ELIMINATING PERSONAL LOANS TO EXECUTIVES SIGNALS CHANGES TO THE EXECUTIVE PAY PACKAGE

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I. INTRODUCTION

Corporate governance advocates have criticized the excessiveness of executive pay for nearly two decades. Experts such as Graef Crystal find no relationship between executive pay and firm performance and argue that escalating compensation destroys shareholder value and erodes workers' loyalty.[1] Legislative and regulatory response to these claims largely have been to create disincentives to corporations providing overly generous pay packages to their executives. Specifically, Congress has enacted several tax provisions imposing additional taxes or removing deductions with respect to certain types of compensation. An early example of this is the anti-golden parachute legislation which was passed as part of the 1984 Tax Reform Act. Effective January 1, 1994, federal income tax law was again amended to deny a corporate tax deduction to publicly traded corporations for pay in excess of $1 million. The Securities and Exchange Commission (SEC) has also weighed in against excessive compensation by issuing rules requiring enhanced public reporting of top executive compensation. A common premise among all of these rules is that corporations could continue to engage in excessive pay practices, as long as they were willing to abide by the rules. The Sarbanes-Oxley Act of 2002[2] represents a significant departure from this view as it contains an outright prohibition against a certain component of executive pay: personal loans to executives. This paper will examine the typical components of executive pay and discuss the laws and regulations that have been passed to curb perceived abuses. It will then analyze the most recent response to corporate excessiveness and suggest targets for future legislation.

II. STRUCTURING EXECUTIVE COMPENSATION

A part of their corporate governance responsibilities, corporate boards of directors have the duty to hire the CEO and other officers of the corporation and to determine their compensation.[3] Typically, the board will appoint three or more directors to a

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[1]Graef S. Crystal, *Why CEO Compensation Is So High*, 34 CAL. MGT. REV. 9 (1991) (hereinafter referred to as Crystal).

[2]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-214, 116 Stat. 745 (July 30, 2002).

[3]Agency theory asserts that the board of directors represents shareholder interests and, therefore, functions as an important monitor of management's decisions. In reality, most scholars recognize the board's limited role in the operations of the corporation. ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (MacMillan 1932). Insofar as their responsibility for appointing CEOs and setting CEO pay, boards rarely select officers, except in times of crises, MYLES E. MACE,

compensation committee which evaluates the recommendations of outside consultants and proposes a compensation package for consideration by the entire board.[4] Over time, the components of executive pay have evolved and the compensation plans offered by most large corporations are remarkably similar, containing the following five elements: (1) base pay; (2) short-term bonus; (3) long term incentives; (4) employee benefits; and (5) perquisites.[5]

A. ANNUAL BASE PAY

Base pay is a fixed part of compensation and is generally stated as an annual amount, paid over the course of the corporation's fiscal year.[6] While most executives receive some amount of base pay, only about 20 percent of a CEO's pay is base salary; the rest is made up of incentives based on the company's performance.[7] This represents a significant difference between executive pay and the compensation of non-executive employees whose base pay represents a much higher percentage of overall compensation. The claimed reasoning is that if the company is performing well and the shareholders are making money, then the CEO should share in that success.[8] Accordingly, base pay represents the corporation's remuneration to the CEO for his or her core role in the day-to-day management of the organization.

More likely, however, is that base pay is limited to $1 million or less because of the limitations imposed by Section 162(m) of the Internal Revenue Code. Section 162 sets forth the provisions for deducting trade or business expenses. In the area of employee compensation, courts had previously applied the "reasonable" test to determined whether executive pay was excessive and, therefore, nondeductible by the company, but generally these cases arose only in connection with privately held concerns.[9] As the 1980's brought with it a heightened public awareness of perceived corporate abuses, primarily as

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DIRECTORS: MYTH AND REALITY (Harvard Business School Press 2d ed. 1986), and do not act independently from management, Crystal, *supra*, note 1.

[4]The NYSE requires the formation of a compensation committee, composed solely of independent directors. NYSE, Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, Section 303A(5), August, 1, 2002, at http://www.nyse.com/regulation/p1020656068597.html?displayPage=%2Fregulation%2F1022221392702.html (last visited Feb. 7, 2004). *See* note 13 and accompanying text *infra.*

[5]GEORGE T. MILKOVICH & JERRY M. NEWMAN, COMPENSATION (McGraw-Hill Irwin 8th ed. 2002) (hereinafter referred to as Milkovich & Newman).

[6]JOSEPH J. MARTOCCHIO, STRATEGIC COMPENSATION. (Pearson Prentice Hall 3rd ed. 2004) (hereinafter referred to as Martocchio).

[7]The Summary Compensation Table in Appendix A presents the compensation information contained in the annual proxy statements filed with the SEC in 2003, based on 2002 data for ten of the largest U.S. publicly traded corporations. SEC rules requiring publication of this information are discussed in further detail in notes 18 and 19 and accompanying text *infra.*

[8]An alternative argument is that corporate boards design executive compensation packages to provide sufficient incentives to maximize shareholder value. Lucien A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, J. ECON. PERSP. (2003) (hereinafter referred to as Bebchuk & Fried).

[9]Inez J. Freeman, *The Deductibility of Executive Compensation: Automotive Investment, Pulsar Components, and New Section 162(m),* 48 TAX L. 255 (1994) (hereinafter referred to as Freeman).

a result of increased institutional shareholdings,[10] Congress enacted Code Section 162(m) in an attempt to curb the escalation of executive pay increases.[11] Specifically, the Code denies a deduction to publicly traded corporations to the extent that compensation paid to the CEO or any of the four most highly compensated officers exceeds $1 million.[12] An important exception to the disallowance is provided, however, for compensation that is based on the attainment of performance goals, determined by a compensation committee compromised of two or more outside directors and approved by the shareholders.[13] Although section 162(m) was designed to discourage corporations from providing their top executives with excessive pay packages, it did little to halt the spiraling increases in executive pay throughout the 1990s and into the twenty-first century.[14]

B. ANNUAL BONUSES

The second component of executive compensation is the short-term bonus, generally awarded annually for meeting a pre-established benchmark relating to company performance.[15] Because bonuses are dependent on attaining performance objectives, they fall outside of the deduction limitation imposed by IRC Section 162(m).[16] As a result, the use of annual bonuses as an essential part of executive pay has risen dramatically over the past few years. In the 1980's, only 36 percent of U.S. companies gave annual bonuses. By 2002, over 90 percent of corporate executives received bonuses.[17]

While annual performance-based bonuses may be fully deductible if they qualify under Section 162(m), they must be disclosed separately in the corporation's annual proxy statement. In order to assure that shareholders are well informed of the facts surrounding compensation of corporate executive and to foster better accountability of

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[10]Gerald F. Davis & Tracy A. Thompson, *A Social Movement Perspective on Corporate Control*, 39 ADMIN. SCI. Q. 141 (1994).
[11]Freeman, *supra*, note 9.
[12]I.R.C. § 162(m).
[13]I.R.C. § 162(m)(4)(C). By requiring approval by an independent compensation committee, the IRS has in effect required most publicly traded corporations to insure that no insiders are members of their compensation committees. Treas. Reg. § 1.162-27(e)(3)(i) define outside directors as a person who is (1) not a current employee; (2) not a former employee; (3) not an officer; and (4) not receiving any remuneration other than as a director. Corporate governance advocates argue that this definition does not go far enough in assuring that the members of the compensation committee are in fact independent directors.
[14]Nancy L. Rose & Catherine Wolfram, *Has the 'Million-Dollar Cap Affected CEO Pay?*, 90 AM. ECON. REV., PAPERS & PROC. 197 (2000). The authors conclude that corporate decisions on overall levels of executive pay seem to be relatively insulated from this type of policy constraint. In fact, the IRS claims that companies are ignoring Section 162(m) by deducting pay over $1 million even if it is not related to performance. *Pay That Raises IRS Eyebrows*, BUS. WK., March 1, 2004, at 13.
[15]Martocchio, *supra*, note 6.
[16]Treas. Reg. § 1.162-27(e)(2) states: "Qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal 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." To meet this requirement, payment of the bonus must be outside the discretion of the board and be subject to risk. Shaev v. Saper, 320 F.3d 373 (3d Cir. 2003).
[17]Milkovich & Newman, *supra*, note 5.

the board of directors to the shareholders,[18] the SEC, in 1992, substantially modified the proxy disclosure rules under Regulation S-K. The most comprehensive of these changes was the requirement that corporations must present a Summary Compensation Table, replacing the cash compensation table previously used and including information for named executives individually for each of the last three fiscal years. Data required to be furnished includes: (1) base pay; (2) bonus; (3) other compensation; (4) restricted stock and dividends on restricted stock; (5) long-term incentives; (6) stock options and stock appreciation rights; and (7) other compensation. According to one author, the inclusion of the Summary Compensation Table makes it virtually impossible to hide any compensation paid to the CEO or another top executive.[19] In addition, the 1992 regulations require companies to estimate the value of stock options granted to executives each year, provide a performance graph showing total shareholder returns for the past five years compared to both a broad market index and an industry peer group index, and include a report of the compensation committee describing its basis for paying rewards to the CEO in the previous year.

By enhancing the information provided to investors regarding CEO compensation, the SEC intended to place shareholders in a better position to challenge excessive pay practices. Thus, while the SEC has resisted demands by corporate governance experts to allow shareholders more input into corporate affairs, the amendments to the proxy statement rules were aimed at achieving a middle ground.[20] Empirical evidence fails to show any increase in the number of shareholder proposals challenging executive compensation as a result of the SEC rule changes.[21] Thus, the SEC's tacit objective in seeking to rein in corporate pay practices through shareholder intervention does not appear to have been met.

C. LONG-TERM AND DEFERRED COMPENSATION

The third element of executive pay covers a wide range of long-term incentives, including both equity based and non equity based pay. Long-term incentive payments are generally awarded for meeting performance objectives over a two- to five-year period. These awards are sometimes described as performance shares, performance units, or long-term cash incentives. They are reportable in the Summary Compensation Table as directed in the SEC proxy rules, but a corporate tax deduction for payment of these awards is not limited by Section 162(m). Accordingly, they have become very popular and account for over 40 percent of total executive compensation.[22]

A popular component of executive long-term compensation is the golden parachute payment. These payments are generally made when the executive is forced to

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[18]Executive Compensation Disclosure, Exchange Act Release No. 33-6940, 57 FR 29,582 (1992).

[19]James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749 (1995). *But see* Gretchen Morgenson, *Executive Pay, Hiding Behind Some Small Print*, THE N.Y. TIMES, Section 3, at 1, February 8, 2004 (hereinafter referred to as Morgenson).

[20]Lori B. Marino, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U. PA. L. REV. 1205 (1999).

[21] *Id.* SEC Rule 14A, 17 C. F. R. § 240.14a-8(i)(7); Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293, 335 (1999).

[22]Milkovich & Newman, *supra*, note 5.

leave the firm in the event the company is acquired or merged with another company or there is otherwise a "change of control".[23] The contractual obligation to make these payments occurs in the future, at which time the parachute is opened and the ousted executive reaps a golden reward.[24]

Corporations offer several justifications for offering such lucrative compensation arrangements. Most importantly, golden parachutes offer a type of insurance protection for the executive who is likely to lose his or her position when the company is taken over. In order to encourage an employee to work for a company which may be a likely takeover target, it is necessary that the executive be compensated in that event. In addition, analysts claim that golden parachutes are important anti-takeover defense mechanisms since payment of the parachute amount will increase the price the acquirer will have to pay for the company. Finally, golden parachutes encourage managers to consider hostile takeover proposals more objectively, since the payment will compensate them for their job loss. Some economists argue that golden parachutes work to increase the price of the targeted company because they allow managers to take a stronger bargaining position when negotiating the deal.[25]

Despite the arguments in favor of golden parachutes, most business observers maintain that they are detrimental to shareholder interests because they discourage hostile tender offers which often operate to increase share price.[26] Critics of parachute payments also note that they amount to corporate waste as they provide generous compensation for executives who presumably will provide no additional services to the company.[27] In response, Congress enacted Sections 280G and 4999 of the Internal Revenue Code as part of the Tax Reform Act of 1984.[28] These provisions affect golden parachute provisions in two ways: Section 280G disallows the corporate tax deduction when the payment is made and Section 4999 subjects the recipient to a 20 percent excise tax to the extent that the payment exceeds a base amount equal to the average compensation received over the past 5 years.[29]

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[23]David J. McLaughlin, *The Myth of the Golden Parachute: What Every Dealmaker Should Know*, 17 MERGERS & ACQUISITIONS 47 (1982).

[24]Comment, *Future Executive Bail Outs: Will Golden Parachutes Fill the American Business Skies*, 14 TEX. TECH. L. REV. 615, 616 (1983).

[25]Ellie G. Harris, *Antitakeover Measures, Golden Parachutes, and Target Firm Shareholder Welfare*, 21 RAND J. ECON. 614 (1990).

[26]Charles R. Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155 (1986).

[27]Henry F. Johnson, *Those "Golden Parachute" Agreements: The Taxman Cuts the Ripcord*, 10 DEL. J. CORP. L. 45 (1985).

[28]The Senate Finance Committee stated its support of anti-golden parachute *legislations* as follows:

> The committee . . . is concerned that in many instances golden parachute contracts do little but assist an entrenched management team to remain in control. They also may provide corporate funds to subsidize officers or other highly compensated individuals. The committee is unwilling to permit the tax law to be used as a subsidy in such situations. In fact, the committee believes that a tax penalty should be enacted in those situations.

Comm. on Finance, 98th Cong., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Comm. on Mar. 21, 1984 195 (Comm. Print 1984).

[29]I.R.C. § 280G(b)(3). I.R.C. § 4999 incorporates by reference the provisions of I.R.C. § 280G. Subsection (b)(2)(A) of I.R.C. § 280G excludes any parachute payment from both the deduction limit and the excise tax if it is less than 300 percent of the individual's base amount.

Despite the adverse tax consequences connected with golden parachutes, companies continue to pay out generous severance packages when executives depart due to a change of control. Executive pay experts observe that inclusion of a golden parachute is almost mandatory in any executive pay package, and moreover, the company often picks up the employee's tax bill.[30] Thus the Internal Revenue Code provisions actually wind up costing the shareholders more in terms of the corporation's after tax expense.[31]

Stock options continue to be the largest component of CEO pay. Currently, options have very favorable accounting treatment for the company, which contributes to their overall popularity.[32] Options also enjoy favorable tax treatment. If the option qualifies as an incentive stock option under Internal Revenue Code section 422, the employee does not have to recognize any income either when the grant is awarded or when the option is exercised,[33] and when the stock is sold, the employee will recognize capital gain income. In the case of nonqualified options, the employee will have taxable income when the option is exercised, equal to the difference between the market price and the exercise price.[34] Another popular form of equity based pay is restricted stock, which is an outright transfer of employer equities, but subject to a restriction on transfer which typically lasts for five years. Until the restriction lapses, there is no income tax payable on the transfer.[35] Other compensation arrangements that allow executives to share in the growth in share price without actually transferring stock include stock appreciation rights and phantom stock.[36]

While stock options are generally subject to favorable tax treatment, an exception occurs when an employee is subject to the alternative minimum tax. The alternative minimum tax applies to any spread between the exercise price and the fair value of the stock at the time an incentive stock option is exercised.[37] Although the original intent was to prevent higher income level taxpayers from avoiding taxes through the use of tax sheltered investments,[38] a taxpayer with income over $75,000 could be subject to the tax, depending on whether he or she has other capital gains or miscellaneous deductions that are considered items of tax preference.

Under the SEC disclosure rules, companies must separately report in the Summary Compensation Table the awards of stock options to their CEO and their four highest paid executives. In addition, transactions between executives who are classified

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[30]In a recent survey of 350 major US companies, 71.7% disclosed some type of parachute arrangement in 2000, compared to 65.1% in 1996. Todd Denmark & Steve Sabow, *Majority of Companies Offer Golden Parachute Protection During Changes in Control*, March 30, 2002, *at* http://www.mercerhr. com/ knowledgecenter/reportsummary.jhtml?idContent=1009530 (last visited February 12, 2004).

[31]Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125 (2001).

[32]Favorable accounting treatment for stock options may be short-lived. The Financial Accounting Standards Board is currently working on an Exposure Draft that would amend FASB 123 to require publicly traded corporations to account for stock options and other equity based awards as an expense on their financial statements. This change is likely to take place in December of 2004.

[33]Alternative minimum tax may be due, however, when an incentive stock option is exercised. *See* note 37 and accompanying text *infra*.

[34]I.R.C. § 83(a).

[35]*Id.*

[36]Martoccio, *supra*, note 6.

[37] I.R.C. § 56(b)(3).

[38]Jim Saxton, *The Alternative Minimum Tax for Individuals: A Growing Burden*, Joint Economic Committee, May, 2001, at http://www.house.gov/jec/tax/amt.pdf (last visited March 9, 2004).

as insiders under SEC Rule 16b and their employers are subject to disclosure rules.[39] Such transactions include (1) stock option grants, restricted stock grants and acquisitions of stock units under non-tax qualified deferred compensation plans, and (2) shares delivered to the company to pay tax withholding amounts or an option exercise price, options surrendered to the company in an option repricing, and sales of shares to a company.[40] With the passage of the Sarbanes-Oxley Act on July 30, 2002,[41] the time for reporting such transactions was accelerated from a monthly filing to the end of the second business day following the day of the transaction. Whether the change is the disclosure rules will have any impact on the level of stock option grants remains to be seen, although prior amendments to the executive compensation reporting requirements did little to reverse the trend of spiraling CEO pay.[42]

D. ENHANCED BENEFIT PLANS AND PERQUISITES

The fourth component of executive pay, employee benefits, covers a wide variety of protection and retirement plans and well as health care plans that provide benefits over and above what the vast majority of employees receive. One such benefit is generically named the supplemental executive retirement plan or SERP. These plans pay benefits to the extent that an employer's qualified plan cannot pay benefits to certain employees because of the limitations under the Internal Revenue Code.[43] The limitations under the Code are designed both to prevent employers from providing benefits to highly compensated employees[44] that are disproportionably more favorable than those provided to non-highly compensated employees as well as to limit the income tax deduction available for provision of the benefits. Failure to comply with these limitations could cost the employer hundreds of thousands of lost tax benefits. Examples of these limitations for 2004[45] include capping the annual benefit payable from a defined benefit plan to

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[39]Securities and Exchange Act of 1934 § 16(a), as amended by Sarbanes-Oxley Act, effective August 29, 2002, requires executive officers, directors and greater than ten percent stockholders ("insiders") to file Section 16 transaction reports "before the end of the second business day following the day on which the subject transaction has been executed."

[40]Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-46313 (August 6, 2002), at http://www.sec.gov/rules/other/ 34-46313.htm (last visited February 12, 2004).

[41]P. L. 107-204, 116 Stat. 745.

[42]Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1 (2000). One argument is that increasing the disclosure requirements may have the unintended effect of increasing compensation levels because it encourages more contingent pay with decreasing base pay. payment of compensation until after retirement when the executive is presumably in a lower tax bracket. In all cases, the supplemental benefits are non-funded liabilities subject to the claims of the employer's creditors. Ellig, *supra*, note 43. In addition, in order to avoid the funding, vesting, reporting, and other requirement of the Employee Retirement Income Security Act of 1975 (ERISA), the plan must benefit only a select group of management or highly compensated employees. ERISA § 301(1)(3), 29 U.S.C. § 1081(a)(3) (2000).

[43]BRUCE R. ELLIG, THE COMPETE GUIDE TO EXECUTIVE COMPENSATION (McGraw-Hill 2002) (hereinafter referred to as Ellig).

[44]Section 414(q) of the Internal Revenue Code defines a highly compensated employee as one who is a 5 percent owner in the current year or preceding year or one who earns compensation in excess of $80,000, as adjusted for cost of living increases. In 2004, that amount is $90,000.

[45]These limits are periodically adjusted to take into account cost of living increases.

$165,000,[46] limiting the amount of compensation that may be taken into account in calculating the benefit to $205,000,[47] and restricting the total amount that may be contributed into a defined contribution plan to the lesser of $41,000 or 100 percent of pay.[48]

As a result of these and other deterrents for providing benefits to executives through qualified plans, employers have set up parallel plans that replicate the benefits paid under the qualified plan, without regard to the limitations. If the SERP is properly constructed, employees have no immediate income tax consequences; however, the employer cannot take a tax deduction until the payouts are actually made at retirement and the employee recognizes income. One of the requirements for deferred tax recognition until the payment is actually made is that the benefit cannot be funded. This means that although a separate trust can be set up to hold the funds for the benefit of the executives, the trust is subject to the general creditors of the employer.[49] Unlike the assets of a qualified plan which are not reachable by either the employer's or the participants' creditors, nonqualified plan trusts offer executives no protection in the event that corporation becomes insolvent or bankrupt. Despite the inherent risks, SERPs are a popular method for providing executives with additional retirement benefits.[50]

Top executives at corporations often receive supplemental life insurance protection that pays higher life insurance to their families in the event of death. In some cases, the insurance is paid for entirely by the employer; however, due to the imputed income rules under IRC Section 79, providing supplemental life insurance can often cost the executive additional income tax on a benefit he or she does not receive until after death.[51] As a result, executive life insurance is often structured as a split dollar arrangement to avoid the implications of Section 79. Under a split-dollar plan, the employer and employee share insurance premium payments, death benefits and cash surrender values. Before a recent change in the treatment of these plans, a split-dollar life insurance plan deferred taxation to the employee on the yearly accumulation of cash

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[46]I.R.C. § 415(b)(1).

[47]I.R.C. § 401(a)(17).

[48]I.R.C. § 415(c)(1). In addition, amounts that may be contributed to a Section 401(k) plan on a tax deferred basis are limited to $13,000, with certain additional allowable amounts for participants over age 50.

[49]A trust established by an employer to provide the funds needed to satisfy the employer's obligation under a nonqualified benefit plan is generally referred to as a rabbi trust because the first IRS letter ruling addressing this type of trust involved a non-qualified plan implemented by a synagogue congregation for its rabbi. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). The ruling stated that the rabbi would not be taxed on the funds in the trust until the funds were distributed to the rabbi as provided in the plan. Later guidance was issued providing model language for rabbi trusts. Rev. Proc. 92-64, 1992-2 C.B. 422.

[50]Other types of arrangements providing for deferred compensation include add-on plans which pay out benefits in addition to those payable under qualified plans. They are typically reflected by a contractual agreement entered into by the employer and the executive and are designed to pay retirement benefits to make up for lost benefits to mid-career hires, to pay benefits on bonuses or other compensation not otherwise included in the calculation of retirement benefits, or simply to furnish executives which a higher level of income replacement than that provided for other employees. In some cases, the executive can elect to contribute to the plan by deferring a portion of his or her annual compensation, most often to delay the

[51]I.R.C. § 79(a) provides that insurance coverage in excess of $50,000 is includable in gross income. The value of the coverage is determined based on rates issued by the Internal Revenue Service. However, in the case of executive life insurance which is generally treated as discriminatory because it disproportionately benefits key employees as defined in I.R.C. § 416(i)(1), the amount includable in income is the greater of the amount determined using the IRS tables or the actual cost of the life insurance.

surrender value. In addition, taxes on any gain over basis were not due until the policy terminated. Effective January 1, 2004,[52] the employer and the employee may treat the transaction as if either the company or the executive owns the policy. If the executive is treated as the owner, then any payment of premiums by the company is treated as a loan and taxed under Section 7278 of the Code. If the company is treated as the owner, the executive must report and pay taxes on the value of the insurance benefit provided by the owner, using IRS published tables or the insurance carrier's term rate.[53]

Even though the value of these benefits can be very large, the SEC reporting requirements do not require disclosure of the actual amounts. All that is required is that the corporation report what the executive may receive under the plan based on the years of service and compensation taken into account. In the case of a deferred compensation plan, which allows executives to defer receipt of annual pay until after retirement, the company only has to report the difference between the market rate of interest and the actual interest credited to the executive.[54]

The final area of executive compensation is perquisites which refer to a broad range of benefits that are available only to the upper ranks of the organization. Perquisites often include membership in exclusive social or country clubs, use of company limousines or jets, tickets to sporting events, financial and estate planning, and vacations.[55] Over the past 20 or so years, Congress has diminished the attractiveness of many of these perquisites by either eliminating the tax deduction or requiring income be imputed to the recipients of these benefits. For example, effective January 1, 1994, companies may no longer deduct the cost of membership for any club organized for business, pleasure, recreation or social purposes.[56] Business meals are deductible but only up to 50 percent of their cost,[57] and private skyboxes are deductible only up to the fair value of non-luxury box seats.[58]

Other perquisites may be deducted by the employer but the value of the benefit must be included in the executive's income. For example, the personal use of a company-owned automobile is subject to income tax. If an executive is provided with an automobile having a fair market value of more than $59,999, an annual lease value must be included in income which equals (.25 × the fair market value of the automobile) + $500.[59] Executives and their families who use company aircraft for personal purposes will recognize income under a formula set forth in the regulations[60] which takes into account the distance travelled and the size of the aircraft. Executives are taxed at a higher

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[52]Treas. Reg. §§ 1.61-22, 1.7872-15; IRB 2003-46. For an explanation of the new regulations and their impact on executive insurance benefits, *see* Philip J. Straub, *What Have They Done to My Split Dollar Plan?*, at http://www.panamericanlife.com/news/june-2003/060203_splitdollar.asp (last visited February 20, 2004).

[53]The rates can be found in IRS Announcement 2001-10.

[54]Regulation S-K, 17 C.F.R. § 229.402(b)(2)(v) (2003). Components of compensation including pension plans, golden parachute payments, contributions to defined contribution plans, life insurance premiums, not reported elsewhere are reported in the "other compensation" column.

[55]Martoccio, *supra*, note 6.

[56]I.R.C. § 274(a)(3).

[57]I.R.C. § 274(n).

[58] I.R.C. §274(l).

[59]Treas. Reg. § 1.61-21(d)(2).

[60]Treas. Reg. § 1.61-21(g).

rate than other employees, but the taxable value is far less than the cost of chartering a private jet.[61]

Under SEC guidelines perquisites are reportable only when the total incremental cost to the company exceeeds $50,000 or 10 percent of the executives's annual compensation. If the total value of any one perquisite is in excess of 25 percent of the total amount of all perquistes reported, then additional disclosure of that benefit is required.[62]

III. EMPLOYER LOANS TO EMPLOYEES

Provision of below market loans is another perquisite that has received considerable attention in the past few years. At first blush, loans to executives appear no more excessive or abusive than other components of compensation. Loans between an employer and any employee above $10,000 are subject to tax under Internal Revenue Code Section 7872 which provides that any forgone interest must be treated as income to the employee. In addition, loans to executives must be reported in the proxy if the total amount of loans outstanding to a corporate executive exceeds $60,000.[63]

Despite the less than advantageous tax and reporting consequences of providing low-interest or interest-free loans to executives, the practice was fairly common among corporations. One report notes that over one-third of U.S. companies have outstanding loans to their executives, with the average loan amounting to $10.7 million.[64] Amid the corporate scandals which surfaced between 2000 and 2003, information revealed that executives had received loans from their companies amounting to millions of dollars which were later forgiven by the boards of directors. For example, WorldCom, Inc. forgave approximately $340 million owed to it by its CEO, which was previously borrowed to purchase the company's stock, plus and additional $165 million to cover the taxes.[65] The CEO of Tyco borrowed more than $7 million from the company to purchase a Manhattan apartment and received over $274 million in loans from 1997 to 2002 from the company's executive loan program.[66]

With the enactment of Section 402 of the the Sarbanes-Oxley Act of 2002, all corporate loans to top executives and directors are now illegal.[67] Provison of such loans could result in both civil and criminal penalties. This means that not only are the types of

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[61]In addition, if 50 percent or more of the passengers are traveling on company business, no imputed income is required. Treas. Reg. § 1.61-21(g)(12).

[62]Regulation S-K, 17 C.F.R. § 229.402(b)(2)(iii)(C)(1) (2003).

[63]Regulation S-K, 17 C.F.R. § 229.404(c) (2002)

[64]Paul Hodgson, *My Big Fat Corporate Loan*, at http://www.thecorporatelibrary.com/Governance-Research/spotlight-topics/spotlight/compensation/PH_BIGFAT-LOAN.html (last visited, March 23, 2004).

[65]The Wall Street Journal, Feb 8, 2002, at http://www.thecorporatelibrary.com/Governance-Research/news/2002/02_06_02.html (last visited March 23, 2004).

[66]Kathryn Stewart Lehman, *Executive Compensation Following the Sarbanes-Oxley Act of 2002,* 81 N.C. L. REV. 2115 (2003) (hereinafter referred to as Lehman).

[67]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-214, 116 Stat. 745 (July 30, 2002). Section 402(a) of the Act, 15 U.S.C. § 78m(k)(1) (West Supp. 2002) provides as follows: "It shall be unlawful for any issuer . . . directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer."

loans specifically targeted by Congress prohibited – loans for personal purposes and loans deemed to be particularly abusive such as the loans to WorldCom's and Tyco's CEOs[68] – but the law may bar other types of transactions viewed as less egregious.[69]

Reaction to Section 402 of Sarbanes-Oxley has been mostly positive.[70] Nevertheless, the overall impact of Sarbanes-Oxley calls for a restructuring of the compensation packages awarded to executives. In addition to ending the popular practice of extending personal loans to executives, other components of executive pay may be affected.

A large component of executive pay includes employer securities, typically acquired through exercise of stock options. In many cases, the executive will not wish to advance the cash to cover the option price. A method known as the cashless exercise is used which in effect allows the executive to "borrow" money from a broker to exercise the option with immediate repayment by the broker's sale of the shares.[71] It has been suggested that the employer in this case may be viewed as having "arranged for the extension of credit" virtue of its setting up the cashless exercise program with the broker.[72]

Similarly, in the case of split dollar life insurance programs, the IRS has taken the view that depending on how the arrangment is constructed, the company's payment of the premiumsmay deemed a loan to the employee.[73] Under a literal reading of Section 402, payments of premiums which are treated as loans would be prohibited for policies on the lives of executives.

IV. POTENTIAL TARGETS FOR FUTURE LIMITATIONS

However broadly the ban against corporate loans is interpreted, the enactment of Section 402 represents a clear change in the way Congress responds to critisisms regarding corporate governance and, in particular, executive compensation. Previously passed legislation requiring enhanced disclosure or reducing tax incentives has proved largely ineffective as a deterrent to escalating pay packages. Not satisfied with the effect of such prior measures,[74] Congress has sent a clear message to corporate America regarding its intentions to deal with abusive practices. One can only speculate what additional components of exeutive pay might be targeted for future elimination. It is suggested that items currently not subject to detailed disclosure might be particularly

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[68]*See* 48 CONG. REC. S6762 (statement of Senator Feinstein); 148 CONG. REC. S6690 (statement of Senator Schumer).

[69]It has been suggested that Section 402 may apply to bar split dollar life insurance arrangements, relocation advances, loans from 401(k) plans, and corporate credit cards. Lehman, *supra*, note 66; Sean A. Power, *Sarbanes-Oxley Ends Corporate Lending to Insiders*, 71 U.M.K.C. L. REV. 911 (2003) (hereinafter referred to as Power).

[70]Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough*?, 2003 COLUM. BUS. L. REV. 801.

[71]Ellig, *supra*, note 43, at 388.

[72]Power, *supra*, note 69.

[73]*See* note 52 and accompanying text *supra.*

[74]Apparently, Congress first considered requiring additional disclosure of corporate loans, but decided to adapt the bill proposed by Senator Shumer disallowing them altogether. Tyler M. Paetkau, *Employment Law Considerations Raised by Post-Enron, Sarbanes-Oxley Act of 2002,* at http://www.lawmemo.com /emp/articles/sarbanes.htm (last visited February 26, 2004).

suseptible. For example, non-qualified deferred compensation in the form of supplemental executive retirement plans are frustrating to shareholders because they represent huge liabilities to the corporation with little or no disclosure.[75] In fact, one could argue that any compensation paid to executives after they leave the company is not justifiable under any sound governance policy.[76] In addition to supplemental retirement benefits, a bar against compensating executives after they leave employment might cover golden parachute payments, deferred payments of salary or bonuses, continued insurance protection or continued provision of executive perquisites.[77]

Stock options have also attracted a lion's share of criticism, based on the arguments that they are not only excessive but are in no way related to the executive's contribution to the company.[78] During the 1990's when stock prices were escalating exponentially, it was not unheard of for executives to earn over $100 million in a single year.[79] With current share prices often below the exercise price for outstanding stock options, the opportunity to reap such benefits in the near future is not as great. However, it is not unthinkable that Congress might consider some type of cap on the level of earnings attributable to equity-based compensation. Under current securities law, certain corporate officers, directors and large stockholders are required to return to the corporation any profits they make on the purchase and sale of securities within a six-month period.[80] The rationale for this law is to prevent insiders from using privileged information for their own personal benefit. Arguably, the CEO and the top officers of the corporation may use their position with the company to garner approval of excessive compensation packages at the expense of less influential shareholders, thus justifying a return of earnings deemed excessive. A more compelling argument for outlawing stock options to executives can be made in the case of discounted stock options, defined as stock options with an exercise price below the current value of the underlying stock. These types of options are particularly disliked by shareholders because they minimize

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[75]S. Rep. No. 107-205, 107th Cong., 2d Sess. 29-30. *See* Morgenson, *supra*, note 19.

[76]Paul Hodgson, *Golden Parachutes and Cushioned Landings*, at http://www.thecorporatelibrary.net/ GoldenParachutes_022103.pdf (last visited, February 26, 2004). Countering the argument that golden parachutes are an essential recruitment tool, Hodgson notes that it "is a sorry state of the employment market indeed, if one of the primary considerations of an executive taking a position is that they will get paid when they are terminated." *Id.* at 2.

[77]Reports of former General Electric CEO Jack Welch's retirement package, which included access to corporate aircraft, use of an apartment in New York City owned by G.E., floor-level seats to the New York Knicks, courtside seats at the U.S. Open, satellite TV at his four homes and all the costs associated with his New York apartment, including dining bills at the restaurant Jean George, raised such a furor that Welch agreed to "give back" many of these perquisites. Geraldine Fabrikant, *G.E. Expenses for Ex-chief Cited in Divorce Papers*, at http://www.freerepublic.com/ focus/news/745429/posts (last visited February 28, 2004).

[78]Bebchuk & Fried *supra*, note 8.

[79]According to proxy statements on file with the SEC, the top earnings reported for fiscal year 1999 were as follows:

Person	Company	1999 salary + bonus	Long-term compensation	Total
Charles Wang	Computer Associates, Int'l	$4,600,000	$650,824,000	$655,424,000
L. Dennis Kozloski	Tyco International	$4,550,000	$165,446,000	$169,996,000
David Pottruck	Charles Swab	$9,000,000	$118,900,000	$127,900,000
John Chambers	Cisco Systems	$ 943,000	$120,757,000	$121,700,000
Stephen Case	America Online	$1,575,000	$115,510,000	$117,085,000

[80]15 U. S. C. § 16(b).

the incentive aspect of equity based compensation and are often viewed as "gifts" to executives.[81]

V. CONCLUSION

The Sarbanes-Oxley Act of 2002 has been called one of the most significant pieces of legislation since the securities acts of 1933 and 1934.[82] Whether additional bills will be passed further limiting the amount and types of compensation that may be paid to executives remains to be seen. What is clear is that Congress has shown a new decisiveness in addressing corporate abuses, an action that should not be ignored.

[81]Karrie. L. Bercik, *Memorandum Regarding Equity Participation Compensation Plans*, at http://www.taxcounsellor.com/Execcomp.html (last visited on March 30, 2004).
[82]Power, *supra*, note 69.

Appendix A
Summary Compensation Table

Name & Company	*Salary*	*Bonus*	*Other Annual Compensation*	*Restricted Stock Units*	*Options*	*Long term Incentives*
J.F.Smith General Motors	1,025,000	0	105,499	2,202,750	300,000	0
L.R.Raymond Exxon	3,250,000	2,160,000	103,884	17,320,000	0	297,960
S.J. Palmisso IBM	1,433,000	4,500,000	75,336	0	300,000	853,505
D.W. Dorman AT&T	1,080,797	2,000,000	490,683	0	1,247,416	0
H.L. Scott Wal-Mart	1,142,308	3,162,500	85,834	13,134,437	605,327	167,604
J. R. Immelt GE	3,000,000	3,900,000	49,093	525,000	1,000,000	6,693,300
P. M. Condit Boeing	1,547,308	982,800	169,879	903,405	0	0
E.S.O'Neal Merrrill Lynch	500,000	7,100,000	0	4,741,177	171,328	0
S. I. Weill Citigroup	1,000,000	0	556,610	0	1,044,229	2,286
C. B. Galvin Motorola	1,250,000	1,500,000	12,485	0	1,000,000	9,552