

## **ARTICLES**

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### **A MATTER OF TRUST, OR WHY “ERISA-QUALIFIED” IS “NONSENSE UPON STILTS”\*: THE TAX AND BANKRUPTCY TREATMENT OF SECTION 457 DEFERRED COMPENSATION PLANS AS EXEMPLAR**

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My propositions serve as elucidations in the following way: anyone who understands me eventually recognizes them as nonsensical, when he has used them as steps to climb up beyond them. He must, so to speak, throw away the ladder after he has climbed up it. He must transcend these propositions, and then he will see the world aright.<sup>1</sup>

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\* Jeremy Bentham, *Anarchical Fallacies; Being an Examination of the Declaration of Rights Issued During the French Revolution*, in 2 THE WORKS OF JEREMY BENTHAM

## I. INTRODUCTION

“I’ll gladly pay you Tuesday for a hamburger today,” Wimpy frequently promised Popeye.<sup>2</sup> If Popeye filed bankruptcy today, would Popeye’s estate include the money Wimpy promised to pay him next Tuesday? Or would Popeye’s estate include only the right to collect the cost of the hamburger next Tuesday?

Of course, Popeye might prefer to be paid next Tuesday for a variety of reasons, including, for example, that he is retiring next Monday or that deferring the income will produce advantageous tax treatment. Popeye’s waiting until next Tuesday requires, however, that he trust that Wimpy will be able and willing to fulfill the promise then. If Popeye does not trust Wimpy with what might be Popeye’s retirement nest-egg, Popeye might require (or lobby Congress to require) that Wimpy pay the money into a trust for Popeye’s exclusive benefit and free of Wimpy’s use and of the claims of Wimpy’s creditors. And if Popeye mistrusts his own prudence or luck, he might want the trust assets to be free from the claims of his own future creditors. It’s a matter of trust.

Thus cast in terms of the problem of second performance (also called the time inconsistency problem) and with a little knowledge of nonqualified deferred compensation arrangements, the transaction between Popeye and Wimpy might look like this: Popeye performs services (cooking the hamburger) for Wimpy, who promises Popeye deferred compensation. Wimpy pays the compensation into a trust, administered by a third-party, the corpus of which he cannot voluntarily transfer, but the trust is subject to the claims of Wimpy’s general unsecured creditors. Alternatively, Wimpy might pay the compensation into a trust created exclusively for Popeye’s benefit, Popeye’s interest in which is itself subject to an enforceable anti-alienation clause.

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2. ELZIE CRISLER SEGAR, THIMBLE THEATER, INTRODUCING POPEYE: A COMPLETE COMPILATION OF THE FIRST ADVENTURES OF POPEYE, 1928-1930 (1977); see also *Chevy Chase Bank, F.S.B. v. Briese (In re Briese)*, 196 B.R. 440, 450 (Bankr. W.D. Wis. 1996) (analogizing a § 523(a)(2) action for nondischargeability of credit card debt to Wimpy’s promise).

If Popeye were to file bankruptcy today, his estate would not include the money under either scenario. In the first scenario, Popeye's estate would include the promise but not the money because the money still belongs to Wimpy (and, if Wimpy files bankruptcy, to Wimpy's estate). In the second scenario, Popeye's interest in the trust would be excluded from his estate by the operation of § 541(c)(2) of the Bankruptcy Code. Internal Revenue Code § 457 plans can be analyzed the same way; plan assets are—or should be—included or excluded from a participant's estate for the same reasons. To see why, we must take a detour through the Employee Retirement Security Act of 1974 (ERISA)<sup>3</sup> and tax law, after which it should be apparent that neither ERISA nor tax law matters.

According to relatively recent statistics, state and local government retirement systems account for more than one dollar in five of the total value of the nation's retirement market<sup>4</sup> and for about thirty percent of the total financial assets of employment-based retirement plans.<sup>5</sup> There are approximately 22 million active and inactive participants and beneficiaries of state and local retirement systems.<sup>6</sup> According to the National Association of Counties, the employees of some 1,900 counties participate in § 457 plans associated with the Association's deferred compensation program.<sup>7</sup> Perhaps of more immediate concern to some readers, who are no doubt law professors, is the fact that § 457 plans are offered by both public<sup>8</sup> and private universi-

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3. Pub. L. No. 93-406, 88 Stat. 829 (1974). Although ERISA included both labor provisions and tax provisions, common usage of the term generally excludes the tax provisions of title II of the Act. I follow custom by using the term "ERISA" to refer to the labor provisions.

4. Employee Benefit Research Inst., *Facts from EBRI* (Sept. 2002), available at <http://www.ebri.org/facts/0902fact.pdf> (last visited Oct. 25, 2003) (reporting, for 2001, \$2.18 trillion in retirement plan assets of state and local governments and \$10.69 trillion total retirement plan assets, including also private-trusted defined benefit (\$1.85 trillion) and defined contribution (\$2.11 trillion) plans, individual retirement accounts and Keough plans 789 -]TJ12.50plansounts ting, for 2001, \$2.18 trillion in retirement plan assets of state and local governments and \$10.69 trillion total reti

ties.<sup>9</sup>

It is difficult to say how many participants in such plans find their way into bankruptcy. Sullivan, Warren, and Westbrook's Consumer Bankruptcy Project Phase II, which contains data on a sample of debtors from 1991, lists occupations that are necessarily local or municipal jobs, such as police officer or correctional officer, occupations that probably are local or municipal jobs, such as teacher, bus driver, social worker, case worker, or community services aide. Some debtors specified that they worked for a city or for the police or street department or parks district. For others, who list their occupations as shipping clerk, custodian, telephone operator, or secretary, there is no way to tell how many participate in § 457 plans.<sup>10</sup> Suffice it to say that a significant number of debtors may participate in § 457 plans.

Despite the economic prominence of state and local retirement systems, bankruptcy scholars who have focused on the relationship between bankruptcy and employees' pension rights have generally discussed the rules that are applicable primarily in the private, for-profit sector. This Article focuses instead on one kind of arrangement—the § 457 plan—that is available only to state and local governments and to charities and how pensions should be analyzed when employees of those employers file bankruptcy.

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9. See, e.g., Priv. Ltr. Rul. 88-13-026 (Apr. 1, 1988).

10. Professors Sullivan, Warren, and Westbrook have graciously shared their database with me. The descriptions of debtors' employment are the result of Professor Sullivan's diligent efforts. A description of the database and the methodology used in its formation can be found in TERESA A. SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* 263-82 (2000).

It may bear noting that a divergence in the bankruptcy rules for ERISA pensions (which predominate in the private, for-profit sector) and § 457 plans (available only to state and local governments and to charities) may disparately affect debtors according to race and sex because women and members of some minority groups are more dependent on government- and non-profit-sector employment than are white males. See, e.g., LYNN C. BURBRIDGE, *GOVERNMENT, CENTER FOR RESEARCH ON WOMEN, FOR-PROFIT, AND THIRD-SECTOR EMPLOYMENT: DIFFERENCES BY RACE AND SEX, 1950-1990* 23-24, 119-20 (1994). Women and minorities also comprise a larger percentage of full-time employees of state and local governments than they do of full-time employees in the private sector. See U.S. EQUAL OPPORTUNITY COMM'N, *INDICATORS OF EQUAL EMPLOYMENT OPPORTUNITY—STATUS AND TRENDS* 6-9 (2000). It *might* be that because there are more women and minorities in the sectors in which § 457 plans are available, an interpretation of § 541(c)(2) that prevents a § 457 plan participant from keeping her pension while shielding an "ERISA-qualified" plan from bankruptcy would tend to



bankruptcy courts may profitably ignore the tax code entirely and virtually all of ERISA. Bankruptcy courts should instead look directly to applicable substantive law with which they have greater familiarity and facility.