baxter was described in proxy statements, in response to request for information made by the Joint Committee staff, Enron stated that current staff was unable to determine what loans were made to Mr. Baxter, and that there may have been two loans. EC002679704; EC002680476.

2069 *In re Enron Corp.*, Case No. 01-16034, Statement of Financial Affairs, Exhibit 3b.2 (Payments to Insiders).

2070 EC000752675.

2071 EC002679704; EC002679766.

2072 According to a services agreement entered into between Enron and Mr. Oxley on August 28, 2000, 2001, he was Vice President of Enron Europe Limited. EC002679832-844. Pursuant to an amendment to the services agreement dated November 28, 2001, his agreement was assumed by Enron North America and he was placed on the payroll of Enron North America. Assignment and Second Amendment Agreement, EX002679848.

be repaid within 120 days.[2073] On November 28, 2001, the services agreement between Mr. Oxley and Enron was amended to provide that the loan would be forgiven if: (1) Mr. Oxley remained employed by Enron until February 5, 2002; or (2) if earlier, Mr. Oxley were terminated involuntarily before February 5, 2002.[2074] The loan was forgiven on November 29, 2001.[2075]

Discussion of Issues

Although Enron had no formal policy regarding loans, there was a practice of making loans, particularly to key executives. Not counting the loans to Mr. Lay, Enron made loans to eight executives totaling over $17 million. Enron forgave over $6 million of these loans, including both principal and interest.

The loans to Mr. Lay stand out from the others by virtue of the total amount involved over time. The structure of his loans was also different. In other cases the loans, even if characterized as a line of credit, involved lending on single occasions, whereas Mr. Lay engaged in a series of transactions in which he borrowed, repaid, and borrowed again. As described above, the total amount withdrawn by Mr. Lay under his line of credit was over $106 million (over $77 million of which was in 2001 alone). During the period 1999-2001, Mr. Lay used stock to repay a portion of his loans; a total of over 2 million shares of Enron stock with a total value of $94.267 million was given to Enron as repayment for loans.

The loans made by Enron to employees raise both tax and nontax questions. From a Federal income tax perspective, Enron treated all these arrangements as loans for Federal tax purposes. That is, no amount was reported as income with respect to the loans, unless the loan was forgiven. A key issue raised by the various loans to Enron executives is whether certain loans should have been treated as compensation to the executive rather than a loan. The arrangements all carried the indicia of loans; there was generally a loan agreement and/or promissory note, interest was accrued (and in some cases paid), and in some cases there was collateral for the loan. Two aspects of the various loans raise the question of whether the loans were in fact compensation when entered into: (1) loan agreements that provide that the loan will be forgiven if the executive works for a specified period of time; and (2) forgiveness of loans (without an explicit forgiveness clause in the loan).

Two loans reviewed by the Joint Committee staff, one of Mr. Skilling's loans and a loan to Mr. Baxter, contained provisions providing that if the executive remained with Enron until a specified date, the loan would be forgiven.[2076] Mr. Baxter remained employed until the date specified in his agreement and, as a result, a $200,000 in indebtedness was forgiven. Mr.

2073 Loan Agreement between Enron North America Corp. and David Oxley (EC002679827-831).

2074 First Amendment to the Services Agreement, at 2 (EC002679845-847).

2075 EC002680476; EX002679849.

2076 As described above, Mr. Baxter's loan agreement provided for forgiveness in two stages.

Skilling did not remain with Enron until the date specified in his loan agreement, and he repaid the loan, with interest, after leaving Enron.

As described above, income results to the executive when a loan is forgiven. However, these loans raise the question of whether they were really in the nature of compensation for services and should have been treated as taxable compensation when entered into. It can be argued that the loan is to be satisfied solely from the performance of future services, and therefore is really compensation for services. From a factual standpoint, at the time the loan was made, the arrangement is not unlike the pre-bankruptcy bonuses paid by Enron in November 2001, which required the employee to repay the bonus, with a 25 percent penalty, if the employee did not remain with Enron for a certain period of time. These bonuses were treated by Enron as compensation and were subject to withholding.

In other cases, Enron forgave loans to executives when the loan agreement did not require forgiveness. Loans to Ms. Mark and Mr. Kinder were of this type. In these cases, the question is whether the forgiveness was contemplated at time of the agreement, which would cast doubt on the intent of the parties to enter into a loan. In order for these arrangements to be considered compensation, it would have to be shown that it was the understanding of the parties that repayment was not in fact anticipated.

In addition to tax issues raised, the loan transactions also raise questions of corporate governance. In particular, some view the use of loans, particularly when substantial amounts are involved over time or in particular instances, as a use of corporate funds for personal purposes. From this perspective, some argue that such loans are inappropriate. This view is reflected in the prohibition on executive loans contained in the Sarbanes-Oxley Act.

The use of stock to repay loans also raises corporate governance issues. Some commentators have argued that Enron executives used stock to repay loans in order to take advantage of exceptions to securities laws reporting requirements, thereby allowing the executives to defer reporting on sales of Enron stock during the months before the Enron bankruptcy. As described above, the loan agreements for Mr. Lay and Mr. Skilling were amended in 1999 to allow for payment with the use of stock; the changes were specifically structured to come within the reporting exceptions.

Recommendations

The Sarbanes-Oxley Act contains a prohibition on executive loans. If this prohibition had been in effect in prior years, it is likely that the loans reviewed by the Joint Committee staff in this case would not have been made. Thus, the Joint Committee staff is not recommending further legislative changes at this time.

4. Purchase and reconveyance of Kenneth L. Lay's annuity contracts

Present Law

Taxation of annuity contracts

In general

Present law provides favorable tax treatment for annuity contracts held by individuals. While no deduction is allowed for the purchase of an annuity contract, income credited to an annuity contract (i.e., "inside buildup") generally is not currently includible in the gross income of the owner of the contract. The extent to which payments received under the contract are includible in gross income depends on when the payments are received and the taxpayer's investment in the contract.[2077]

In general, for amounts received as an annuity, an "exclusion ratio" is provided for determining the taxable portion of each payment.[2078] The portion that represents recovery of the taxpayer's investment in the contract is not taxed. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Each annuity payment is multiplied by the exclusion ratio, and the resulting portion of each payment is treated as nontaxable recovery of the investment in the contract. Once the taxpayer has recovered his or her investment in the contract, the entire amount of all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Amounts not received as an annuity generally are included in income if received on or after the annuity starting date. If amounts not received as an annuity are received before the annuity starting date, such amounts generally are included in income to the extent allocable to income on the contract (i.e., as income first).

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59-1/2, made after the owner dies or becomes disabled, made in the form of certain periodic payments, or that satisfies certain other requirements.

[2077] Sec. 72. Section 72 uses the term "investment in the contract" in lieu of the general tax notion of basis. Investment in the contract is defined (as of the annuity starting date) as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount already received under the contract (to the extent it was excludable from income).

[2078] Special rules apply to variable annuity contracts. Treas. Reg. sec. 1.72-4(d)(3).

Annuities held by nonnatural persons

In general, if an annuity contract is held by a person that is not a natural person, such as a corporation, then the income on the contract is treated as ordinary income currently received or accrued during the taxable year. Thus, under this rule, no deferral is permitted to the holder of the contract. The contract is not treated as an annuity contract for Federal income tax purposes (except with respect to the insurance company issuing the contract).[2079]

Sale or disposition of annuity contracts

In general, a sale or disposition of an annuity contract is subject to the normally applicable gain recognition rules. That is, the seller of the contract recognizes gain to the extent that the amount received for the contract exceeds his or her investment in the contract. A number of courts have held that gain on the sale of an annuity contract is taxed as ordinary income to the seller.[2080] In general, if an annuity contract is transferred by an individual for less than full and adequate consideration, the individual is treated as receiving the difference between the cash surrender value of the annuity over the investment in the contract as an amount not received as an annuity.[2081]

Receipt of property for services

Property transferred in connection with the performance of services generally is includible in gross income of the person performing the services for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture.[2082] The amount includible is the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property.

[2079] Sec. 72(u). For purposes of this rule, the holding an annuity contract by a trust or another entity as an agent for a natural person is not taken into account. Section 72(u) provides several narrow exceptions to the rule of inclusion in the case of an annuity contract that: (1) is acquired by the estate of a decedent; (2) is held under certain types of retirement plans or arrangements; (3) is a qualified funding asset for a structured settlement arrangement; or (4) is purchased by an employer upon termination of certain types of retirement plans and meets certain other requirements.

[2080] *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); *Roff v. Commissioner*, 304 F.2d 450 (3rd Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960).

[2081] Sec. 72(e)(4)(C).

[2082] Sec. 83. Under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.

The person for whom the services were performed is entitled to a deduction equal to the amount includible in the service provider's gross income[2083] (subject to the $1 million cap on the deductibility of executive compensation).[2084] The deduction generally is allowable in the taxable year in which the amount is included in the income of the person performing the services. If the property is substantially vested upon transfer, the deduction is allowable in accordance with the method of accounting used by the taxpayer.[2085]

Factual Background

On September 14, 2001, the Compensation Committee of the Enron Board of Directors approved what the Committee minutes[2086] refer to as an "insurance swap transaction" as part of the compensation to be provided to Mr. Lay in connection with the resumption of his duties as Chief Executive Officer following the resignation of Mr. Skilling in August of 2001.[2087] According to documents provided by Enron, this transaction involved two annuity insurance contracts that had been purchased by Mr. Lay and his wife, one in each of their names. Mr. Lay's contract was purchased on September 30, 1999, and Mrs. Lay's contract was purchased on February 8, 2000. The contracts were to mature after approximately 30 years. As stated in the contracts, the initial premium made on each of the contracts was $2.5 million.[2088]

Under the transaction,[2089] Enron purchased the annuity contracts from the Lays for $5 million each (a total of $10 million)[2090] and also agreed to reconvey the annuity contracts to Mr.

[2083] Sec. 83(h).

[2084] Sec. 162(m).

[2085] Treas. Reg. sec. 1.83-6(2).

[2086] Minutes of the Meeting of the Compensation and Management Development Committee, September 14, 2001, at 4. EC2 000026740-41.

[2087] Mr. Skilling became Chief Executive Officer in February 2001. Prior to that time, Mr. Lay was both Chairman of the Board and Chief Executive Officer. When Mr. Skilling became Chief Executive Officer, Mr. Lay retained the title of Chairman.

[2088] Mrs. Lay's insurance contract is EC 000897921-50. Mr. Lay's is EC 000897964-99. Other internal Enron documents indicate that the amount of the initial investment was $5 million for each contract. "Inter Office Memorandum to Annuity Contracts, Liquidation for Compensation - Tax Issues, September 25, 2001," EC 002680472.

[2089] Documents regarding the transaction were executed by the Lays and Enron on September 21, 2001. Purchase, Sale, and Reconveyance Agreement, EC 000752808-814.

[2090] Information provided to Joint Committee staff indicated that Mr. Lay and Mrs. Lay each had a $5 million basis in their respective contracts. However, it is not clear from reviewed documents whether the Lays made payments in addition to the initial $2.5 million payments.

Lay if he remained employed with Enron through December 31, 2005.[2091] If Mr. Lay were to leave Enron prior to that date, reconveyance still would take place on the occurrence of one of four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination (other than a termination for cause); or (4) termination for "good reason."[2092] If Mr. Lay were to leave Enron prior to December 31, 2005, for a reason other than those provided, then Enron would have no further obligation to Mr. Lay with respect to the annuity contracts. The agreement regarding the transaction also provided that if either of the Lays died while Enron owns the contracts and continues to have a potential obligation to reconvey them to Mr. Lay, Enron will pay all proceeds received under the contracts to Mr. Lay if the decedent is Mrs. Lay and to Mr. Lay's estate if he is the decedent.

At the September 14, 2001, meeting, the Compensation Committee was presented with two different possible transactions involving the annuity contracts.[2093] The first alternative was the one adopted by the Committee. The second was the same as the first, except that the contracts would be purchased for their current market value (for a total of $4.691 million for both contracts combined). Both alternatives indicated that the Lays' basis in the contracts was $5 million each (for a total of $10 million) and that the current floor value of the policies was a total of $11.240 million. The presentation included a comparison of the each alternative with providing Mr. Lay with additional Enron stock, in terms of issues for Enron (deductibility of the payment, dilution to common shares outstanding, and taxes) and issues for Mr. Lay (liquidity at various time frames and vesting).

In addition to the material presented at the Compensation Committee meeting, the Committee requested a letter from Towers Perrin regarding the transaction. The letter is dated November 2, 2001, and states that it reflects discussions with Enron that occurred prior to the date of the Committee meeting.[2094] The letter indicates that the transaction grew out of a desire

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[2091] Technically, only one of the annuity contracts would be reconveyed. The contract originally owned by Mrs. Lay would be not be reconveyed to her but conveyed to Mr. Lay. The term a "reconveyence" is used here because that is how the transaction is described in the relevant agreements.

[2092] "Good reason" is defined by reference to Mr. Lay's employment contract, and generally refers to a constructive termination by reason of the occurrence of certain events, such as a change in his duties or a material reduction in salary without his consent.

[2093] Attachment to Minutes of the Meeting of the Compensation and Management Committee, (Sept. 14, 2001). Committee meeting minutes indicate that this analysis was presented by employees of Enron, and was prepared in consultation with lawyers at Vinson & Elkins and others. Mr. Lay was present while the proposed transaction was being discussed, but was reported as not present when the decision to go forward with the transaction was made. Minutes of the Meeting of the Compensation and Management Committee, at 4 (EC 2000026740) (Sept. 14, 2001).

[2094] Letter from Charles E. Essick, Principal, Towers Perrin to Dr. Charles A. LeMaistre (Nov. 2, 2001). EC 000897960-EC 000897961.

by Enron to provide an incentive for Mr. Lay to remain with Enron for a period of years. Members of the Compensation Committee also indicated in interviews with the Joint Committee staff that the motivation for the transaction was to provide a retention device. The documents executed in connection with the transaction also state that Mr. Lay's services have been and are expected to be of substantial value to Enron and that Enron wishes to encourage Mr. Lay to remain in the employment of Enron.

The Towers Perrin letter states that a retention incentive typically is handled by issuing restricted stock, but that Mr. Lay had indicated that he currently had large holdings in Enron stock and wanted more liquidity. The letter makes a number of points with respect to the transaction. First, the letter states that the transaction, while involving a current cash flow drain for Enron, will be beneficial to Enron overall because the $10 million payment to the Lays for the contracts is less than the current net present value floor value of the contracts of $11.240 million. That is, the letter indicates that the fair value of the contract is more than $10 million. Second, the letter states that the feature of the arrangement which allows Mr. Lay to earn the contracts back over four years is similar to the way a restricted stock award would be structured and thus should serve as a similar retention device.[2095] Third, the letter recommends that because the arrangement is in lieu of restricted stock, the $10 million value of the payment to Mr. Lay should be subtracted from future stock or stock option awards that would otherwise be granted to Mr. Lay over the next four years (at a rate of $2.5 million per year).[2096] Finally, the letter states the understanding that an alternative structure that was suggested was to pay Mr. Lay a cash signing bonus and to purchase his annuity, but not his wife's. The letter concludes that the structure adopted by the Committee is preferable to this alternative because it provides a meaningful retention incentive.

As of January 23, 2002, Mr. Lay was no longer with Enron. Thus, whether he is entitled to have the annuity contracts reconveyed to him depends on whether his termination meets the requirements as set forth in the agreement with the Enron. It is unclear whether the contracts have been or will be reconveyed to Mr. Lay. During the course of interviews, the Joint Committee staff was informed by counsel for former Compensation Committee members that the issue of whether Mr. Lay was entitled to receive the annuity contracts given the terms of his departure was under review by Enron and various legal counsel. At the time of publication, Enron stated it was unable to give the Joint Committee staff any further information regarding the status of the annuity contracts and whether they had been or would be reconveyed to Mr. Lay.

[2095] The letter refers to Mr. Lay as being able to "earn back the annuities over 4 years." This phraseology implies that Mr. Lay earned the contracts back ratably over the 4-year period, much as restricted stock might vest over a period of years. However, under the terms of the purchase, sale, and reconveyance agreement, Mr. Lay had no rights with respect to the annuity contracts unless he stayed through December 31, 2005 (or was terminated before then for one of the stated reasons).

[2096] The letter states that the Compensation Committee agreed to this reduction. However, the minutes from the meeting at which the transaction was approved do not mention this transaction. Thus, it is not clear whether this was the intent of Enron at the time.

The Joint Committee staff submitted written questions to Mr. Lay's counsel, Piper Rudnic, regarding his compensation arrangements. As part of these questions, the Joint Committee staff asked if the annuity contracts had been reconveyed to Mr. Lay (or if they would be) and, if they had been reconveyed, when this occurred. Mr. Lay's counsel did not respond directly to the question, but stated that "We are not in a position to give a legal opinion about the current status of the annuity contracts." They also stated their understanding that the characterization of Mr. Lay's termination for purposes of severance benefits was still under review.

Discussion of Issues

The purchase and reconveyance arrangement involving the Lays' annuity contracts can be analyzed both from the perspective of whether it would accomplish the stated objective of the arrangement, and from a Federal income tax perspective.[2097]

As described above, the stated purpose of the arrangement was to provide an attractive retention package to Mr. Lay upon his resumption of duties as Chief Executive Officer. The total range of options considered by Enron is not clear, but appears to have included (1) giving Mr. Lay a $5 million cash bonus, and purchasing and possibly reconveying one of the Lays' annuity contracts to Mr. Lay, and (2) the issuance of restricted stock. The first alternative would have provided a retention incentive but arguably not as significant an incentive as the arrangement Enron approved, because the value of the conditional benefit under the first alternative was less (i.e., the value of one annuity contract versus the value of both the annuity contracts). The use of restricted stock, an arrangement frequently used by Enron, would provide a retention incentive, but was not attractive to Mr. Lay because of his interest in more liquidity in his financial portfolio. Thus, the purchase and reconveyance arrangement provided liquidity to Mr. Lay, as well as serving as a more significant retention incentive.

In addition to other perceived benefits, from a tax perspective, use of the annuity purchase and reconveyance arrangement had advantages both for Enron and Mr. Lay when compared to other arrangements considered by Enron. The tax effects can be analyzed separately for the purchase aspect of the transaction and the reconveyance.

The purchase of the annuity contracts had current tax advantages for Mr. Lay compared to payment of a cash bonus (or any arrangement including a cash bonus). If he had been paid a cash bonus, the amount of the bonus would have been currently includible in gross income and subject to employment taxes. On the other hand, Mr. Lay would recognize gain on the sale of the annuity contracts to Enron only to the extent the amount received exceeded the Lays' basis in the contracts.

[2097] The focus of the Joint Committee staff review is Enron, not individuals. Thus, examination of the Federal tax consequences to the Lays arising from this transaction is beyond the scope of this review. Some general discussion is provided in order to give a full picture of the transaction.

Viewing the tax consequences of the purchase of the annuity contracts compared to payment of a cash bonus from Enron's perspective, as a practical matter, no deduction would be allowable with respect to either type of transaction. Enron would not be entitled to a deduction for the amount of the cost of the contracts; the amount paid would be basis in the contracts. If Enron paid a cash bonus, given Mr. Lay's total compensation package, the bonus would not be deductible due to the $1 million dollar cap on deductibility of compensation of certain executives.[2098] A key difference, however, is that if a cash bonus had been paid, Enron would be liable for its share of employment taxes;[2099] no employment taxes would be due as a result of the purchase of the annuity contracts. Another important difference is that, as a nonindividual holder of annuity contracts, Enron would be required to include in income each year the amount of the income on the contracts. This income inclusion would apply as long as Enron held the contracts. Thus, from Enron's perspective the current tax consequences of the annuity purchase and reconveyance arrangement were less favorable than the payment of a cash bonus or the payment of restricted stock.

The use of restricted stock would have provided some tax advantage to Mr. Lay compared to an arrangement involving a cash bonus, depending in part on the specifics of the arrangement. In general, restricted stock is includible in gross income when no longer subject to a substantial risk of forfeiture. Thus, for example, if Enron had granted Mr. Lay $10 million of restricted stock that vested over four years, the value of one fourth of the stock would be includible in income in each year (and subject to employment taxes). This is more favorable to Mr. Lay from a tax perspective than a current payment of $10 million, but less favorable than the annuity purchase arrangement agreed to by Enron which would result in income in excess of basis.

If restricted stock had been used, Enron theoretically would have been entitled to a compensation deduction when the stock was includible in Mr. Lay's income. However, as with a cash bonus, the deduction likely would be limited by the $1 million cap on deductibility of executive compensation.

With respect to whether Enron treated the purchase properly from a tax perspective, a key issue is whether Enron paid fair market value for the contracts. If Enron paid the Lays more than the fair market value for the contracts, then the question would arise as to whether the excess of the amount paid over such value was disguised compensation. If so, Enron would have had employment tax obligations.[2100] According to documents provided by Enron, three different purchase price alternatives were presented to the Compensation Committee: (1) a total of $4.692 million, which was described as the market value of the contract investments; (2) a total of $10 million, which was described as the Lays' basis in the contracts; and (3) a total of $11.240

[2098] Sec. 162 (m).

[2099] There is no dollar cap on the amount of compensation subject to the Hospital Insurance (Medicare) portion of employment taxes.

[2100] There also could be tax consequences for the Lays.

million, which was described as the net present value floor value of the annuities (i.e., the minimum amount the annuities were expected to be worth at maturity).[2101]

While the documents supplied by Enron do not clearly indicate a fair market value, the net present value floor value appears to represent the current value of the future payments in the policy. If this is accurate, the amount paid by Enron did not exceed the fair market value of the contracts, and there would be no question as to whether some amount should have been treated as taxable compensation.

If the annuity contracts are reconveyed to Mr. Lay, then the fair market value of the policies should be treated as compensation by Enron for reporting purposes, and would be subject to withholding and employment taxes. Enron's deduction would be limited by the $1 million cap on the deduction of executive compensation.[2102]

5. Split-dollar insurance arrangements

Present Law

Background

Overview

The term "split-dollar life insurance" refers to splitting the cost and benefits of a life insurance contract. The cost of premiums for the contract often is split between two parties. One party typically pays the bulk of the premiums, and is repaid in the future from amounts received under the contract. The other party often pays a small portion of the premiums, but has the right to designate the recipient of the bulk of the benefits under the contract. This type of arrangement transfers value from one party to the other party.

Split-dollar life insurance arrangements have been used for several purposes. A principal use has been by employers to provide low-cost life insurance benefits or to provide funds for other compensatory benefits (such as nonqualified deferred compensation) for employees on a tax-favored basis. Split-dollar life insurance arrangements are also used in other contexts. For example, such an arrangement can be used to fund a buy-sell agreement between shareholders or owners of a business, or to provide estate liquidity (sometimes with a trust as the owner of the contract).

The type of life insurance generally used in a split-dollar life insurance arrangement is referred to as whole life insurance. This does not refer to the period for which the insurance contract is in effect, but rather, to the fact that the contract has a "cash value," as well as providing a death benefit upon the death of the insured person. The cash value arises because the premiums paid to the insurer for the contract are invested, and some of this investment income is

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[2101] Attachment in the Minutes of the Compensation and Management Committee, at 7-8 (Sept. 14, 2001). EC 000026744 - EC 000026750.

[2102] Sec. 162(m).

credited to the contract. The amount of the future death benefit payable under the contract is funded both by premium payments and by investment earnings on the premium payments. The amount of the cash value at any point in time generally is the sum of the premiums paid plus the earnings on premiums that are credited to the policy, reduced by the cost of death benefit coverage for the current period, fees, and other charges imposed by the insurer. The amount of the cash value generally is zero or small at first, and increases over the duration of the contract.

The cash value of a whole life insurance contract may be borrowed or withdrawn by the contract holder (reducing the amount that will be paid as a death benefit under the contract). A whole life insurance contract can be contrasted with a term life insurance contract, which pays a death benefit upon the death of the insured person, but has no cash value. Under a term life insurance contract, the death benefit coverage applies only for a set term (e.g., one year or five years), and the premium payments are set at a level to fund the death benefit only during that period. The contract holder does not have the right to borrow or withdraw cash under a term life insurance contract, because it has no "cash value."

Methods for splitting the cash value and death benefits of a life insurance contract

The benefits that are split under a split-dollar life insurance arrangement generally are the death benefit (the amount paid upon the death of the insured person) and the cash value (which includes the earnings under the contract). Because the arrangement is by contract, the parties can split these features of the life insurance contract in whatever manner they agree upon. Over the past 50 years, a variety of split-dollar life insurance products have been developed.

One form of split-dollar life insurance arrangement is known as the endorsement method. Under this arrangement, as applied, for example, between an employer and an employee, the employer is the owner of the contract and pays the bulk of the premiums. The employee generally is the insured person, and pays a smaller amount of the premiums. The employer endorses over to the employee the right to designate the beneficiary of the death benefit under the contract. The employer's premium payments are repaid from the cash value of the contract or from the death benefit when the insured employee dies. Under some arrangements, ownership of the contract is turned over, or "rolled out," to the employee at a contractually agreed time, such as upon retirement, after the employer has recouped its premium payments.

Another common type of split is referred to as the collateral assignment method. Under this arrangement, as applied, for example, between an employer and an employee, the employee (or sometimes a trust he or she establishes) owns the policy and pays the premiums with amounts loaned by the employer, assigning the life insurance contract as collateral for the loans. The employer has the right to the portion of the cash value of the contract funded by its premium loans, but the employee (or trust) has the right to designate the beneficiary of the death benefits. The employee (or trust) may also have the right to the portion of the cash value of the contract that exceeds the employer's share of the cash value, if any.

Other types of splits, in which ownership of the cash value, the right to death benefits, or both, are split between the parties (e.g., between the employer and employee (or trust)), are also possible. Arrangements in which the cash value is split between the parties are sometimes referred to as equity split-dollar arrangements. Another variation, sometimes referred to as a reverse split-dollar arrangement, is created when the owner of the contract and its cash value is the employee; the employee pays premiums with amounts loaned or reimbursed by the employer. The employee endorses or assigns to the employer the right to the death benefit under the contract, and perhaps also a portion of the cash value.

Tax treatment of split-dollar life insurance arrangements between employer and employee

Transfers of property to employees

Under present law, compensation of an employee generally is included in the employee's income when it is received (or constructively received). If property is transferred to a person in connection with the performance of services, the fair market value of the property (reduced by the amount, if any, that is paid for the property) generally is included in income at the time the interest in the property is transferable, or is not subject to a substantial risk of forfeiture (whichever is sooner).[2103]

Life insurance

Present law provides that no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup"). Amounts paid by reason of the death of the insured under the contract ("death benefits") are also generally excluded from income of the recipient.[2104]

Other favorable rules apply to amounts paid out or borrowed under a life insurance contract. Distributions from the contract prior to the death of the insured generally are taxed only to the extent they exceed the taxpayer's investment in the contract; that is, the distributions are first treated as tax-free recovery of the investment in the contract, and then the excess is included in income.[2105]

[2103] Sec. 83. The rules of section 83 are discussed in greater detail in Parts III.C.1. and III.C.2.

[2104] Sec. 101(a). An exception is provided to this general rule of exclusion for death benefits, in the case of a transfer of a life insurance contract for valuable consideration. The amount of the death benefit includible in the beneficiary's income under this exception is the amount that exceeds the premiums and other consideration paid for the contract by the transferee. However, this rule of inclusion does not apply in certain cases, including when the transfer is to the insured or to a corporation in which the insured is a shareholder or officer. Sec. 101(a)(2).

[2105] Sec. 72. These favorable distribution rules do not apply to certain types of high-initial-premium policies (those funded more rapidly than seven annual level premiums); for those contracts, known as modified endowment contracts, distributions (and loans) are treated as income first, then tax-free recovery of investment in the contract.

Present law provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract.[2106]

1960s rulings: cost of current term insurance protection

Until 2001, IRS guidance as to the Federal income tax treatment of split-dollar arrangements was limited. In the 1960s, the IRS published rulings[2107] providing that the amount includible in an employee's income under a split-dollar insurance arrangement is the cost of current term insurance protection (less the amount, if any, paid by the employee). Any policyholder dividends paid to, or benefiting, the employee are also includible in income.

In determining the cost of current term insurance protection, the employee may use either the cost as determined under an actuarial table known as the "P.S. 58 table," or the insurer's published rates for one-year term life insurance coverage. This election arguably permitted the parties to the arrangement to choose the lower rate for determining the amounts includible in the employee's income, or the higher rate for determining the employer's share (as in a reverse split-dollar arrangement).

Notice 2001-10: loan or compensation

In January 2001, the IRS issued Notice 2001-10.[2108] It provided interim guidance for the tax treatment of split-dollar life insurance, including types of split-dollar life insurance arrangements between an employer and employee in which the employee has an interest in the cash value of the contract (equity split-dollar arrangements) that were not addressed by the 1960s rulings. The IRS has issued subsequent guidance that continues to apply the general concepts of Notice 2001-10.

Notice 2001-10 provided that the IRS generally would accept the parties' characterization of a split-dollar life insurance arrangement in either of two ways. The first way is to treat the employee as the owner of the contract, and treat the employer's payments for premiums as loans to the employee. Foregone interest on the loans is included in the employee's income under the rules of present law.[2109]

The second way is to treat the employer as owning the contract by reason of paying its share of premiums. The employee includes compensation income equal to the value of the life insurance protection. This approach is similar to the requirement under the 1960s rulings that the cost of current insurance protection be included in income. Notice 2001-10 also specifically provided that the present-law rules taxing transfers of property to employees[2110] apply to split-

[2106] Sec. 264(a)(1).

[2107] Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12.

[2108] 2001-5 I.R.B. 459, Jan. 9, 2001.

[2109] Sec. 7872.

[2110] Sec. 83.

dollar life insurance arrangements in which the employer transfers the cash value of the life insurance contract to the employee. If the contract is "rolled out" to the employee, he or she would generally include the cash value in income at that time.

Notice 2001-10 provided a new table, Table 2001, to replace the P.S. 58 table for valuing the cost of current life insurance protection. The Notice also provided that, after 2003, taxpayers would no longer be permitted to choose to determine the value of current life insurance protection by using the insurer's lower published premium rates (as under the 1960s rulings). Rather, if an insurer's published premium rate were used for this purpose, it would have to be a premium rate at which the insurer regularly sells term insurance (so long as the insurer does not more commonly sell standard-risk term insurance at higher premium rates).

Notice 2002-8

A year after Notice 2001-10 was issued, it was revoked by Notice 2002-8.[2111] Notice 2002-8, however, applies the general concepts of the earlier Notice, and provides that Table 2001 generally applies for valuation purposes for arrangements entered into after January 28, 2002 (the date Notice 2002-8 was issued). It also provides that for valuation purposes under arrangements entered into after January 28, 2002, the taxpayer may continue to choose the insurer's lower published premium rates; however, for such arrangements, after 2003, these rates must be rates at which the insurer regularly sells term insurance (not just published rates).

Notice 2002-8 specifically provides that the proposed regulations addressing the Federal tax treatment of split-dollar life insurance arrangements will be effective for arrangements entered into after the date of publication of final regulations.

Proposed split-dollar life insurance regulations

In general.--The IRS issued proposed regulations on split-dollar life insurance arrangements on July 5, 2002.[2112] The proposed regulations provide guidance on the income, employment, and gift tax treatment of split-dollar life insurance arrangements. Somewhat like the earlier notices, the proposed regulations generally provide two mutually exclusive regimes for taxing split-dollar arrangements, one taking an economic benefit approach,[2113] and the other applying loan treatment.[2114]

A central feature of the proposed regulations is to treat one party as the owner of the policy, even if more than one party has an interest in the policy. Whether the split-dollar arrangement comes under the economic benefit approach or the loan approach generally depends

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[2111] 2002-4 I.R.B. 398.

[2112] REG-164754-0, July 5, 2002. Regulations are proposed under Code sections 61, 83, 301, 1402, 7872, 3121, 3231, 3306, and 3401.

[2113] Sec. 61.

[2114] Sec. 7872 (or secs.1271-1275, if the loan is not below-market).

on which party is considered the owner. The loan approach generally applies if the party who is not the owner is making payments (premiums) and is reasonably expected to be repaid from the contract's cash value or death benefits. Otherwise, the economic benefit approach generally applies for income, employment, and gift tax purposes.

The preamble to the proposed regulations states that the economic benefit approach generally will govern endorsement split-dollar arrangements, and the loan approach generally will govern collateral assignment split-dollar arrangements.[2115] Special rules provide that the economic benefit approach always applies to a split-dollar arrangement in connection with the performance of services if the service provider's only benefit is current life insurance protection (a "non-equity" split dollar arrangement).[2116] The economic benefit approach applies to certain "non-equity" collateral assignment arrangements (if the employee or donee is the listed owner of the contract), as well as to endorsement arrangements (the employer or donor is the listed owner).

The proposed regulations would be effective for arrangements entered into after the final regulations are published in the Federal Register. However, taxpayers may rely on the proposed regulations if all parties treat the arrangement consistently.

Owner of the contract.–Generally, under the proposed regulations, the owner named in the contract is treated as the owner or, if more than one is listed, the first one is treated as the owner.[2117] An employer is treated as the owner if the employee's only benefit at any time is current life insurance protection (no cash value or possible future ownership of the contract, for example).

Split-dollar life insurance arrangement defined.–The proposed regulations define a split-dollar life insurance arrangement broadly, with especially inclusive definitions in the case of arrangements between service providers and recipients, and between corporations and shareholders.[2118]

Economic benefit approach.–Under this approach, the value of economic benefits under the life insurance contract is treated as being transferred from the contract owner to the nonowner (reduced by any consideration paid by the nonowner to the owner). The tax

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[2115] REG-164754-0, preamble at 11 (under the heading mutually exclusive regimes), July 5, 2002.

[2116] Prop. Treas. Reg. 1.61-22(b)(3)(ii). The economic benefit approach also applies to a split-dollar arrangement between a donor and donee (e.g., a life insurance trust) if the donee's only benefit is the value of current life insurance protection.

[2117] However, if multiple listed owners each have an undivided interest in every right under the contract, the contract is treated as two or more separate contracts that are not part of a split-dollar arrangement. Prop. Treas. Reg. sec. 1.61-22(c)(1).

[2118] Prop. Treas. Reg. sec. 1.61-22(b)(2).

consequence of the transfer depends on the relationship of the owner and nonowner;[2119] in the employment context, compensation for services.

The proposed regulations distinguish between equity split-dollar (in which the nonowner also has a right to some or all of the cash value of the contract), and non-equity split-dollar (in which the nonowner has no such right and has only the right to current insurance protection).

In the non-equity split-dollar arrangement, the nonowner includes in income (and also in wages for employment tax purposes) the cost of current insurance protection. Unlike under the 1960s rulings, the proposed regulations provide that the amount of current insurance protection is measured as the excess of the average death benefit under the contract over the total amount payable to the owner (including outstanding policy loans). The cost of this is determined as the amount of current insurance protection times the "premium factor" published by the IRS in separate guidance.[2120]

In the equity split-dollar arrangement, the nonowner is also required to include in income (and for employment tax purposes) the value of any interest in the contract– for example, the value of any interest in the cash value of the contract provided during the year.[2121]

Under the economic benefit approach, in the event of transfer of a contract by the owner to a nonowner (a "rollout" of the contract by the employer to the employee), the fair market value of the contract is included in the nonowner's income (less any portion on which he has already paid tax). In the service provider context, applicable present-law rules[2122] permit deferral of income inclusion (and also the employer's deduction) if the transferee's rights in the contract are not yet substantially vested.

Loan approach.–Under the loan approach, the owner and nonowner are treated as borrower and lender, respectively, if the nonowner (e.g., employer) paying premiums is reasonably expected to be repaid from the contract's cash value or death benefits. If the loan does not provide sufficient interest, then interest is imputed under the rules of section 7872. In general, such interest is not deductible by the borrower, but is includible in the income of the deemed lender in the arrangement. If sufficient interest is provided for, then the general rules for debt instruments apply (including OID rules). The proposed regulations provide rules for treatment of term, demand, and contingent payment split-dollar loans.

[2119] E.g., depending on the relationship, the arrangement may be a payment of compensation, dividend distribution under section 301, gift under the gift tax rules, or other transfer. Prop. Treas. Reg. sec. 1.61-22(d)(1).

[2120] Prop. Treas. Reg. sec. 1.61-22(d)(2). This separate guidance had not yet been published as of February 5, 2003.

[2121] The proposed regulations do not provide specific guidance for determining the value of the includible economic benefit. Prop. Treas. Reg. 1.61-22(d)(3)(ii).

[2122] Sec. 83.

Guidance on valuation

After the issuance of the proposed regulations, the IRS issued further guidance, Notice 2002-59, specifically on valuation of benefits under certain types of reverse split-dollar life insurance arrangements.[2123] This Notice provides that the IRS will challenge the use of high current term insurance rates, prepayment of premiums, or other arrangements to understate the value of benefits under the life insurance policy that are to be included in income in a reverse split-dollar life insurance arrangement.

Factual Background

Overview of Enron's split-dollar insurance arrangements

Enron entered into split-dollar life insurance arrangements with three of its top management: Mr. Lay, Mr. Skilling, and John Clifford Baxter.[2124]

Enron entered into two split-dollar life insurance arrangements with Mr. Lay.[2125] Enron entered into a split-dollar arrangement with Mr. Lay on April 22, 1994, with respect to a life insurance contract with a face amount of $30 million.[2126] Mr. Lay's position was chairman and chief executive officer of Enron Corp.[2127] Enron entered into another split-dollar arrangement with Mr. Lay on December 18, 1996. The face amount of the life insurance contract under the 1996 agreement was $11.9 million.

Another split-dollar life insurance agreement with Mr. Lay for $12.75 million of life insurance coverage was later approved by the Compensation Committee of the Board of Directors on May 3, 1999, at Mr. Lay's request, to trade out his Executive Supplemental Pre-Retirement Death Benefit under the Houston Natural Gas Corporation Executive Supplemental

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[2123] Notice 2002-59, 2002-36 I.R.B. 1, Aug. 16, 2002.

[2124] Enron's split-dollar arrangements with employees appear to be individualized, rather than part of a larger plan or arrangement to enter into split-dollar arrangements with employees.

[2125] Appendix D contains Enron's split-dollar life insurance agreements with Mr. Lay.

[2126] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 143.

[2127] Mr. Lay had been chairman and chief executive officer since February 1986. Enron Form 10-K for 1996, as filed with the Securities and Exchange Commission.

Benefit Agreement.[2128] Although Enron purchased the life insurance contract in 2000, Enron and Mr. Lay did not enter into the split-dollar arrangement.[2129]

Mr. Skilling entered into a split-dollar arrangement with Enron on May 23, 1997, with respect to an $8 million life insurance contract.[2130] Mr. Skilling's position was then president and chief operating officer of Enron Corp.[2131] Mr. Skilling said in an interview with Joint Committee staff[2132] that his insurance broker noticed Mr. Lay's split-dollar arrangement in proxy materials issued by Enron, and the broker suggested that Mr. Skilling should ask Enron to enter into a similar agreement with him.

Mr. Baxter's split-dollar arrangement with Enron was dated January 26, 2000, for $5 million of life insurance coverage. At that time, Mr. Baxter's position was chairman and chief executive officer of Enron North America Corp.[2133]

Specific split-dollar arrangements

Split-dollar arrangements with Mr. Lay

1994 arrangement. On April 22, 1994, Enron entered into a split-dollar arrangement with Mr. Lay and the KLL & LPL Family Partnership, a Texas limited partnership.[2134] KLL and LPL are the initials of Mr. Lay and his wife, Linda. The life insurance contract covered the joint lives of Mr. Lay and his wife, Linda. The life insurance contract had a face amount of $30 million[2135]

[2128] Agenda Item No. 8(d), Split Dollar Policy, EC 000752761, and Minutes, Meeting of the Compensation and Management Development Committee of the Board of Directors, Enron Corp., May 3, 1999, EC 000752759-EC 000752760.

[2129] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 12.

[2130] Appendix D contains Enron's split-dollar life insurance arrangement with Mr. Skilling.

[2131] Mr. Skilling took this position in January, 1997. Enron Form 10-K for 1996, as filed with the Securities and Exchange Commission.

[2132] Interview of Mr. Skilling by Joint Committee on Taxation staff on November 13, 2002.

[2133] Enron Form 10-K for 2000, as filed with the Securities and Exchange Commission.

[2134] Appendix D contains the Split Dollar Life Insurance Agreement (dated April 22, 1994) (EC 000752803 - EC 000752807) and the Collateral Agreement (dated April 22, 1994) (EC 000752801 - EC 000752803).

[2135] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 143.

and was issued by Transamerica Occidental Life Insurance Company. The arrangement was a "collateral assignment," whereby the family partnership was the owner of the contract, but Enron agreed to pay each of the nine annual premiums of $280,265. The family partnership assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron paid as premiums. The family partnership agreed not to withdraw, surrender, borrow against, or pledge as security for a loan any portion of the cash value of the policy.

The agreement provided that upon Mr. Lay's death while the agreement remained in force, Enron would be entitled to receive, from the death benefit proceeds, the amount of the premiums that Enron had paid. The beneficiary designated by the family partnership would be entitled to the balance of the death benefit proceeds. Enron would not be entitled to recoup its premium payments in the event of Mr. Lay's death after the termination of the agreement.

The 1994 agreement would be terminated by: (1) payment to Enron of the amount of premiums it had paid; (2) surrender of the life insurance contract; (3) death of the second of Mr. Lay and his wife, Linda, to die; or (4) 30 days after the ninth anniversary of the date the contract was issued or upon Mr. Lay's retirement from Enron, whichever is later. If the split-dollar agreement is terminated by the passage of nine years or Mr. Lay's retirement, Enron relinquishes the right to recoup its premium payments (unlike the other terminating events).

1996 arrangement.–Effective December 13, 1996, Enron entered into a similar "collateral assignment" split-dollar arrangement with Mr. Lay and the same family trust.[2136] The life insurance contract had a face amount of $11.9 million, and was also issued by Transamerica Occidental Life Insurance Company.[2137] The family partnership was the owner of the contract, but Enron paid each of the five annual premiums of $250,000. The family partnership assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron paid as premiums. The family partnership had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Lay's death, Enron would have the right to receive $1.25 million of the death benefit (the total of the five annual premiums of $250,000), or the amount of premiums paid by Enron to date if Mr. Lay died before all five premiums were paid. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by the family partnership.

The 1996 agreement could be terminated by the family partnership at any time during Mr. Lay's life by a lump sum cash payment to Enron of $1.25 million (or, if less, the amount of premiums Enron had paid by the time Mr. Lay's employment terminated). In addition, the

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[2136] Appendix D contains the Split Dollar Agreement (dated December 18, 1996) (EC 000752792 - EC 000752798). The agreement stated that it was to be effective as of December 13, 1996.

[2137] The effective date of the life insurance contract was October 14, 1996.

agreement would be automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, or by mutual written agreement of the parties. In the event of an automatic termination, the family partnership could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

Split-dollar arrangement with Mr. Skilling

On May 23, 1997, Enron entered into a split-dollar arrangement with Mr. Skilling and the trustee of the Jeffrey Keith Skilling Family 1996 Trust.[2138] The trustee of this trust was Mark David Skilling. The life insurance contract had a face amount of $8 million, and was issued by Massachusetts Mutual Life Insurance Company.[2139] The arrangement was a "collateral assignment," whereby the Skilling family trust was the owner of the contract, but Enron paid most of the five annual premiums of $115,250 for each of the five years 1997 – 2001.

The trustee of the Skilling family trust agreed to pay a portion of the annual premium (amounts between approximately $4,400 and $7,600) for each of the five years.[2140] The agreement provided that these amounts were "equal to the annual cost of current life insurance protection on the life of the employee [Mr. Skilling], measured by the Insurer's current published minimum premium rate for standard risks."[2141] Enron agreed pay the balance of each of the five annual premiums. The Skilling family trust assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the contract to secure the repayment of amounts Enron paid as premiums. The Skilling family trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Skilling's death, Enron would have the right to receive a portion of the death benefit in cash equal to the aggregate premium payments made by Enron. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by the trustee of the Skilling family trust.

The agreement could be terminated by the trustee of the Skilling family trust at any time during Mr. Skilling's life upon written notice to Enron by a lump sum cash payment to Enron in the amount of the aggregate premiums Enron had paid. In addition, the agreement would be

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2138 Appendix D contains the Split Dollar Agreement (dated May 23, 1997) (EC 000752568 - EC 7525574), the Assignment of Life Insurance Policy as Collateral (dated June 25, 1997, effective as of May 23, 1997) (EC 000752563 0 EC 000752566), and the Jeffrey K. Skilling Split Dollar Premium Payment Schedule (EC 000752567).

2139 The effective date of the life insurance contract was May 23, 1997.

2140 Jeffrey K. Skilling Split Dollar Premium Payment Schedule, EC 000752567. Appendix D contains this document.

2141 Split Dollar Agreement at 2 (dated May 23, 1997) (EC 000752569).

automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, by termination of Mr. Skilling's employment with Enron for any reason, by failure of the trustee of the Skilling family trust to pay its portion of the premium (unless Enron agreed to pay), or by mutual written agreement of the parties. In the event of an automatic termination, Mr. Baxter's trust could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

Split-dollar arrangement with Mr. Baxter

On January 26, 2000, Enron entered into a split-dollar arrangement with Mr. Baxter and his insurance trust, of which Margo Baxter was trustee. The life insurance contract had a face amount of $5 million, and was issued by Transamerica Occidental Life Insurance Company.[2142] Under the terms of the agreement, the arrangement, like Enron's other split-dollar arrangements, was a "collateral assignment," whereby Mr. Baxter's trust was the owner of the contract, but Enron paid the annual premium of $50,565. Mr. Baxter's trust assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron pays as premiums. Mr. Baxter's trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Baxter's death, Enron would have the right to receive a portion of the death benefit in cash equal to the aggregate premium payments made by Enron. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by Mr. Baxter's trust.

The agreement could be terminated by Mr. Baxter's trust at any time during Mr. Baxter's life by a lump sum cash payment to Enron in the amount of the aggregate premiums Enron had paid. In addition, the agreement would be automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, or by mutual written agreement of the parties.[2143] In the event of an automatic termination, Mr. Baxter's trust could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

Subsequent developments

Enron filed for bankruptcy under chapter 11 on December 2, 2001. Bankruptcy of Enron was one of the events giving rise to automatic termination of the split-dollar arrangements with

[2142] The effective date of the life insurance contract was January 26, 2000.

[2143] Unlike the agreement with Mr. Skilling, the agreement with Mr. Baxter was not automatically terminated upon the termination of his employment with Enron.

Mr. Lay, Mr. Skilling, and Mr. Baxter. Mr. Baxter died on January 25, 2002.[2144]

Discussion of Issues

Enron's split-dollar life insurance arrangements with Mr. Lay, Mr. Skilling, and Mr. Baxter were entered into between 1994 and 2000, before the issuance of the series of recent IRS guidance starting with Notice 2001-10 in January, 2001. Under the limited guidance issued by the IRS prior to Notice 2001-10, the cost of current term insurance protection would be includible in income of the owner of the life insurance contract (less the amount paid by the owner).[2145] Enron would not be permitted to deduct the premiums.[2146]

Under the two split-dollar life insurance arrangements with Mr. Lay and the arrangement with Mr. Baxter, Enron paid the entire amount of the premiums under the life insurance contracts. The portion of this premium that constituted the cost of current term insurance protection would have been includible in income by the employee.

Under Mr. Skilling's arrangement, the Skilling family trust paid a portion of each annual premium under the life insurance contract, while Enron paid the balance of the annual premium. The terms of the split-dollar agreement provide that the amounts paid by the Skilling family trust are intended to constitute the full cost of current insurance protection, based on the insurer's "published minimum premium rate for standard risks." Under the 1960s rulings, taxpayers were permitted to choose to determine the amount includable in income on this basis. Because the Skilling family trust, rather than Enron, paid this portion of the premiums, no amount would have been includible in income. Each of the five annual premiums on the $8 million life insurance contract was $250,000, but the "cost of current insurance protection" was determined to be an amount between $4,400 and $7,600 each year. This disparity in amount illustrates the valuation issues that arise from permitting the use of insurers' "published" premium rates to set the amount includable in an employee's income.

[2144] His death was alleged to be a suicide. Paul Duggan and Lois Romano, *Enron Official Shaken In Days Before Suicide*, Washington Post, Feb. 9, 2002, at A1.

[2145] Examination of the Federal tax consequences of the split-dollar life insurance arrangements to the individual Enron employees is beyond the scope of this Report. Some general discussion is provided in order to illustrate the issues relating to the tax treatment of split-dollar life insurance arrangements into which Enron entered.

[2146] Section 264(a)(1) provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract. Prior to amendment in 1997, the rule provided that no deduction was allowed for premiums on a life insurance contract covering any officer or employee, if the taxpayer is directly or indirectly a beneficiary under the contract. Enron generally had the right to recoup all of its premium payments from the death benefits paid by the life insurance contracts, by the terms of the split-dollar life insurance arrangements. The premium deduction denial rules are discussed in more detail in Part Three, section IV of this Report, relating to company-owned and trust-owned life insurance.

Enron employees' split-dollar insurance arrangements were entered into prior to the issuance of the 2002 proposed regulations. Further, the regulations are in proposed form, and would become effective generally for arrangements entered into after the date final regulations are published. However, if the rules of the proposed regulations applied, the tax treatment probably would be conceptually similar to the treatment under the pre-Notice 2001-10 letter rulings published by the IRS, in that the value of the economic benefit would be includible in income. However, the analysis of whether to apply this approach or the proposed regulations' loan approach would be new, and the process of determining the amount of this cost would differ from under prior law.

Under the proposed regulations, the tax treatment of the non-equity collateral assignment split-dollar arrangements that Enron entered into with Mr. Lay, Mr. Skilling and Mr. Baxter would likely be subject to the "economic benefit" approach. The proposed regulations provide a special rule that the economic benefit approach always applies to a split-dollar arrangement in connection with the performance of services if the service provider's only benefit is current life insurance protection (a "non-equity" split dollar arrangement). Because the partnership and the trusts that were the owners of the contracts in these collateral assignment arrangements did not have the right to borrow or otherwise gain access to the cash value of the life insurance contracts,[2147] the contracts would be treated as non-equity split dollar arrangements under the proposed regulations. In this circumstance, the proposed regulations would provide that the owner of the contract[2148] would include in income the cost of current insurance protection. Valuation of this cost would be an issue, as the proposed regulations do not provide new guidance.[2149]

Alternatively, if the arrangements were subject to the loan approach under the proposed regulations, they would be treated as loans of each premium payment made by Enron. The borrower under this analysis would be the person deemed to be the owner of the life insurance contracts.[2150] The foregone interest on these deemed loans would be included in the income of the partnership or trust.

[2147] Under each agreement described, the employee's family partnership or trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

[2148] Under the proposed regulations, the owner may be the partnership or trust. However, in the employment context, it could be argued that attribution or look-through to the employee would be appropriate, because the income is in the nature of compensation for his services.

[2149] Notice 2002-8 provides that until final regulations are published, the P.S. 58 rates, or the insurer's lower published premium rates for standard risks as permitted under the 1960s rulings, may be used to determine the value of current life insurance protection for split-dollar life insurance arrangements entered into before January 28, 2002.

[2150] Under the proposed regulations, the owner may be the Lay family partnership, the Skilling family trust, or Mr. Baxter's trust, respectively.

The enactment of the Sarbanes-Oxley Act of 2002, relating to corporate governance, has raised the issue of whether a split-dollar life insurance arrangement between and employer and an employee is characterized as a loan, for purposes of that Act's prohibition of certain loans to executives.[2151] The resolution of that question is not necessarily related to whether the arrangement is characterized as a loan, or otherwise, under Federal tax rules.[2152]

Until the issuance of Notice 2001-10 in 2001, the IRS had issued very little guidance on split-dollar life insurance since the 1960s. During this period, the use of split-dollar life insurance became more widespread, and variations on the product proliferated. In the absence of guidance, some taxpayers may have taken a variety of positions as to the includibility in income of benefits under the arrangements, and as to the timing or amount of items that are includible. From a tax policy perspective, taxpayers' failure to include in income the appropriate value of an economic benefit received by an employee from an employer indicates a need for guidance as to the proper tax treatment of split-dollar life insurance arrangements.

More recently, since 2001, the IRS has issued far more detailed guidance, both as general statements published in Notices, and as more specific rules published as proposed regulations. In addition, the IRS has superceded the previous valuation table, known as the P.S. 58 table, and supplanted it with Table 2001 for new split-dollar arrangements. The effect has been to treat the economic benefit received in a split-dollar life insurance arrangement more like other economic benefits received by employees, specifying the tax treatment in greater detail than previously in an area in which practices that may not accurately measure income had become increasingly common.

Recommendations

Requiring taxpayers to include in income the economic value of the benefit received in a split-dollar life insurance arrangement (or to treat the arrangement as a loan, if that treatment reflects the nature of the transaction) is consistent with the goal of the income tax system to accurately measure income. The Notices and proposed regulations generally serve the tax policy goal of improving accurate income measurement in the case of split-dollar life insurance arrangements. The Joint Committee staff recommends that guidance relating to split-dollar life insurance should be finalized.

[2151] Sarbanes-Oxley Act of 2002, sec. 402, Pub. L. No. 107-204. The Sarbanes-Oxley Act is discussed in more detail in Part Four, section III.C.3., relating to employee loans.

[2152] Postal, *Will SEC Exempt Split-Dollar From Ravages Of Sarbanes-Oxley Loan Rules?*, Insurance Chronicle, Jan. 13, 2003, at 1.

6. Limitation on deduction of certain executive compensation in excess of $1 million

Present Law

In general

Present law allows a deduction for ordinary and necessary business expenses, including a reasonable allowance for salaries and other compensation for personal services actually rendered.[2153] The reasonableness standard has been used primarily to limit payments by closely-held companies in cases in which nondeductible dividends may be disguised as deductible compensation. The reasonableness standard has rarely, if ever, been applied in the context of compensation paid to an employee of a large publicly held corporation, where the question of whether a payment is really a return to capital is generally not an issue.

Under present law, compensation in excess of $1 million paid by a publicly held company to the company's "covered employees" generally is not deductible.[2154] Covered employees are the chief executive officer and the four other most highly compensated employees of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid, whether the compensation is for services as a covered employee, and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of a nonqualified stock option, the deduction is normally taken in the year the option is exercised, even though the option was granted with respect to services performed in a prior year.

Certain types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds $1 million. With respect to compensation paid to Enron executives, the most relevant exception to the deduction limitation is for performance-based compensation. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals and with respect to which certain requirements are satisfied, including a shareholder approval requirement.[2155]

[2153] Sec. 162(a)(1).

[2154] Sec. 162(m). The $1 million limit is reduced by any amount of excess parachute payments that are not deductible for the year (as determined under sec. 280G). The deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

[2155] In addition, the following types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds $1 million: (1) compensation payable on a commission basis; (2) payments to a tax-qualified retirement plan (including salary reduction contributions); and (3) amounts that are excludable from the individual's gross income (such as employer-provided health benefits). In addition,

Performance-based compensation: In general

The deduction limitation does not apply to any compensation payable solely on account of the attainment of one or more performance goals, but only if: (1) the performance goals are determined by a compensation committee of the board of directors of the publicly held company which is comprised solely of two or more outside directors; (2) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such compensation; and (3) before payment of such compensation, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.[2156]

Compensation generally does not satisfy the requirements for performance-based compensation if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. However, compensation does not fail to be performance-based merely because the compensation may be paid upon death, disability or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of the exception.[2157]

Performance goal requirement

Preestablished objective performance goal

In order to qualify for the exception for performance-based compensation, the compensation must be paid to the covered employee pursuant to a preestablished objective goal. A performance goal generally is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal.[2158] A performance goal is considered objective if a third party having knowledge of the relevant facts could determine whether the goal is met.[2159]

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under a transition rule, compensation is not subject to the limitation and is not taken into account in determining if other compensation exceeds $1 million if the compensation is payable under a written binding contract in effect on February 17, 1993, and at all times thereafter before such compensation is paid and which was not modified thereafter in any material respect before such compensation is paid. Sec. 162(m)(4).

[2156] Sec. 162(m)(4)(C).

[2157] Treas. Reg. sec. 1.162-27(e)(2)(v).

[2158] In no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. Treas. Reg. sec. 1.162-27(e)(2)(i).

[2159] *Id.*

The term performance goal is broadly defined. A performance goal can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Treasury regulations provide that such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, for example, a vesting provision based solely on continued employment does not constitute a performance goal.[2160]

A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.[2161]

Discretion

The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the performance goal. A performance goal is not discretionary merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. That is, negative discretion to reduce the amount payable to a covered employee is generally permitted, as long as such discretion does not result in an increase in the amount payable to another employee. A formula or standard is not considered discretionary merely because the amount of compensation to be paid upon attainment of the performance goal is based on a percentage of base pay or salary and the dollar amount of the salary is not fixed at the time the performance goal is established if the maximum dollar amount to be paid is fixed at that time.[2162]

Changes in the timing of payments can affect the amount being paid and thus raise the question of whether the change involves impermissible discretion. As described below, Treasury regulations provide guidance on what types of timing changes are or are not considered increases in the amount payable.[2163]

If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation unless the

[2160] *Id.*

[2161] Treas. Reg. sec. 1.162-27(e)(2)(ii).

[2162] Treas. Reg. sec. 1.162-27(e)(2)(iii)(A).

[2163] Treas. Reg. sec. 1.162-27(e)(2)(iii)(B).

amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment).[2164]

If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation. Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.[2165]

Stock option and stock appreciation rights

Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the performance goal requirement if: (1) the grant or award is made by the compensation committee; (2) the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and (3) under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is considered performance-based compensation.[2166] The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the applicable requirements.

[2164] *Id.*

[2165] *Id.*

[2166] Treas. Reg. sec. 1.162-27(e)(2)(vi). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option.

Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of the exception for performance-based compensation to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan.[2167]

Outside director requirement

The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director:

- Is not a current employee of the publicly held corporation;
- Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;
- Has not been an officer of the publicly held corporation; and
- Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.[2168]

Specific rules apply in determining whether a director falls within any of these categories.[2169]

[2167] If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. *Id.*

[2168] Treas. Reg. sec. 1.162-27(e)(3)(i).

[2169] For example, the determination of whether an individual was an officer of the publicly held corporation is based on the facts at the time that the individual is serving as a member of the compensation committee. A director is not precluded from being an outside director solely because the director is a former officer of a corporation that was previously within the affiliated group of the publicly held corporation but is no longer within the group when the individual is serving on the compensation committee. As another example, specific rules apply, including certain rules disregarding de minimis remuneration, in determining whether and when the individual is receiving remuneration from the publicly held corporation in a capacity other than as a director. Treas. Reg. sec. 1.162-27(e)(3)(ii) - (viii).

Shareholder approval requirement

In general

The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The shareholder approval requirement is not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders.[2170]

The material terms that must be disclosed to shareholders include: (1) the employees eligible to receive compensation; (2) a description of the business criteria on which the performance goal is based; and (3) either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).[2171] To the extent not otherwise specifically provided in Treasury regulations, whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Securities Exchange Act of 1934.[2172]

Eligible employees

Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient.[2173]

Business criteria

Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation

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[2170] Treas. Reg. sec. 1.162-27(e)(4)(i).

[2171] *Id.* The disclosure requirement may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders if the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Treas. Reg. sec. 1.162-27(c)(4)(iii)(B).

[2172] Treas. Reg. sec. 1.162-27(e)(4)(v).

[2173] Treas. Reg. sec. 1.162-27(e)(4)(ii).

rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is not less than current fair market value.[2174]

Compensation payable under a performance goal

Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (e.g., fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

Other rules

Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.[2175]

The material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.[2176]

Factual Background

Statement of Enron policy regarding deduction limitation

Since the enactment of the $1 million deduction limitation,[2177] Enron has expressed the intent to structure certain compensation arrangements to qualify as performance-based

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2174 Treas. Reg. sec. 1.162-27(e)(4)(iii).

2175 Treas. Reg. sec. 1.162-27(e)(4)(vi).

2176 Treas. Reg. sec. 1.162-27(e)(4)(vii).

2177 The $1 million deduction limitation was enacted in 1993, effective for amounts that would otherwise be deductible for taxable years beginning on or after January 1, 1994. Pub. L. No. 103-66, sec. 13211(a) (1993).

compensation not subject to the $1 million limit. The 1994 Enron Corp proxy statement contains this initial statement regarding the limitation:[2178]

> [The deduction limitation], enacted in 1993, generally disallows a tax deduction to public companies for compensation over $1 million paid to the company's Chief Executive Officer and four other most highly compensated executive officers, as reported in the proxy statement. Qualifying performance-based compensation will not be subject to the deduction limit if certain requirements are met. Enron intends to structure the performance-based portion of the compensation of its executive officers (which currently consists of stock option grants, certain restricted stock grants, performance unit grants and annual incentive awards) in a manner that complies with the new statute, including presentation of each of these plans to stockholders for approval. Occasionally, Enron may grant restricted stock for specific reasons which would not qualify as performance-based.

Subsequent annual proxy statements continued to indicate the general intent to structure most, but not necessarily all, compensation arrangements so as to meet the requirements for performance-based compensation. For example, the proxy statement for the annual shareholder meeting in 2001 contains the following statement as part of the "Report from the Compensation and Management Development Committee Regarding Executive Compensation:"[2179]

> Section 162(m) of the Internal Revenue Code, as amended (the "Code"), generally disallows a tax deduction to public companies for compensation over $1,000,000 paid to a company's CEO and four most highly compensated executive officers, as reported in its proxy statement. Qualifying performance-based compensation is not subject to the deduction limit if certain requirements are met. Enron has structured **most** aspects of the performance-based portion of the compensation for its executive officers (which includes stock option grants, performance units, and performance based annual incentive awards) in a manner that complies with the statute. The Amended and Restated Enron Corp. 1991 Stock Plan, the Amended and Restated Performance Unit Plan, and the Enron Corp. Annual Incentive Plan were presented to and approved by shareholders at the 1999 [sic], 1995 and 1999 Annual Meetings of Shareholders, respectively.[2180] (emphasis added)

[2178] 1994 Enron Corp. Proxy Statement, at 11.

[2179] 2001 Enron Corp. Proxy Statement, at 16.

[2180] Similar statements were included in previous proxy statements. For example, the 2000 proxy statement contained the same language, except that dates given as to when shareholder approval was obtained are different. The 2000 proxy contains the following dates of shareholder approval: 1994, 1997, and 1999 for approval of the Amended and Restated 1991 Stock Plan; 1994 and 1995 for approval of the Amended and Restated Performance Unit Plan; and 1994 and 1999 for the Annual Incentive Plan. 2000 Enron Corp. Proxy Statement, 15.

Other proxy statements clarify which portions of the 1991 Stock Plan were intended to qualify as performance-based compensation (as Amended and Restated Effective May 4, 1999). For example, the 1999 proxy contains the following: [2181]

> [E]nron believes that the income generated in connection with the exercise of stock options granted under the 1991 Stock Plan should qualify as performance-based compensation and, accordingly, Enron's deductions for such compensation should not be limited by [the deduction limitation]. The 1991 Stock Plan has been designed to provide flexibility with respect to whether restricted stock awards will qualify as performance-based compensation under [the deduction limitation]. Enron believes that certain awards of restricted stock under the 1991 Stock Plan will so qualify and Enron's deduction with respect to cash awards should not be limited by [the deduction limitation]. However, certain awards of restricted stock and all awards of phantom stock units will not qualify as performance-based compensation and, therefore, Enron's compensation expense deductions relating to such awards will be subject to the ... deduction limitation. [2182]

<u>Shareholder approval</u>

<u>In general</u>

As noted in the proxies, three plans, the 1991 Stock Plan, the Performance Unit Plan, and the Annual Incentive Plan[2183] were submitted for shareholder approval (and subsequently approved) so that compensation provided under these plans would qualify as performance based. As discussed in more detail below, with respect to certain plans, Enron initially took the position that the plans would be considered performance-based even if the plans would be effective absent shareholder approval. Treasury regulations made clear that this was not the case.[2184]

[2181] 1999 Enron Corp. proxy statement, at 16. Similar statements were included in other proxy materials. *See, e.g.*, 2001 Enron Corp. Proxy Statement, at 32.

[2182] The terms of the 1991 Stock Plan (as Amended and Restated Effective May 4, 1999), which the 1999 proxy describes, distinguished between restricted stock (secs. 5.2(i)-(v) of the Plan), performance-based restricted stock (sec. 5.2(vi) of the Plan), and phantom stock units (sec. 5(vi) of the Plan). According to these plan provisions only the performance-based restricted stock is specifically designed to qualify for the performance-based exemption to the deduction limitation.

[2183] The 1991 Stock Plan and the Performance Unit Plan are discussed in more detail in Part III.C.2., above. The Annual Incentive Plan is discussed in Part III.B.2., above.

[2184] Treas. Reg. sec. 1.162-27(e)(4)(i).

1991 Stock Plan

The 1991 Stock Plan initially was approved by the shareholders in 1991. Amendments to the Plan 1991 Stock were presented to the shareholders in 1994, including amendments determined necessary by Enron to meet the requirements for performance-based compensation under the deduction limitation.[2185] The 1994 proxy materials state that shareholder approval of the amendment was required so that certain awards under the 1991 Stock Plan would qualify as performance-based compensation under the compensation deduction limitation.[2186]

The proxy materials do not state what happens if the amendment is not approved by the shareholders, and the 1991 Stock Plan amendment submitted with the proxy materials is silent on the issue. The only reference to an effective date in the amendment is the following:

> "NOW, THEREFORE, the Plan is amended as follows:
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> "1. The plan name will be changed to 'ENRON CORP. 1991 STOCK PLAN (AS AMENDED AND RESTATED EFFECTIVE MAY 3, 1994),' and the Plan shall be restated to incorporate this and all prior amendments."[2187]

An amended and restated 1991 Stock Plan was submitted to shareholders for approval in 1997. The plan submitted for approval says that it is effective upon approval of the shareholders.

The 1991 Stock Plan (as Amended and Restated Effective May 4, 1999) was again submitted for shareholder approval in 1999, and again (as Amended and Restated Effective May 1, 2001) in 2001. These versions of the 1991 Stock Plan provided that it is not effective unless shareholder approval is obtained.[2188]

Performance Unit Plan

The Performance Unit Plan was initially presented for approval by the shareholders for the purpose of meeting the requirements for performance-based compensation under the deduction limitation in 1994. The proxy materials in 1994 stated that, if shareholder approval

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[2185] The amendments were also submitted to the shareholders in order to comply with an exemption under the short-swing profit recovery provisions of the applicable securities laws. 1994 Enron Corp. Proxy Statement, at 31.

[2186] 1994 Enron Corp. Proxy Statement, at 31.

[2187] 1994 Enron Corp. Proxy Statement, Exhibit C. The Joint Committee staff was unable to obtain a copy of the 1991 Stock Plan as originally adopted; it is possible the Plan had separate effective date provisions.

[2188] Sec. 9 of the Enron Corp. 1991 Stock Plan (as Amended and Restated Effective May 4, 1999); sec. 9 of the Enron Corp. 1991 Stock Plan (as Amended and Restated Effective May 1, 2001). The Plans are included as Exhibit B of the 1999 and 2001 Enron Corp. Proxy Statements.

was not obtained, the Performance Unit Plan would continue but payments made on or after January 1, 1994, would not be deductible by Enron.[2189] The Performance Unit Plan document submitted with the proxy did not contain a provision conditioning the effectiveness of the Plan on shareholder approval.

An amended and restated Performance Unit Plan was presented for approval by the shareholders in 1995. The amended and restated Performance Unit Plan was substantially the same plan that was approved in 1994. Proxy materials explain that the Performance Unit Plan was being resubmitted to shareholders in order to comply with the requirements of the compensation deduction limitation. The proxy states that Treasury Regulations under the compensation cap, issued after the proxy materials had been finalized, made it clear that compensation was not performance based if it would be paid regardless of whether the terms are approved by the shareholders. The Performance Unit Plan presented in 1995 provided that, if shareholder approval was not obtained, the Plan would not be continued and grants made in 1994 and 1995 would be cancelled. The proxy materials state that, "Upon further guidance from legal counsel after consultation with the Internal Revenue Service, the clarification contained herein now complies with the Internal Revenue Service's interpretation of this provision."[2190] In addition, the Performance Unit Plan document provided with the 1995 proxy materials expressly provides that:

> Upon approval by the stockholders of the Company at the 1995 annual meeting, the Plan shall be considered effective for Performance Periods beginning on or after January 1, 1994. In the event that the Plan is not approved by the stockholders of the Company at the 1995 annul meeting, all Performance Units granted prior to such meeting with respect to Performance Periods beginning on or after January 1, 1994, shall be cancelled without the payment of any amount to the holders thereof and no Performance Units shall thereafter be granted under the Plan.[2191]

Annual Incentive Plan

The Annual Incentive Plan was initially presented for approval by the shareholders for the purpose of meeting the requirements for performance-based compensation under the deduction limitation in 1994. The 1994 proxy materials state that, if the requisite shareholder approval is not obtained, the Annual Incentive Plan will continue, but payments made on or after January 1, 1994, will not be tax deductible if compensation to executives exceeds $1 million.[2192] However, the Annual Incentive Plan document provides that "Upon approval by the stockholders

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[2189] 1994 Enron Corp. Proxy Statement, at 28.

[2190] 1995 Enron Corp. Proxy Statement, at 27.

[2191] Section X.G. of the Enron Corp. Performance Unit Plan (As Amended and Restated Effective May 2, 1995), the Plan is included as Exhibit A to the 1995 Enron Corp. Proxy Statement.

[2192] 1994 Enron Corp. Proxy Statement, at 30.

of the Company at the 1994 Annual Meeting, the Plan shall be considered effective as of January 1, 1994," indicating that the Plan would not be effective unless approved by the shareholders.[2193]

A new Annual Incentive Plan was presented for shareholder approval at the 1999 annual meeting. The proxy materials for this meeting state that approval of the shareholders is required in order for the payments from the Plan to be tax deductible as performance-based compensation and that the Plan will not become effective unless approved by the shareholders.[2194] The Annual Incentive Plan document submitted with the proxy materials provides that "upon approval by the shareholders of the Company at the 1999 Annual Meeting, the Plan shall be considered effective as of January 1, 1999."[2195]

Role of the Compensation Committee

Composition of the Committee

During the period of the Joint Committee staff review, the Compensation Committee consisted of a chairman, Charles A. LeMaistre, and three or four other directors. In 1993, 1994, and 1995, the other members of the Compensation Committee were Robert A. Belfer, John H. Duncan, and Joe H. Foy. In 1996, Mr. Foy and Mr. Belfer were replaced by Norman P. Blake and Robert K. Jedicke. Frank Savage joined the Compensation Committee at the end of 1999.

The 1997 proxy states that changes were made in the composition of the Compensation Committee in order to comply with the requirements of the $1 million deduction limitation.[2196] The proxy does not describe the precise reason for the change. As discussed above, in order to meet the requirements for performance-based compensation, the compensation must be approved by a committee consisting of at least two outside directors. Thus, it appears probable that the change was related to this requirement.

1991 Stock Plan

The 1991 Stock Plan provides that the plan is to be administered by a committee of the Board of Directors of Enron Corp. designated by the Board and composed of not less than two nonemployee directors, as defined in Rule 16b-3 of the Securities Exchange Act of 1934. The Compensation Committee acted as the administrator of the 1991 Stock Plan. The 1991 Stock

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[2193] Sec, XIV of the Enron Corp. Annual Incentive Plan. The Plan is included in as Exhibit B to the 1994 Enron Corp. Proxy Statement.

[2194] 1999 Enron Corp. Proxy Statement, at 29.

[2195] Sec. XIV of the Enron Corp. Annual Incentive Plan. The Plan is included as Exhibit A to the 1999 Enron Corp. Proxy Statement.

[2196] 1997 Enron Corp. Proxy Statement, at 15-16.

Plan[2197] provides that, subject to applicable law and the terms of the 1991 Stock Plan, the Committee has the sole power, authority and discretion to:

- Designate participants,
- Determine the types of awards to be granted to a participant,
- Determine the number of shares to be covered by or with respect to which payments, rights, or other matters are to be calculated in connection with awards,
- Determine the terms and conditions of any award,
- Determine whether, to what extent, under what circumstances and how awards may be settled or exercised in cash, Enron Corp. common stock, other securities other awards, or other property, or may be canceled, forfeited, or suspended, determine whether, to what extent, and under what circumstances cash, shares, other securities, other awards, other property, and other amounts payable with respect to an award under the Plan shall be deferred either automatically or at the election of the holder thereof or of the Committee,
- Interpret, construe, and administer the Plan and any instrument or agreement relating to an award made under the Plan,
- Establish, amend, suspend, or waive such rules and regulations and appoint such agents as it shall deem appropriate for the proper administration of the Plan,
- Make a determination as to the right of any person to receive payment of an award or other benefits,
- Except for awards made to persons subject to Section 16 of the Securities Exchange Act of 1934, delegate to individuals in specified officer positions of the company the authority to make and issue awards for a specified number of shares subject to the terms and provisions of the Plan,[2198] and
- Make any other determination and take any other action that the Committee deems necessary or desirable for the administration of the Plan.

The Plan provides that a majority of the Committee constitutes a quorum and that the acts of a majority of the members present at any meeting at which a quorum is present or acts approved in writing by all members of the Committee are considered acts of the Committee.[2199]

Performance Unit Plan

The Performance Unit Plan provides that the Compensation Committee of the Board of Directors[2200] is responsible for the administration of the Plan. The Compensation Committee is

[2197] Except as otherwise described, Plan provisions are included in both the 1999 and 2001 Restatements of the 1991 Stock Plan.

[2198] This provision was not in the 1999 Restatement of the 1991 Stock Plan.

[2199] The authority of the Committee to make plan amendments was added in the 2001 restatement; it was not in the 1999 restated Plan.

[2200] In some years, the Compensation Committee was called the Compensation and Management Committee.

granted certain specific authority under the Plan, as described below, and also has such other powers and authority necessary or proper for the administration of the Plan, as determined from time to time by the Compensation Committee. Notwithstanding that the Compensation Committee is the Plan administrator, day-to-day administration of the Plan is the responsibility of the Vice President of Human Resources, who in carrying out such day-to-day administrative activities is acting as the Committee's delegate. The Compensation Committee may also delegate to any person designated by the Compensation Committee any power or duty granted to it under the Plan. The Compensation Committee may adopt such rules for the administration of the Plan as it deems necessary.

As part of the specific authority granted to the Compensation Committee under the Performance Unit Plan, the Committee is responsible for designating, in its sole discretion, which eligible employees will receive an award of performance units for the year. Prior to the Compensation Committee making its designation, the Office of the Chairman of the Company is to present a nomination list to the Compensation Committee of those eligible employees, if any, recommended to the Committee for consideration as recipients of performance units. The Performance Unit Plan provides that the Compensation Committee is to make its designation after "giving due consideration to the nomination list." The Compensation Committee is not bound by the nomination list, and may include any, all, or none of the eligible employees on the nomination list and may include other eligible employees as the Compensation Committee considers appropriate. The Compensation Committee is to provide each designated eligible employee with a written notice of any performance units granted to the employee during the year. The Committee also determines, in its sole discretion, the number of performance units to be granted to any eligible employee, subject to the terms of the Plan.

The Compensation Committee is to maintain, or is to cause to be maintained, accounts reflecting each participants interest in the Performance Unit Plan. The Compensation Committee has the authority, in its discretion, to determine whether benefit payments with respect to performance units are made in cash, Enron Corp. common stock, or both.

The Plan provides that the Board, or the Compensation Committee acting on behalf of the Board, may amend or modify the Performance Unit Plan at any time and in any manner, except that no change in any grant previously made may be made which would impair the rights of the recipient of a grant without the consent of the recipient. In addition, no amendment may be made without the approval of stockholders if the amendment would:

- Change the class of eligible employees who may be designated to receive an award under the Performance Unit Plan,
- Change the criteria used to determine the adjusted value to a performance measure other than total shareholder return,
- Change the schedule used to determine adjusted value,
- Increase the maximum grant of performance units that any eligible employee may receive in a year, or
- Otherwise modify the material terms of the Performance Unit Plan.

Annual Incentive Plan[2201]

The Compensation Committee of the Board is responsible for administering the Annual Incentive Plan and has a variety of duties and responsibilities under the Annual Incentive Plan. It has the sole discretion to: (1) interpret the Annual Incentive Plan; (2) approve preestablished, objective annual performance measures; (3) certify the level to which the performance measures were attained prior to any payment under the Annual Incentive Plan; (4) approve the amount of awards made under the Annual Incentive Plan; and (5) determine who is to receive any payment under the Annual Incentive Plan. The Annual Incentive Plan provides that decisions of the Compensation Committee are conclusive and that the Compensation Committee shall have no liability for any action taken or decision made in good faith relating to the Annual Incentive Plan or any award made under the Annual Incentive Plan.

The Annual Incentive Plan as approved by shareholders in 1994 provided that the Compensation Committee was to establish annually an award fund, expressed as a percentage of after-tax net income, prior to the beginning of the year (or such later date as permitted under applicable law). The Annual Incentive Plan as restated in 1999 provides that the maximum annual award fund is five percent of recurring after-tax net income of Enron and eligible employees are limited to Section 16 officers. Recurring after-tax net income means after-tax net income subject to downward adjustment by the Compensation Committee in its sole discretion for what it considers unordinary or nonrecurring items of after-tax net income and other items or events, including, but not limited to, financial impact on Enron resulting from changes in law and/or regulations pertaining to Federal taxes imposed on corporations.

The maximum permitted individual target award under the 1994 Plan was one-half of one percent (.5 percent) of the after-tax net income of Enron. The 1999 Annual Incentive Plan provides that, for eligible participants subject to the deduction limitation (and officers subject to section 16 of the Securities Exchange Act), the Compensation Committee is to establish an individual target award level, expressed as a percentage of recurring after-tax net income. The maximum individual target award level that can be established under the Annual Incentive Plan is one percent of the recurring after-tax net income of Enron.

Under the 1999 Annual Incentive Plan, the Compensation Committee is to verify the actual recurring after-tax net income of the Company, if any, and the resulting award fund, taking into consideration any downward adjustments that the committee may make at is sole discretion. The Compensation Committee then determines which participants will receive payments under the Plan, and the amount of such payments. Discretionary upward adjustment of the actual award level above the target aware level is not allowed.[2202]

[2201] Unless otherwise indicated, this description is based on the 1999 Annual Incentive Plan.

[2202] The Compensation Committee had similar responsibilities under the 1994 Annual Incentive Plan.

The 1994 Annual Incentive Plan provided that the Compensation Committee has the authority to modify or terminate the plan at any time, except that, without prior approval of the shareholders, no amendment may be made that would: (1) change the class of participants eligible to receive awards under the plan. (2) base the award on a performance measure other than after-tax net income. (3) base the award fund on a performance measure other than recurring net after-tax income. (4) increase the maximum individual target award level under the plan, or (5) modify any other material terms of the plan. The 1999 Annual Incentive Plan contains similar authority, except that, consistent with plan terms in effect at the time, provides that the Compensation Committee cannot change the total fund to an amount greater than five percent of recurring after-tax net income or base an award on a performance measure other than net after-tax income without the consent of the shareholders.

<u>Information from third-party consultants</u>

In 1998, Towers Perrin was asked to provide information regarding how other companies address the $1 million deduction limitation. Towers Perrin provided a letter which was presented to the Compensation Committee at the February 9, 1998, meeting.[2203] The report says that in May 1997, Towers Perrin conducted a survey of 275 companies regarding annual incentive plan design issues. The survey showed that about 45 percent of the survey participants have sought shareholder approval of their annual incentive plans because of the deduction limitation. Towers Perrin suspected that this was relatively low because many companies either do not have cash compensation in excess of $1 million for covered employees or manage the deduction limitation by deferring compensation in excess of $1 million. The latter technique was reportedly used by about 10 percent of surveyed companies.

Towers Perrin did not have data regarding how companies structure annual incentive plans to comply with the deduction limitation, but stated that it was their understanding that companies often establish a "soft" incentive funding target for covered employees which makes it likely that the total amount the company desires to pay such employees will be within the cap. Towers Perrin explained that this is done because the deduction limitation permits bonuses to be less than the shareholder-approved target.

Towers Perrin reported that they conducted a survey in August 1997 of 150 large U.S. companies. This survey showed that annual bonuses for management employees represent from two percent to 10 percent of after-tax profit, with a median of five percent. They suggested that, if a company were attempting to leave room for a reduction in the target amount, it would be common to set the funding pool approved by shareholders somewhat above these levels.

Towers Perrin also described a second approach of having shareholders approve the maximum dollar payouts to individuals under the Plan, with a laundry list of possible performance measures that can be used. The compensation committee could then select the performance measures to be used under the Plan each year, subject to the dollar limits. Towers Perrin commented that this approach would give the Compensation Committee considerable

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[2203] Letter from Towers Perrin to Vice President, Compensation and Benefits, Enron Corp., (April 21, 1998). EC000104240 - EC000104241.

latitude, but that some shareholder groups recommend against approval of this type of Plan because the standards of performance are not revealed.

As described above, Enron adopted an approach that gave an overall target based on after-tax net earnings.

Other actions of the Compensation Committee

Proxy statements included an annual report from the Compensation Committee. These reports typically discussed the overall Enron philosophy regarding executive compensation and the activities of the Compensation Committee regarding executive compensation, including the methods for determining appropriate levels and components of executive compensation.[2204] In years since the enactment of the $1 million deduction limitation, this report has included a section regarding compliance with the deduction limitation. As reflected above, this portion of the report typically stated the intent to structure certain compensation arrangements in order to meet the exception to the $1 million limitation for performance-based compensation.[2205]

Despite the apparent attention paid by the Compensation Committee to the deduction limitation, as reflected in Compensation Committee meetings and reports, one member of the Committee interviewed by the Joint Committee staff indicated that he was not aware that there was such a limitation.

Data

Table 26, Table 27, and Table 28, below, show the aggregate amount of total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for Enron's covered employees for 1998, 1999, and 2000.

[2204] *See, e.g.,* 1999 Enron Corp. Proxy Statement, at 13-16.

[2205] 1994 Enron Corp. Proxy Statement, 12; 1995 Enron Corp. Proxy Statement, at 14-15; 1996 Enron Corp. Proxy Statement, at 13-14; 1997 Enron Corp. Proxy Statement, at 15-16; 1998 Enron Corp. Proxy Statement, at 15; 1999 Enron Corp. Proxy Statement, at 16; 2000 Enron Corp. Proxy Statement, at 15; 2001 Enron Corp. Proxy Statement, at 16.

Table 26.–Application of $1 Million Deduction Limitation for 1998 (Millions of Dollars)

Employee	(1) Total Compensation	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation [(4)=(1)-(2)-(3)]
Employee 1	14.942	13.570	1.0	.372
Employee 2	8.214	3.336	1.0	3.878
Employee 3	16.700	2.148	1.0	13.552
Employee 4	8.651	1.884	1.0	5.767
Employee 5	Information not provided by Enron	Information not provided by Enron	Unknown	Information not provided by Enron
Total*	48.505	20.937	4.0	23.568

*Details may not add to totals due to rounding.

**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

Table 27–Application of $1 Million Deduction Limitation for 1999 (Millions of Dollars)

Employee	(1) Total Compensation	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation [(4)=(1)-(2)-(3)]
Employee 1	48.478	47.058	1.000	.420
Employee 2	54.322	48.680	1.000	4.642
Employee 3	7.204	2.832	1.000	3.372
Employee 4	6.874	6.517	.357	0
Employee 5	7.324	6.484	.839	0
Total*	124.202	111.572	4.100	8.434

*Details may not add to totals due to rounding.

** Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

Table 28.–Application of $1 Million Deduction Limitation for 2000
(Millions of Dollars)

Employee	(1) Total Compensation	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation
Employee 1	105.990	104.376	1.000	614.153
Employee 2	81.988	66.894	1.000	14.094
Employee 3	29.897	30.022	0.0	0.0
Employee 4	21.427	18.631	1.000	1.796
Employee 5	21.597	21.077	.520	0.0
Total*	260.899	241.00	.520	16.504

*Details may not add to totals due to rounding.

**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

The amounts shown in these tables are from information provided by Enron to the IRS in connection with the IRS' review of Enron's tax returns for 1998, 1999, and 2000. The information was provided in response to specific questions regarding the deduction limitation. The Joint Committee staff has compared this information with other information provided by Enron to the IRS and the Joint Committee staff, as well as proxy information. This comparison yielded a number of inconsistencies that stem from a variety of sources. In some cases Enron has provided information which was later modified by Enron, in other cases there are internal inconsistencies with the information provided, and in other cases it is difficult to reconcile various pieces of information. These inconsistencies may raise questions as to the accuracy of the information provided. For example, seemingly straightforward and simple information such as the job title of a particular individual varies between proxy statements and information provided to the IRS. In one case, shown on Table 28, performance-based compensation of an individual was more than the individual's total compensation.

Some of the inconsistencies discovered could have a significant impact on the amount of compensation subject to the $1 million cap. As shown in Table 28, above, based on information provided by Enron to the IRS, in 2000, the top-five highest paid officers received total compensation of $261 million. However, based on information relating to total the highest paid 200 employees for 2000 provided by Enron to the Joint Committee staff, the five highest paid employees received compensation of over twice that amount--$573 million.[2206] On the top-200 list for 2000, the highest paid employee is listed as having the title Chairman and Chief Executive Officer of Enron (the list does not include names) and as having total compensation of $169 million. This amount of compensation does not correspond to any amount provided to the IRS for 2000.

[2206] The information relating to the highest paid 200 employees provided by Enron to the Joint Committee staff for 1998 through 2001 is in Appendix D to this Report.

In interviews with the Joint Committee staff, IRS personnel also indicated that they had discovered inconsistencies with information provided by Enron and expressed difficulty in obtaining complete compensation information. The IRS attributed this, in part, to Enron's recordkeeping system. According to the IRS, Enron personnel stated to the IRS that Enron did not maintain a centralized file for each executive reflecting total compensation for that executive.

The IRS informed the Joint Committee staff that, as part of its examination of Enron's returns for 1998, 1999, and 2000, it is investigating discrepancies of this nature. The Joint Committee staff has not attempted to duplicate this work. While the information provided below may not be completely accurate, it is the best information available.

Discussion of Issues

The $1 million limitation on the deductibility of certain executive compensation does not appear to have had a substantial impact on either the amount of compensation paid by Enron or the structure of its compensation arrangements.

Table 29, below, shows total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for 1998 through 2000. This is the combined information contained in Table 26, Table 27, and Table 28.

Table 29–Application of $1 Million Deduction Limitation for 1998-2000 (Millions of Dollars)

Year	(1) Total Compensation of Covered Employees	(2) Performance-Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation
1998	48.5	20.9	4.0	23.6
1999	124.2	111.6	4.2	8.4
2000	260.9	241.0	3.5	16.5
Total 1998-2000*	433.6	373.5	11.7	48.5

* Details may not add to totals due to rounding.

**Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of $1 million.

It appears evident that the existence of the $1 million deduction limitation had no effect on the total compensation provided to Enron executives. Based on information provided by Enron to the IRS, as shown in Table 29, above, total compensation for the top-five executives for 1998-2000 was $433.6 million.[2207]

[2207] Enron also paid compensation in excess of $1 million to many employees not subject to the deduction limitation. The information regarding the top-200 most highly compensated employees provided by Enron to the Joint Committee staff indicates that 46 employees, 93

Enron intended certain of its compensation arrangements to qualify as performance-based for purposes of the deduction limitation, and treated substantial amounts of compensation as meeting this requirement. Based on information provided by Enron to the IRS, as shown in [link to table 4], above, performance-based compensation for 1999 and 2000 was comparable, 90 percent and 92 percent, respectively. In those years, seven percent and six percent, respectively, of total compensation of covered employees was not deductible. In the case of certain individuals, the amount of performance-based compensation was so great compared to total compensation that less than $1 million of compensation was potentially subject to the deduction cap.

For 1998, however, performance-based compensation was only 43 percent of total compensation of covered employees, and 49 percent of the total compensation of covered employees was not deductible. This is due in large part to the compensation provided to two covered employees. The nondeductible compensation for those two employees was 82 percent of the total nondeductible compensation of all five covered employees. Seventy-six percent of the total compensation for those two employees was not deductible.

Although Enron treated substantial amounts of compensation as performance-based, the $1 million deduction limitation does not appear to have had a significant impact on the overall structure of Enron's compensation arrangements. The arrangements that Enron considered to provide performance-based compensation were generally utilized prior to the enactment of the deduction limitation. Enron made certain modifications to its compensation arrangements in order to meet the Code's definition of performance-based compensation; however, these modifications were generally limited to relatively minor changes needed to meet the requirements rather than changes to the overall structure of its compensation arrangements. For example, in the case of bonuses, the Compensation Committee was advised by its outside consultants to establish a high enough "soft" target that could be approved by the shareholders so that whatever level of bonuses Enron ultimately paid would be within the target and thus would not fail to be performance based. It is possible that certain arrangements might not have been submitted for shareholder approval had this not been required in order to meet the requirements for performance-based compensation.

The Compensation Committee was required to take certain actions in order for compensation to qualify as performance-based. A review of the Compensation Committee minutes indicates that the deduction limitation was discussed from time to time, and the role of the Compensation Committee with respect to approval of performance targets was mentioned.[2208] In addition, the annual report of the Compensation Committee in proxy statements discussed the deduction limitation. While the deduction limitation was discussed in Compensation Committee meetings, it appears that more time was spent on broader compensation issues, such as overall

employees, and all 200 top-paid employees received compensation in excess of $1 million in 1998, 1999, and 2000 and 2001, respectively. This information is included in Appendix D to this Report.

[2208] *See, e.g.*, Minutes of the Meeting of the Compensation Committee, at 2 (Feb. 9, 1998).

compensation targets. One former member of the Compensation Committee interviewed by the Joint Committee staff indicated he had no knowledge of the deduction limitation and did not remember it ever being discussed. This may be an indication that the limitation was not a significant concern for Enron.

The existence of the $1 million deduction limitation did not prevent Enron from paying nondeductible compensation. From 1998 through 2001, $48.5 million of nondeductible compensation was paid to covered employees.[2209]

Another aspect of the deduction limitation that can be observed from the review of Enron is the discrepancy between the operation of the limitation, which is based on generally applicable tax rules, and compensation as reported in Federal proxy statements. Proxy statements include a summary compensation table for covered employees (referred to as "named officers" under the securities laws) as well as other information regarding executive compensation.

Because of timing differences and other factors, compensation as reported for proxy purposes can vary significantly from compensation subject to the $1 million deduction limitation. For example, because the deduction limitation applies when amounts would otherwise be deductible, compensation may be taken into account for purposes of the limitation at a different time that it is reported for proxy purposes. Restricted stock is an example of such a timing difference. For proxy purposes, the value of restricted stock is shown in the year the stock is granted,[2210] whereas restricted stock is taken into account for purposes of the deduction limitation when it is includible in income, i.e., as it vests. Salary and certain other compensation that is deferred may also be reported at a different time for proxy purposes than when it is taken into account under the deduction limitation. Income attributable to the exercise of stock options is also treated differently for proxy reporting purposes and tax purposes.

The securities laws requiring that certain compensation information be reported in the proxy statement and the Federal income tax laws have different purposes. Thus, each set of laws may appropriately treat items of compensation differently in order to accomplish their respective purposes. However, the difference in the treatment may cause confusion for persons who are attempting to determine the amount of nondeductible compensation from publicly available sources; it is not possible to make this determination based on proxy information.

The IRS is reviewing the application of the $1 million deduction limitation to Enron for the years 1998 through 2001. Determining whether the requirements for performance-based compensation were in fact met involves extensive, labor intensive factual determinations. The Joint Committee staff has not attempted to duplicate the efforts of the IRS. Issues that would need to be addressed include an analysis of the total compensation of covered employees, terms of all plans and arrangements and individual compensation agreements, examining materials provided to shareholders for approval, and determining whether the Compensation Committee took required actions with respect to the compensation. As described above, there are a number

[2209] *See* Table 29, above.

[2210] *See e.g.*, 1998 Enron Corp. Proxy Statement, at 20.

of inconsistencies in the information provided by Enron regarding compensation, making the examination more difficult in this case.

Recommendations

The Joint Committee staff believes that the $1 million deduction limitation is ineffective at accomplishing its purpose, overrides normal income tax principles, and should be repealed. The concerns reflected in the limitation can be better addressed though laws other than the Federal tax laws.

The $1 million deduction limitation reflects corporate governance issues regarding excessive compensation, rather than issues of tax policy.[2211] It is often difficult for tax laws to have the desired effect on corporate behavior.[2212] Taxpayers may simply choose to incur the adverse tax consequences rather than change their behavior. In Enron's case, due to the existence of net operating losses, the denial of the deduction may not have been an issue.

In Enron's case, the $1 million deduction limitation appeared to have little, if any, effect on the overall level of compensation paid to Enron executives or the structure of compensation arrangements. To the extent that performance-based compensation is viewed as being a preferable form of compensation, some may argue that the $1 million limitation was effective in the Enron case, because such a large part of compensation was structured to be performance-based. However, as noted above, the deduction limitation did not appear to be a motivating factor in the structure of Enron's compensation and the arrangements that it treated as performance-based (or similar arrangements) generally predated the enacted of the limitation. In addition, some may question whether the compensation was truly performance based, particularly given Enron's financial decline; to the extent the limitation affected Enron's compensation arrangements, it may have merely placed more emphasis on the desire to increase reported earnings.[2213]

[2211] H.R. Rep. No. 103-111, at 646 (1993).

[2212] Another example of tax laws that are aimed at corporate governance issues are the golden parachute rules that limit the compensation that may be paid to certain employees due to the change of control of a company. Sec. 280G. Failure to comply with these rules results in a denial of the deduction to the company and the imposition of a 20 percent excise tax, payable by the employee. Sec. 4999. Commentators generally observe that the golden parachute rules have done little to affect the amount of compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. It is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer's payment of the tax.

[2213] *See* Part I. of Part One of this Report.