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. 1


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1. LUDWIG WITTGENSTEIN, TRACTATUS LOGICO-PHILOSOPHICUS § 6.54, at 189 (C.K. Ogden ed. & trans., 1922). To the extent the ladder in this Article is tax law, I would expect some or most readers to reply: “Anything that I might reach by climbing a ladder does not interest me.” LUDWIG WITTGENSTEIN, CULTURE AND VALUE 7e (G.H. von Wright ed., Peter Winch trans., 1984). Or, to the extent my positions seem at odds with most case law, to offer the advice: “Don’t concern yourself with what, presumably, no one but you grasps!” Id. at
I. INTRODUCTION

“I’ll gladly pay you Tuesday for a hamburger today,” Wimpy frequently promised Popeye. 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.

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) 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 and for about thirty percent of the total financial assets of employment-based retirement plans. There are approximately 22 million active and inactive participants and beneficiaries of state and local retirement systems. 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. 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 and private universi-

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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-trusteed defined benefit ($1.85 trillion) and defined contribution ($2.11 trillion) plans, individual retirement accounts and Keough plans ($2.40 trillion), private insured plans ($1.34 trillion), and federal government plans ($811 billion)).


ties.\footnote{See, e.g., Priv. Ltr. Rul. 88-13-026 (Apr. 1, 1988).}

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.\footnote{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 \textit{Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, The Fragile Middle Class: Americans in Debt} 263-82 (2000).}

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.

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., \textit{Lynn C. Burbidge, 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 \textit{U.S. Equal Opportunity Comm’n, Indicators of Equal Employment Opportunity—Status and Trends} 6-9 (2000). It \textit{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 favor white males and disfavor others. Such a hypothesis, although plausible, is speculative. I am unaware of any data about debtors that could be used to address the question.
The purpose of this Article is to examine the term “ERISA-qualified” through the lens of § 457 plans (certain deferred compensation plans of tax-exempt governmental entities and public charities). These plans are neither “qualified” nor generally subject to ERISA. Nonetheless, they contain many attributes essentially identical to qualified plans and to plans governed by ERISA. By examining § 457 plans, I hope not only to assist courts and bankruptcy attorneys in dealing with § 457 plans, but also to make several suggestions with regard to “ERISA-qualification.” In Part II, I discuss the decisions about § 457 plans within the context of bankruptcy case law on deferred compensation generally. In addition, I discuss the origins and operation of nonqualified deferred compensation, and show how § 457 plans evolved out of rules of nonqualified deferred compensation taxation that depended on state law. I suggest that state law is the only law that bankruptcy courts need consider in addressing whether § 457 plan assets are property of a participant’s estate. In Part III, I examine bankruptcy decisions that have analyzed the inclusion, exclusion, and exemption of § 457 plan assets in a variety of ways, and offer a critique of those I consider wrongly decided. Part IV offers a summary of the argument and suggests an extension of the argument that is relevant to the proper interpretation of Patterson v. Shumate.

As to this Article’s general applicability to deferred compensation in bankruptcy, I hope the approach that I offer to § 457 plans suggests the possibility of similar analysis for ERISA plans. First, I adumbrate that conditioning the exclusion of plan assets from the bankruptcy estate based on whether the plan is “ERISA-qualified” makes no sense whether “ERISA-qualified” means qualified under the tax code or conforming to ERISA. Second, I suggest that the tax and ERISA rules on which bankruptcy courts rely are themselves evolved out of the substantive state law of ownership that still applies to a greater extent in § 457 plans. I1 conclude, therefore, that in determining whether deferred compensation is property of the estate,

11. At no point in this Article do I address what Professor Dilley properly identifies as a “more important question”: “[S]hould pension trusts be protected from creditors at all?” Patricia E. Dilley, Hidden in Plain View: The Pension Shield Against Creditors, 74 IND. L.J. 355, 387 (1999). For another policy perspective, see Sharon Reece, The Gilded Gates of Pension Protection: Amending the Anti-Alienation Provision of ERISA Section 206(d), 80 OR. L. REV. 379, 403-04, 415-35 (2001). I do not aspire to improve on their treatments and content myself here with a traditional exposition of doctrine.
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.