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Corporate Heroin: A Defense of Perks

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Abstract: *We argue that firms undertake to reduce employee savings in order to avoid final period problems that occur when employees accumulate enough wealth to retire and leave the industry. Normally, reputation constrains employee behavior, since an employee who "cheats" at one firm will then find herself unable to get a job at another. However, employees who have saved such that they no longer care about continued employment will act opportunistically in the final periods of employment, which can destroy much or all of the surplus otherwise created by the employment relationship. We believe that this sort of final period cheating creates significant problems for employees in positions of delicate trust, particularly those with a large variable compensation component, such as corporate CEOs, securities professionals, and even corporate lawyers.*

Payment in-kind (perks), deferred compensation (corporate loans), and the encouragement of employees' conspicuous consumption—either through screening, inculcation, or signaling—are strategies that firms enact to combat this final period problem of employee cheating. Employees who reduce savings are more reliable over the long term than employees who do not, since reduced savings makes employees more dependent upon remaining employed into the future; these employees will invest in their reputations by engaging in less cheating. We make an analogy to drug dependency: the employee who consumes all her resources immediately enjoys large present utility, as does the addict, but is ultimately dependent on the firm to provide her with the same opportunities in the future. Applying the theoretical framework we develop to the real world can help explain much of observable behavior and compensation practice.

Thus, far from being prima facie evidence of corporate fraud—the picture painted by the media, academia, and prosecutors at recent corporate trials—high levels of in-kind compensation, corporate loans, and personal consumption may be evidence of optimal incentivization, where principal and agent have contracted (explicitly or implicitly) for just the amount and type of remuneration that maximizes their joint welfare.

[†] Forthcoming, Georgetown Law Journal, 2005.

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Table of Contents

> **"**[Flying by private jet] is like heroin: it's so good, you shouldn't even try it once. But this is what the life of top executives of public companies is like—not only in air travel, but in terms of limos and hotel suites and never waiting in lines and getting courtside tickets to N.B.A. games and never having to worry about how much anything costs because the shareholders are paying for it all."—Ben Stein[1]

I. Introduction

Corporate perks and greed are bad, so says the conventional wisdom. They are, at the best, inefficient motivators, and, at the worst, they enable and encourage theft of shareholder property. This view is widely shared by academics in economics, business, and law, as well as prosecutors, the media, and the public at large. According to the mainstream view, the perquisites and obscene spending habits of investment bankers or CEOs of public companies are evidence of a failure of corporate governance and government regulation, and proof of the rot and waste of corporate America. In the

[1] Ben Stein, *Climbing Above It All (in a Private Jet, of Course)*, N.Y. TIMES, June 20, 2004, § 3, at 5.

academic lingo: high levels of noncash compensation are often viewed as evidence of large agency costs within a firm, and justification for regulation or corporate governance reforms. The recent cover of Forbes magazine summed up the prevailing attitude: "Have They No Shame? How Self-Dealing Fat Cats Still Dump on Investors."[2]

Prosecutors have attempted to capitalize on this view in recent high-profile corporate fraud cases. For example, in the trial of Dennis Kozlowski, former chief executive of Tyco, evidence of Kozlowski's lavish lifestyle and exorbitant expenditures, often purchased with company money but for his benefit, took center stage. A $15,000 poodle-shaped umbrella stand, a $6,000 shower curtain for the maid's bathroom, a $2 million birthday bacchanalia in Sardinia replete with loin-cloth clad Roman "slaves" and an ice-sculpture of Michelangelo's David urinating liquor—you name it, at some point Kozlowski purchased it, or, rather, Kozlowski had Tyco purchase it, or lend him the money to do so.[3] The intended implication of all this profligate consumption, from the prosecution's point of view, was that Tyco was a company out of shareholders' control but firmly in Kozlowski's pocket, and open to his machinations, expropriation, and abuse.[4] The fact that these purchases were extravagances on which Kozlowski would not have spent his own money was meant to illustrate their unreasonableness, and to make it appear more likely that, later on when Kozlowski was granted hundreds of millions of dollars in cash compensation and loan forgiveness, this was an act of corporate looting by an insatiable, out-of-control glutton. The repulsion at this corporate greed was not confined to the courtroom, but permeated subsequent academic accounts as well: as one commentator recently stated, "[t]he Sardinian soiree serves as a fitting emblem of what will likely be remembered as one of the greatest periods of corporate excess in American history."[5]

So, exorbitant lifestyles and company perks can carry a negative implication in the minds of jurors investigating alleged fraud after-the-fact, helping to establish "guilt

[2] Elizabeth MacDonald, *Crony Capitalism*, FORBES, June 21, 2004, at 140-6.
[3] See Mark Maremont, *Executives on Trial: Next Evidence for Kozlowski Jurors: The Party Video*, WALL STREET J., October 28, 2003, at C1; Colleen DeBaise, *Executives on Trial: Newest 'Tyco Gone Wild' Video Is Out, And Jurors See $6,000 Shower Curtain*, WALL STREET J., November 26, 2003, at C1; D. Polek, *The Rise and Fall of Dennis Kozlowski*, Businessweek 12/32/02 at 64
[4] See *id*.
[5] Note, *Developments in the Law – Corporations and Society*, 117 HAR. L. REV. 2169, 2173-74 (2004).

by ostentation."[6] At least, this is what the prosecution in such cases hopes.[7] Corporate reformers—in the academy, at pension funds, in Congress, and at the SEC—also took the negative view of corporate loans and perks in the wake of the recent corporate scandals, believing that they were the symptom of a larger corporate governance disease. But is this the correct implication? There is a competing vision of corporate "excess" that we still see, even in the post-Enron world. The Wall Street Journal occasionally carries reports, when economic times are good, of lavish expenditures by successful executives and investment bankers, such as a Learjet stocked with Jack Daniel's and Cookie Crisp to fly with friends to the Super Bowl, a wedding at the Palace of Versailles, or, of course, the usual Ferraris, Porsches, and Roll-Royces.[8] And when times turn bad, the Journal strikes a tone of lamentation as perks and conspicuous consumption decline.[9] Overall, there is bemused approval of excess, rather than puritanical disdain. While it easy to dismiss these articles as appealing to the ego of Wall Streeters or the voyeuristic interests of the masses, they contain, perhaps, an appreciation that such conspicuous consumption is a barometer of a well-functioning economy, and that corporate jets and one-thousand dollar bottles of wine are important parts of the compensation mix for high-powered individuals. While we might not go so far as to accept the unqualified maxim of Gordon Gecko (Ivan Boesky's fictionalized alter-ego) that "greed is good,"[10] there does seem to be an extent to which the desire on the part of some individuals to accumulate wealth in order to enjoy prodigious amounts of consumption is socially beneficial. After all, why else would anyone ever work the hours required of investment banking or corporate law

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[6] *See* Stephen Bainbridge, Guilt by Ostentation, available at http://www.professorbainbridge.com/2004/04/guilt_by_ostent.html

[7] This certainly appears to be the case in the Stewart and Kozlowski trials. *See* Leslie Eaton, *Web of Friends and Business Blurs Stewart's Glossy Image*, N.Y. TIMES, February 29, 2004, at __; Alex Berenson, *Overcompensating: In Fraud Cases, Guilt Can Be Skin Deep*, N.Y. TIMES, February 29, 2004, at __. *See also* Barry Meier, *Looking to Add a Bit of Glamour to Adelphia Trial*, N.Y. TIMES, March 8, 2004, at __ (describing the prosecution's attempts to show the Rigas family greedily used Adelphia resources for their own purposes, such as chartering the corporate jet to transport a Christmas tree).

[8] *See* Gregory Zuckerman & Cassell Bryan-Low, *With the Market Up, Wall Street High Life Bounces Back, Too*, WALL STREET J., February 4, 2004, at A1. Similar pieces over the years: Patrick McGeehan, *Now Suddenly Rich, Wall Streeters Spark a Very Fancy Boom*, WALL STREET J., April 10, 1997 at A1; George Anders, Paul Blustein & Patricia Bellew Gray, *Inside Wall Street: Merger Whiz Kids: Wall Street Prodigies Seek Money and Power as They Build Careers*, WALL STREET J., June 2, 1986, at __.

[9] *See* Anita Raghavan, *Nickel and Dimed: Wall Street Sweats the Small Stuff*, WALL STREET J., October 27, 2003, at A1; Wrin White & Teri Agins, *Sellers of Big Ticket Items Brace for Less Splurging*, WALL STREET J., October 2, 2001, at B1; Mitchell Pacelle, Wendy Bounds, & Suein L. Hwang, *The Market Bounceback: When Stocks Shimmy, New York Shakes*, WALL STREET J., October 29, 1997, at __.

[10] WALL STREET (20th Century Fox 1985).

if not to spend the occasional forty-five minutes of free time savoring a five hundred dollar lunch at Le Bernardin?

Branching off from that basic intuition, we explore how perks, corporate loans, and conspicuous consumption may actually work in the firm's best interest. We believe that, by reducing employee savings, these compensation mechanisms allow the firm to *reduce* agency costs and maximize the value of the employment relationship: they force-feed the employee consumption, at the expense of savings, which fosters dependence upon the firm and subjects the employee to the threat of retaliation for misbehavior in the future. More specifically, a reduction in savings makes the employee a "repeat player," and can therefore deter "cheating"—actions by the employee that enrich her while harming her employer—while also improving employee retention.

Consider, first, an employee who saves her money: savings enables the employee to retire or downshift her career to a less high-powered industry where her reputation may not follow her.[11] With enough savings, the employee no longer cares whether she remains employed or not, rendering toothless the firm's chief incentivization tool, the ability to fire the employee and blackball her from future employment. When savings is great enough, there is no reason not to cheat: with enough savings in hand, the employee simply does not care whether she is fired and blackballed from other firms; she has become immune to reputational constraints on her behavior.[12] In these cases, the employee and her firm face a "final period problem," where the employee has no incentive to refrain from cheating. This can destroy much of the surplus from the employment relationship.

So what should the firm do? We argue that the firm will do what it can to reduce employee savings, and we identify several mechanisms for reducing savings that firms actually utilize, which either reduce the amount of cash the employee receives on the front end, or else, on the back end, increase the employee's spending and consumption. On the front end, the firm has essentially two choices: first, payment in deferred cash, better known as corporate loans, and, second, payment via in-kind transfers, better known as perks. Deferred compensation, such as loans that will be forgiven in the future if the

[11] For example, if an investment banker saves enough wealth to retire to the Bahamas, her reputation in the investment banking world simply does not matter to her any more.
[12] In Wall Street patois, this is referred to as "fuck-you money."

firm determines that the employee has not cheated, provides a useful carrot and stick to deter cheating, but has limitations because of difficulties in observing and verifying outcomes and in drafting and enforcing complete contracts.[13] Perks, on the other hand, are not subject to limits on the ability to contract, since they involve simply the transfer of a good or service, along with the firm's ability to fire. For example, front-row Knicks tickets are used up right away, and an employee who receives them in lieu of some amount of cash will not, *ceteris paribus*, be able to save as much, making her more dependent on the firm into the future. Perks have the advantage of leveraging upon the firm's ability to fire at will the misbehaving employee; no contract is required. As with deferred cash, there is a limit to how cost effective perks can be, since employees will always (absent the productivity, status, and tax considerations discussed in Part II) prefer cash to the same dollar amount of perks.

On the back end, firms have several strategies at their disposal to encourage their employees to save less or desire more. First, the firm can invest in hiring-stage sorting, attempting to identify and hire employees with a high degree of enjoyment for money and consumption—that is, firms will look for "greedy" people. Second, by plying them with perks, the firm can inculcate in its employees a taste for luxury and high consumption, so that employees become "addicted" to increasingly more expensive lifestyles—the famed "golden handcuffs." Third, a firm can "force" employees to consume at higher levels through signaling games, where the employee signals her loyalty to the firm by spending her wage in a certain way.

One might (and we do) make an analogy to drug dependency: the employee who consumes all her resources immediately enjoys large present utility, but is ultimately dependent upon the firm to provide her with the opportunity to enjoy similar consumption in the future. It is as though the employee were paid with heroin rather than with cash: all the employee's resources are converted into immediate utility, leaving the employee wanting more as soon as the current round of consumption wears off. The source of her next "fix," of course, is her employer, and so she lives hand-to-mouth and

[13] As discussed herein, a deferred compensation arrangement is essentially a contract between the firm and employee that states that the employee will refrain from cheating in the future. Deferred compensation arrangements are thus subject to limits on the ability to draft and enforce contracts.

remains dependent upon the firm from one period to another.[14] The addictive quality of these compensation mechanisms is value-adding: greedy employees are (somewhat counter-intuitively) more trustworthy than ascetic ones, as the desire for high consumption motivates performance and loyalty in demanding or unpleasant jobs that no one would persist at for long.

Thus, "outrageous" perks and spending habits may be signs of a well-functioning labor market for high-valued employees, not necessarily misappropriation of shareholder resources or shortcomings of character; in contrast, a high level of cash compensation and savings may suggest sub-optimal incentivization packages, and can be symptomatic of executive over-reaching. In other words, what is commonly believed to be evidence of large agency costs is actually an effective way to *reduce* the agency costs inevitable in the modern American firm. Counter to the mainstream media and academic accounts, high levels of corporate loans, in-kind compensation, and extravagant consumption may be evidence of optimal incentivization, where principal and agent have contracted (explicitly or implicitly) for just the amount and type of remuneration that maximizes their joint welfare.

Applying this theoretical framework to the real world can help explain much of the observable behavior and practice in high-compensation and high-variable pay industries (such as upper corporate management, investment banking, and corporate law), and can also help to distinguish between "good" and "bad" compensation practices. Furthermore, we argue that these beneficial forms of compensation may in fact be significantly underprovided from a social welfare perspective, since reduced savings deters not just present period cheating but also past and future cheating at other firms, leading individual firms to free-ride. Thus, while perks, corporate loans, and conspicuous consumption are not without their downsides, there are valid arguments for granting them favored treatment.

This paper proceeds as follows: Part II briefly surveys the existing literature on perks and conspicuous consumption, including a discussion of the possible productivity, organizational, and tax benefits of perks that has, heretofore, largely been absent from the

[14] There is, of course, a dark side to drug addiction, and we believe there may, similarly, be a negative side to perks and conspicuous consumption. We discuss these and address normative concerns in a later part of the paper.

legal literature. This Part broadly addresses all types of perks—including run-of-the-mill, nonextravagant perks—many of which are provided for reasons other than to reduce savings and buttress reputational constraints. We include discussion of these perks, which are only somewhat related to our core argument, to provide a more comprehensive treatment of the general subject of perks, which is highly negative and one-sided in the existing literature. Focusing more narrowly on the core puzzle we try to solve, Part III describes potential weaknesses in the reputation constraint in certain industries where effort and quality are not immediately observable, and illustrates how high levels of savings may lead to final period problems and increased agency costs. Part IV explores how in-kind compensation and corporate loans can be used to prevent reputational failings caused by high savings, as well as how prehire sorting, inculcation of preferences, and signaling via corporate culture can further align the incentives of firm and employee. Part V discusses normative implications of this theory, including the dark side of "corporate heroin" and appropriate policy reforms. Part VI concludes.

II. The Conventional Wisdom

A. The Critics

The prevailing wisdom among corporate observers is that perks are bad (especially "excessive" perks, although "excessive" isn't typically defined). There are two primary objections. The first is that the separation of ownership and control—the classic "agency problem"[15]—allows greedy executives to steal from the cookie jar while diffuse and distant shareholders remain indifferent or unable to stop them. In this view of the world, perks are an example of "stealthy" compensation that shareholders have more difficulty observing or preventing, and therefore high levels of perks suggests weak corporate governance.[16] The second objection is that perks are inefficient and perhaps counterproductive incentives for employees.

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[15] Adam Smith in The Wealth of Nations first described the different and conflicting incentives of ownership and management. See ADAM SMITH, THE WEALTH OF NATIONS, ___ (____). The modern theory was extended by the work of Berle and Means, see ADOLF BERLE & GARNIDER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, ___ (1932), and Jensen and Meckling, *see* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS, 305-360 (1976).

[16] *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, NBER Working Paper Series, Working Paper 9813, at 10-11 (July 2003), available at

To the first point, most academic discussions of employment incentives cast perks in a highly negative light. A quick search of legal journals on WESTLAW yields over 100 articles in the past three years discussing perks, and all of these articles view perks as evidence of, at best, an unavoidable, value-destroying cost of the corporate form with its separation of ownership and control, and, at worst, managerial misbehavior. George Triantis describes the weak form of criticism as an agency problem, with perks being evidence of inevitable slippage in the corporate gears: "Managers enjoy private benefits [in the form of perquisites] that are not shared by other investors because of their control over decisionmaking."[17] Lucian Bebchuk and Christine Jolls extend this thinking a bit, claiming that perks are presumptively evidence of high agency costs because executives often "provide themselves with various perks not germane to their responsibilities."[18] Likewise, Harvard Business School professor Brian Hall links perks and waste: "Without incentives tied to shareholder value creation . . ., top executives may face stronger incentives to . . . purchase excessive perquisites that are privately beneficial but value-destroying (to both society and shareholders)."[19] The accepted wisdom is that perks "are attractive to management but are of no interest to shareholders" and in fact are "value destroying."[20]

A more strident criticism—the managerial misbehavior view—surfaced recently in the wake of the allegation of spectacular fraud at Enron, WorldCom, and several other firms. Dozens of recent legal articles have itemized a litany of alleged corporate excesses

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http://www.nber.org/papers/w9813 (noting that the grounds for offering perks are unclear, and that the primary purpose is "to make [the amount of executive] pay less salient.").

[17] George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, __ HARV. L. REV. __ (2004).

[18] Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J. L. ECON. & ORG. 487, 487-8 (1999).

[19] Brian J. Hall, Incentive Strategy II: Executive Compensation and Ownership Structure, HAR. BUS. REV. Reprint 9-902-134, 12 (Oct. 11, 2002).

[20] ____, *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital*, 39 TEX. J. BUS. L., 1, 27 n. 69 (2003). A recent empirical study by David Yermack concludes that "CEOs' personal use of company aircraft is associated with severe and significant under-performance of their employers' stocks." David Yermack, Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns, at 3, unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=529822. Yermack conjectures that "these managers run their firms inefficiently, tolerating waste, excess overhead, or uncompetitive cost structures." An alternative interpretation of his result is, we think, that granting the CEO use of the corporate jet is an attempt by the compensation committee to address a potential cheating problem that looms on the horizon, which the perk is an attempt to ward off. The fact that perks are correlated with the potential for cheating does not mean that perks cause the problem, just as it would be incorrect to conclude that the administration of medicine is symptomatic (or even causative) of a disease.

at these firms, and presented this as evidence of a kind of rot rampant in American corporate governance. The picture these scholars paint is one of greedy CEOs motivated by pure self-interest and focused more on creating a lavish lifestyle for themselves than shareholder value. A recent article tellingly entitled "Are Corporations Evil?," makes the typical academic link between perks and fraud: "The particulars of each case are unique, but certain elements remain constant [including] outrageous perks for insiders . . ..."[21] The search for causes of frauds at Enron, WorldCom, and other firms is a cottage industry whose main output seems to be what could only be described normatively as an anti-greed view of corporations. For example, John Coffee blames Enron's downfall on the moral and ethical lapses of management, calling the culture infused with "infectious greed."[22] And the most comprehensive treatment of the Enron bankruptcy blames Enron's collapse on "a culture of excess," evidenced by "a fleet of corporate jets, limousines . . ., and . . . concierge [services]."[23] None of these articles examines perks in depth or offers any potential counter arguments as to why they might be evidence of a rationally efficient employment contract.

The ineffectiveness of perks is another popular refrain in the academic literature, although this argument is found primarily in the management and finance journals. The main argument here is that perks "typically undermine the very processes they are intended to enhance"[24] by creating employees who are primarily motivated by their own interests and are subjected to (supposedly) hostile environments of reward and punishment. This view is premised on the belief that rewards and punishment are different sides of the same coin, and that the use of perks creates "a workplace in which people feel controlled," and "that experience of being controlled is likely to assume a punitive quality over time."[25] Perks are typically referred to as "bribes," and critics point to anecdotal evidence suggesting that companies suffer a backlash from incentive-rich

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[21] Douglas Litowitz, *Are Corporations Evil?*, __ UNIV. MIAMI L. REV. __ (2004).
[22] John C. Coffee Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 269-71 (2003).
[23] BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON, 122-3 (2003).
[24] Alfie Kohn, *Why Incentive Plans Cannot Work*, HAR. BUS. REV., Reprint 93506, 2 (Sept.-Oct. 1993).
[25] *Id* at 5.

environments.[26] Rather bleakly, these scholars describe perk-rich companies as plagued by "a hoard of incentive-driven individuals trying to curry favor with the incentive dispenser," and predict doom—or at least under- or improperly motivated employees.[27] Here again, the implication is that greed is bad, and that perks and conspicuous consumption are *prima facie* evidence of high agency costs or some sort of corporate mismanagement or wrongdoing.[28]

The typical solution offered by these scholars involves linking pay to seniority[29] or other group-based metrics[30] or a focus on "intrinsic human motivations," with fuzzy concepts like "[s]atisfaction and respect" being the best incentives for high performance.[31] Compensation experts offer vague recipes for motivation, such as Alfie Kohn's "Three C's" framework: choice, collaboration, and content, with a focus on "empowering" workers and creating a "happy" work environment, or rely on inchoate notions of "'enlightened' self-restraint of managers" or "strong ethical norms."[32] These proposed solutions turn Adam Smith's suggestion to rely on the self interest (not the benevolence) of the butcher or the baker[33] on its head:

> [T]he corporation's reward structure, or individual self-interest, should not be perceived as the prime employee motivator. . . . While individual self-interest is a given, the institutional structure of the corporation should

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[26] Colloquy, Rethinking Rewards, HARV. BUS. REV., Reprint 93610, 7 (Nov.-Dec. 1993) ("But the more they [give] you, the more they think they own you.").

[27] *Id* at 6. See also EDWARD DECI & RICHARD RYAN, INTRINSIC MOTVATION AND SELF-DETERMINATION IN HUMAN BEHAVIOR, __ (1985).

[28] A few legal articles express a sort of puzzlement at the size and scope of perks typical in corporate America. *See, e.g.,* Stewart J. Schwab & Randall S. Thomas, What Do CEO's Bargain For?: An Empirical Study of Legal Components of CEO Employment Contracts, Vanderbilt Law & Economics Working Paper No. 04-12, unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=529923. Schwab and Thomas describe the litany of perks in CEO employment contracts – such as use of company aircraft, country club memberships, and company cars – and then express their disbelief that CEOs need any perks at all: "Given the very large amounts of money that these executives already earn for their efforts, we are surprised that companies are willing to offer them such a wide range of perqs [sic] of this nature." *Id* at __.

[29] This is, in fact, a deferred compensation mechanism, as we describe in Part IV.A.

[30] *See, for example*, Egon Zehner, *A Simpler Way to Pay*, HARV. BUS. REV., 3-9 (Apr. 2001) (describing how seniority-based pay at large consulting firm reduced turnover to 2% compared with industry average of 30%).

[31] Colloquy, Rethinking Rewards, HARV. BUS. REV., Reprint 93610, 6 (Nov.-Dec. 1993).

[32] Brian J. Hall, *Incentive Strategy II: Executive Compensation and Ownership Structure*, HARV. BUS. REV., Reprint 9-902-134, 11 (Oct. 11, 2002) ("[S]trong ethical norms and behaviors represent an important and powerful check on necessarily imperfectly designed and enforced incentive schemes.").

[33] See ADAM SMITH, THE WEALTH OF NATIONS, ___ (____) ("It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest.").

> encourage and validate an attitude of caring for the corporation's stakeholders and persons affected by the corporation's decisions.[34]

No plan to change human nature to achieve enlightened benevolence is typically offered.[35]

Similarly, the sort of conspicuous consumption—even when purchased on the employee's own dime—that we discuss in this paper has not been well-regarded in the legal journals or case law.[36] The grotesquely inflated appetite of high-powered individuals for extravagant consumption is usually regarded as crossing the line from legitimate self-interest into myopic greed.[37] In a survey of "greed" in the case law, Eric Posner recounts that courts, while recognizing that some degree of greed may be useful and necessary to a well-functioning market,[38] regard gluttonous, short-sighted behavior of the sort in which corporate CEOs and Wall Street securities professionals regularly indulge as undermining capitalism in general.[39] In short, "[c]apitalism needs moderation, not excess, . . . self-interest, not greed."[40] Lynn Stout goes even farther, arguing that purely self-interested actors, without the behavioral checks of ingrained altruism, will ultimately lead to the collapse of the cooperative venture that is the modern business corporation.[41] Like Brian Hall's call for "enlightened self-restraint of managers," Stout concludes that while "[p]ersonal payoffs count," the "solution" to corporate ills is

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[34] Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 RUTGERS L.J. 1, __ (2004).

[35] Alan Greenspan proposes what seems like a more reasonable solution to the problem he labeled "infectious greed," one that recognizes human nature and accords well with the argument we develop in this article. Greenspan wrote: "Although we may not be able to change the character of corporate officers, we can change behavior through incentives and penalties." *Federal Reserve Board's Semiannual Monetary Policy Report to Congress*, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, (July 16, 2002) (testimony of Chairman Alan Greenspan), available at http://www.federalreserve.gov/ boarddocs/hh/2002/july/testimony.htm.

[36] Perks are rarely discussed in federal or state cases. Perks are occasionally mentioned in cases in which levels of executive compensation are challenged, but not often and only as throwaway color when included. In fact, the most famous executive compensation challenges in the past few years don't mention perks at all. *See, for example, Brehm v. Eisner*, 746 A.2d 244, 249 (Del.2000); *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del.Ch. 2003). And even when perks are mentioned, they don't warrant separate legal analysis but rather are included in the analysis of total compensation under doctrines of corporate waste. Perks are more commonly mentioned in divorce cases, but only with respect to divvying the largess.

[37] See Eric Posner, *The Jurisprudence of Greed*, 151 U. PA. L. REV. 1097, 1099-1100 (2003).

[38] For instance, Judge Frank Easterbrook has praised greed as "the engine that propels the market economy," and "the basis of Smithian market-economics." *Id*. at 1103, 1130
(citations omitted).

[39] *See id* at 1100-2, 1132.

[40] *Id* at 1132.

[41] *See* Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003).

"character."[42] A veritable legion of academic and general media articles pile on, sounding a chorus of condemnation of the perceived "infectious greed"[43] that led to the downfall of companies such as Enron, Adelphia, Global Crossing, Arthur Andersen, and Tyco.[44]

Finally, we would note that it is not just perks and conspicuous consumption that have come under fire, but also a prominent form of deferred compensation: corporate loans to employees. Corporate loans come in essentially two flavors: first, subsidized loans that are often earmarked for some sort of expenditure, such as purchase of a house, car, or company stock, and, second, loans available for any use that may be forgiven by the firm in the future, at the firm's discretion. Critics have contended that such loans cannot be efficient since a bank's cost of borrowing would be lower than that of the firm,[45] and that such loans are intended to hide compensation from shareholders, as the economic consequence of the loans are not disclosed in way investors can readily understand, and because the loans are often forgiven by the firm later on.[46] Firms and regulators completely ignored this criticism, however, until the apparent abuse of corporate loans took a central role in the scandals at Enron, WorldCom, Adelphia, and others. To take just one example, evidence at the fraud trial of former Tyco CEO Dennis Kozlowski showed he received subsidized loans totaling tens of millions of dollars, including $33 million for homes, $15 million for home furnishings, $13 million to buy a yacht, and $5 million for a diamond ring.[47] The outrage at these apparently indefensible

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[42] *Id* at 25.

[43] *See* Floyd Norris, *Yes, He Can Top That*, N.Y. TIMES, July 17, 2002, at A1 (noting that Federal Reserve Chairman Alan Greenspan observed that: "An infectious greed seemed to grip much of our business community.").

[44] *See*, *for example*, John C. Coffee Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 269-71 (2003); BARBARA LEY TOFFLER WITH JENNIFER REINGOLD, FINAL ACCOUNTING: AMBITION, GREED AND THE FALL OF ARTHUR ANDERSEN (Broadway Books 2003); John Cassidy, *The Greed Cycle: How the Financial System Encouraged Corporations to Go Crazy*, THE NEW YORKER, Sept. 23, 2002, at 64-77; ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON 12 (2002); BRIAN CRUVER, ANATOMY OF GREED: THE UNSHREDDED TRUTH FROM AN ENRON INSIDER (2002); David Streitfeld & Lee Romney, *Enron's Run Tripped by Arrogance, Greed; Profile: A Lack of Discipline and a Drive to Bend the Rules Were Key Factors in the Meltdown*, L.A. TIMES, Jan. 27, 2002, at A22.

[45] *See* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1203 (2003) (criticizing corporate loans at reduced interest rates).

[46] *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, NBER Working Paper Series, Working Paper 9813, at 10-11 (July 2003), available at http://www.nber.org/papers/w9813 (criticizing loans as "stealth compensation" due in part to inadequacies of disclosure).

[47] *See* Mark Maremont, Kara Scannell & Charles Forelle, *Executives on Trial: Mistrial Scuttles Possible Guilty Verdicts in Tyco Case*, WALL ST. J., Apr. 5, 2004 at A1.

excesses (we will offer a defense in Section IV below) grew to the point where President George W. Bush called for an end to corporate loans at a speech at the New York Stock Exchange, and an anti-corporate loan provision was quickly added to the pending Sarbanes-Oxley legislation. Section 402 of the Sarbanes-Oxley Act now specifically prohibits loans to executive officers of public companies.[48]

B. The Supporters

There is some weak support in the literature for perks, with a few management scholars noting the important role of in-kind compensation when it comes to paying the "market wage" for particular employees. For example, Jeffrey Pfeffer of the Stanford Business School uses the case example of the company SAS Institute Inc. to show the retention power of perks and to debunk the myth that money is the most effective way to motivate employees. Pfeffer notes that SAS, the world's largest privately held software company, has achieved an industry low turnover rate of four percent by offering employees, *inter alia*, "a family-friendly environment that features exceptional benefits."[49] In fact, SAS's employees attribute the low turnover to the motivation provided by the firm's "unique perks," such as on-site schools, day care, and doctors, as well as free meals cooked by famous gourmet chefs.[50] While we echo this analysis, these perks are much less controversial and serve a different purpose than the anti-savings, extravagant perks we defend in Part IV.

In addition, recent empirical work by Raghuram Rajan and Julie Wulf suggests that while "perks may be a form of excess" in some firms, "the blanket indictment of the use of perks is unwarranted" because they serve shareholder interests, since perks may, in some instances, increase productivity, avoid taxes, or play an important behavioral role in defining hierarchies.[51] Rajan and Wulf also call into question any alleged linkage between "excessive" perks and bad corporate governance. Their study uses regressions of numerous firm variables (size, location, org structure, productivity) against three common perks (company plane, chauffer service, and club memberships), to conclude

[48] See nn. 141 to 151, infra, discussing treatment of corporate loans over time.
[49] Jeffrey Pfeffer, *Six Dangerous Myths About Pay*, HARV. BUS. REV., Reprint 98309, 110-11 (May-Jun. 1998). In this way, SAS has created a modern day company town that effectively captures employees and makes them dependent on the firm for essential services.
[50] *Id* at 116.
[51] *See* Raghuram G. Rajan & Julie Wulf, *Are Perks Purely Managerial Excess?*, NBER Working Paper Series, Working Paper 10494, at 2-8 (May 2004), available at http://www.nber.org/papers/w10494.

that there is "no direct relationship" between measures of governance and access to these perks.[52] This recent analysis is broader and more favorable to perks than most work in this area, but it falls short of explaining fully the use of extravagant perks that are not justified on grounds of increased productivity, cultural signals, or taxes.

Articles in support of perks (or even simply offering alternative explanations) are quite rare in the legal literature, which makes it worth recounting here some of the standard arguments (along with some augmentations) in favor of routine, nonextravagant perks. From an employer perspective, there are at least three major benefits of providing perks (beside the argument we describe in Parts III and IV below). First, there is the ability of a firm to capture value marginal benefits from perks that exceed their costs and that it wouldn't capture if the buying decision were left to the employee. For example, a firm may benefit more from providing first-class airfare—so that an executive arrives fresh for an important meeting—than would the executive, who might pay for economy if forced to pay his own way.[53] This same logic applies to a whole range of perks, from health insurance and gym memberships (to promote healthy employees) to parties and sporting tickets (to foster esprit de corps or capture the innovation benefits possible from mixing different parts of an organization together).

A second potential benefit is the ability to create or signal (internally and/or externally) a specific organization structure. Perks enable firms to foster a hierarchal or flat organization in ways that compensation cannot because perks are generally more observable than salaries to other employees.[54] A firm looking to foster a collegial atmosphere might provide the same fringe benefits to all employees (like free massages or on-site doctors) while firms trying to reinforce a chain of command or create an internal tournament for top jobs might offer lavish perks only to top executives. One reason a successful firm might have an executive dining room and fly its top executives around the world on a fleet of private jets is because of the informational signals these perks send to employees, the labor market, and to other firms.[55] Firms might also use

[52] *See id* at 25.
[53] *Id* at __.
[54] *See, for example*, FRED HIRSCH, SOCIAL LIMITS OF GROWTH, __ (1976) (noting how perks can serve an important organizational role as a status or positional good).
[55] Another example of this, writ small, is the practice at Merrill Lynch of assigning separate models of chairs to employees based upon rank. An associate of the authors, then a lowly analyst at Merrill, had his

particular types of perks to create or reinforce a particular firm culture.[56] In this way, perks can help create a firm culture that can be transmitted throughout the organization through the use of stories. According to management gurus Tom Peters and Robert Waterman, "the dominance and coherence of culture proved to be an essential quality of . . . excellent companies," and cultures are created largely through the use of "story" and "legend."[57] On the other hand, firms that want to emphasis egalitarian values such as equality, teamwork, and collegiality (perhaps because of the relative importance of the rank and file or a more horizontal management structure) do so also through the regulation of perks. Some firms openly brag about the lavishness of their perks (in order to create one type of culture) while others take pride in austerity (to achieve the opposite culture).[58]

The third potential employer benefit is the ability to tailor the firm's compensation mix to attract and retain employees with particular traits. For example, a firm looking to hire more women could offer on-site day care facilities or concierge services in lieu of or in addition to cash compensation. Likewise, an investment firm trying to attract greedy, money-focused employees could offer lavish offices, parties, and lifestyles. This powerful tool allows firms to sort according to certain characteristics in ways that paying cash cannot. This is because cash—the ultimate commodity—can convey only one signal from the firm. To combat this informational weakness of cash,

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chair removed and mothballed, and an analyst's chair purchased for him, when human resources discovered he was sitting on, in fact, a vice-president's chair.

[56] For example, Enron created its culture in part by sending executives on a 1200-mile jeep/dirt bike road race through Mexico. According to Enron employees, "[t]hese trips entered Enron lore, serving as a symbol of the company's macho, risk-taking culture." BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON, 122 (2003). While in hindsight Enron's culture appears to have led it to take at least one risk too many, the point is that perks are a powerful way to create and sustain corporate culture, be it good or bad.

[57] THOMAS J. PETERS & ROBERT H. WATERMAN, JR., IN SEARCH OF EXCELLENCE, 75 (Warner Books 1984). While in hindsight Enron's culture appears to have led it to take at least one risk too many, the point is that perks are a powerful way to create and sustain corporate culture, be it good or bad.

[58] For example, Intel proudly reports that the "CEO works in a cubicle," that there are "no reserved parking spaces," that there is no executive dining room, and that "executives fly coach." *See* Robert Levering & Milton Moskowitz, *The 100 Best Companies to Work For*, 141 FORTUNE, ___, 2000, at 83; Robert Levering & Milton Moskowitz, *The 100 Best Companies to Work For*, 147 FORTUNE, Jan. 20, 2003, at 127. Similarly, a former Enron executive who now heads KinderMorgan, recently said that providing perks to senior executives "sends the wrong signals" to the other employees and the shareholders. See Joann S. Lublin, *Cheap, Cheap, Cheap: The CEO of a Houston Pipeline Company Talks About His Low-Cost Approach to Executive Compensation*, WALL STREET J., Apr. 12, 2004, at R11.

firms may choose to offer in-kind compensation that is replete with information from the firm about what is valued.[59]

There are also several potential benefits to employees that aren't readily apparent from reading the academic literature or media reports. First, an employee's subjective value for a particular perk may, in some cases, be greater than the cost of a perk. This could be due simply to economies of scale or greater bargaining leverage, but perks may have an additional psychic value to the employee—an "ego premium"—that represents the utility the recipient gets from feeling important or appreciated. Anyone who has worked at a big city law firm or investment bank knows that it is cool to have a black Town Car waiting to swift you off to whatever destination you specify, and it is even better when friends and acquaintances can see you get out at your destination. A former senior executive at Enron described it this way: "I used to walk off the company plane after being picked up and being dropped off by limousine, and I'd have to remind myself that I was a real human being."[60] Anecdotal evidence suggests that this "ego premium" is fairly inelastic to wealth. Mega-millionaire Martha Stewart routinely submitted receipts to be reimbursed by her firm for miniscule expenses, such as coffee and limo trips. Clearly the administrative cost to Stewart (even if she was simply giving receipts to her assistant for processing) exceeds the marginal financial benefit to her, so an ego premium of sorts may well have made up the difference.[61] Our interviews with CEOs and executive headhunters corroborate this potential benefit of perks and its importance to even wealthy executives. A leading executive recruiter believes that "recognition" is a primary motivator for high-powered individuals, and that it is "the trappings of high corporate office" that keep many wealthy corporate executives from flying the coop. "These [executives] have all the money they can spend—what they want, and can't get in

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[59] For example, Patagonia, the maker of outdoor equipment for the "crunchy" set, signals to the labor market the type of employees it wants by offering employees "training in civil disobedience," "$2000 to subsidize the purchase of a hybrid vehicle," and "organic food in the cafeteria." Robert Levering & Milton Moskowitz, *The 100 Best Companies to Work For*, 145 FORTUNE, Feb. 4, 2002, at 72. It would be hard for Patagonia to achieve similar results with cash or employment advertisements.

[60] BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON, 123 (2003).

[61] Interestingly, for most of the time Stewart submitted these expenses, she owned a significant part of the firm, so she bore more of the cost of the perks than the average CEO.

retirement, is the corner office, the attractive secretary, the limos, expense accounts, and corporate jets."[62]

Another benefit for an employee is the ability to satisfy preferences that are repressed by the particular "mental accounting" of an individual. Mental accounting is the heuristic whereby people may partition money on an intuitive level, mentally setting aside some money to pay bills, some for retirement, some for instant gratification, and so on.[63] According to this school of thought, the primary reason people engage in mental accounting is to impose "financial self-control."[64] Perks may have particular value because they are a convenient way of getting around this safety valve and exercising real but repressed preferences. For example, one may value a free $100 meal as much (or even more than) $100 in cash because it is something one wouldn't otherwise buy given the restrictions of self-imposed mental accounting. Furthermore, we would point out that there is a more tangible benefit as well: the employee, who would otherwise have to share income with her spouse, family, or creditors, does not have to share her perks with them.

There are also tax benefits to perks. Although perks are technically considered "income" within the meaning of the Internal Revenue Code, exceptions for "de minimis" perks (such as business meals, entertainment, and athletic facilities) [65] and generous exclusions for employer-provided health insurance and pension contributions swallows the rule for most employees.[66] Because of the tax breaks, in-kind compensation can be preferable to an equivalent amount of cash. For instance, $100 in perks could theoretically be equivalent to $167 in cash for an employee in the 40 percent tax bracket.[67] As tax rates increase, one would expect the rate of substitution to increase. Anecdotally, this is what we see when comparing the level of perks in countries with low

[62] Interview with corporate headhunter conducted by authors on July 11, 2004.
[63] Christine Jolls, *Behavioral Economic Analysis of Redistributive Legal Rules*, in BEHAVIORAL ECONOMIC ANALYSIS OF LAW, 288, 294 (Cass R. Sunstein, ed., 2000).
[64] Cass R. Sunstein, *Introduction*, in BEHAVIORAL ECONOMIC ANALYSIS OF LAW, 1, 6-7 (Cass R. Sunstein, ed., 2000).
[65] See 26 C.F.R. § 1.132-6. While perks are generally considered taxable income, gross income does not include (1) no-additional cost services; (2) qualified employee discounts; (3) work condition fringe benefits; or (4) de minimis fringe benefits. See IRC § 132 and Treas. Reg. § 1.132-1T-8T.
[66] *See, for example*, I.R.C. § 404(a) (2003); I.R.C. 106 (1994); *see also* STEPHEN A. WOODBURY & WEI-JANG HUANG, THE TAX TREATMENT OF FRINGE BENEFITS, __ (Upjohn Institute 1991).
[67] There are also tax benefits to employers. Employers can deduct as business expenses perks that are not income to employees. There are some limitations on this, however. For example, only 50 percent of most business meals and entertainment expenses are deductible by employers, though *de minimis* fringe benefit meals are fully deductible. *See* I.R.C. §§ 274(n), § 132.

tax rates (like America) and high rates (like Europe): European executives enjoy more fringe benefits than their American counterparts.[68] So tax breaks may drive a significant proportion of perks, especially the nonextravagant perks discussed in this Part.[69]

These several benefits are considerable. But as we will discuss in Parts III and IV, these justifications—increased productivity, informational benefits, and tax avoidance—do not fully explain the common use of extravagant perks often pilloried in the academic literature and public accounts. Extravagant perks—like large corporate loans or liberal use of corporate jets—are instead used because of their ability to incentivize good, firm-dependent behavior by making reputation work better through avoidance of final period cheating problems.

III. How Savings Causes the Failure of Reputation

Even without the potential productivity and tax advantages discussed in the preceding Part, we would argue that perks, corporate loans, and conspicuous consumption provide a useful benefit by helping to minimize agency costs. This argument runs counter to the prevailing intuition that such perks are a symptom (or even a cause) of an agency problem, not its potential cure. As we will discuss in this Part, cash compensation enables employees to save. At a certain level of saved wealth, the employee is no longer reliant upon the firm, which allows two bad things to happen from the firm's (and perhaps society's) perspective: the employee can leave the industry, and the employee becomes immune to the firm's ability to penalize her through firing and blackballing for cheating.

[68] *See* Towers Perrin 1998 Worldwide Total Rewards Study (concluding that in-kind compensation makes up a significantly larger portion of total compensation in European countries (Sweden ~40%; Belgium ~40%; France ~30%; Italy ~30%; U.K. ~30%) than in the U.S. (~10%). Anecdotally, we observe that in one case new consultants at a top firm in America are paid about $100,000, while German consultants at the same firm receive significantly less in salary (about $60,000) but get a BMW automobile, precisely to arbitrage the tax effects of perks. Our simple model predicts that European firms would have less of a problem with reputational cheating due to the higher use of perks. We leave this analysis for another day.

[69] One should note that to the extent that tax (or any other productivity benefit described in this Part) drives perks, perks cannot be agency costs. Moreover, the tax treatment of firms is less relevant here. From the firm's perspective, perks are equivalent to cash from a tax standpoint, because it appears (though it is hard to tell) that most perks are deducted as business expenses.

A. Savings, Cheating, and Retention

Firms rely on reputation to enforce good behavior where complete monitoring is impracticable or where complete contracts are difficult to write and enforce. For example, a client may rely on its investment banker's reputation for doing "good deals" when it obtains advice from the investment banker about whether a certain acquisition would be advisable. Because oftentimes the efficacy of an acquisition is not revealed until long after completion (and, even then, it may be impossible or prohibitively costly to say with finality whether the outcome was due to a poor acquisition or intervening factors), it may be impossible for the client to monitor the investment banker's level of effort, or to draft a contract that properly aligns the investment banker's incentives with the client's. Since the banker gets paid only in the event that a deal goes through, the client might suppose that a banker would always push even a bad deal ahead, which could lead the client to never enter into a relationship with the banker in the first place.

In such a case, then, the client may look to the investment banker's past record of success (or failure) in deciding whether to retain that investment banker. If the banker has a history of good deals, or satisfied customers, as revealed over time (i.e., a good reputation), the client will be more likely to deal with the banker.[70] The investment banker, realizing this, will make an investment in her reputation by foregoing immediate gains, if necessary, in order to achieve higher long term profits. Essentially, the banker is a repeat player, and her reputation will follow her into the future even if clients are not repeat players; thus, the banker has an incentive not to cheat in each iteration of the game.[71] Reputation allows the agent to bond herself to act in the principal's interest.[72]

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[70] Firm reputation may be as important or more important in these decisions, but this doesn't change the analysis. It simply moves the burden to judge reputation from the client to the firm.

[71] The importance of reputation is illustrated by the way firms with highly paid employees, like investment banks and consulting firms, evaluate employees. For example, a leading investment bank evaluates prospective partners in large part on whether the banker "has earned a reputation for reliability and putting clients' interests first" and "has chosen long-term firm value over short-term personal gain." (Disguised example from top U.S. investment bank.)

[72] The finance and economics literature is replete with studies showing the importance of reputation in fields like investment banking, accounting, and law. For example, it is well documented that underwriters and auditors with greater reputation charge larger fees and are more profitable than less reputable competitors. Thomas J. Chemmanur & Paolo Fulghieri, *Investment Bank Reputation, Information Production, and Financial Intermediation*, 49 JOURNAL OF FINANCE 57, 75 (1994); *see also* Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 JOURNAL OF FINANCE 1045, 1062 (1990) (finding that underwriter reputation is maintained by only marketing the IPO of firms expected to have low price run-up variance); *see also* Andrew McLennan & In-Uck Park, *The Market for Liars:*

This view of reputation is, however, premised on one assumption that is likely to be faulty: in order for reputation to constrain the employee's behavior, there must always be a *next* period in which the employee would face negative consequences from cheating. If not, then the cooperative relationship may fall apart. In such a situation, one or both players in the game realize that there is no point to maintaining cooperation past the termination of the game, and each player chooses, in the final period, to cheat, since there can be no repercussions after that. Since this result—final period cheating—is predictable, each player then realizes that, if the other player is going to cheat in the final period, then it makes sense to cheat in the penultimate period as well.[73] This reasoning carries forward all the way even to the first period, destroying the cooperative relationship altogether. Thus, in extreme cases this "final period problem" can prevent the business relationship from ever forming.[74]

So, why would a final period problem develop among employees? The reason is that accumulated wealth enables employees to leave their jobs. Over time, as an employee accumulates wealth by saving, the employee becomes enabled to quit her job and retire, which she will do if she would derive a greater utility from leisure and living off her accumulated wealth than from working. (See Figure 1.) For any job at any given wage, a higher degree of past savings (i.e., wealth) makes the employee less likely to desire employment in the future.[75] A wealthier person, all things being equal, chooses to increase her consumption of leisure.[76] If a worker cannot choose to reduce her hours,[77]

Reputation and Auditor Honesty, at 19-20, unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=422701 (finding that "honest" auditors charge higher fees and earn more profits). In addition, Chemmanur and Fulgheiri show that "the ability of financial intermediaries to acquire a reputation for veracity mitigates the moral hazard problem in information production." *Id* at 76.

[73] For example, if the banker would cheat in final period N, the firm should anticipate this and fire her in period N-1, which the employee would anticipate by cheating in period N-1. The firm, again, anticipates this, and would fire her in period N-2, which the banker anticipates, and so on, all the way down to the initial period.

[74] For a good and detailed explanation of final period problems and the optimality of retaliatory strategies of conditional cooperation, *see* AVINASH K. DIXIT & BARRY J. NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE, __ (Norton & Co. 1993).

[75] While the effect of an increase in the wage on the supply of labor is ambiguous, the effect of wealth (i.e., past savings) on the supply of labor is not. See Borjas, infra. So long as one prefers leisure to labor, a wealthier person will choose to consume more leisure. This change in labor supplied would grow or shrink depending on just how unpleasant the employee finds her job.

[76] *See* N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS, 469-72 (South Western 3d. ed. 2003). Studies done of people who win the lottery shows that winners are more likely to leave the labor force than

the employee has a choice between full employment and full unemployment. At a certain threshold of accumulated savings (the "exit threshold"), then, the employee is actually perfectly indifferent between remaining employed or becoming unemployed, while above that exit threshold the employee would actively prefer to retire.

Figure 1

Employee piggy-bank

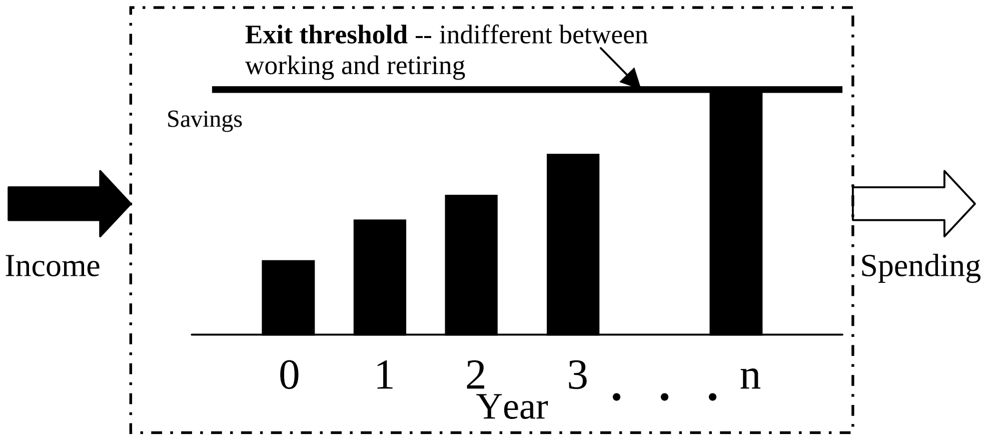

Figure 1 shows a simple model of employee savings. The black arrow on the left depicts income paid to the employee, some of which is saved (the black bars), and some of which is spent (the white arrow on the right). Over time, the employee's total accumulated savings can rise, as depicted by the increasing height of the black bars. At time *n*, the employee has saved up to her "exit threshold," which is the point of accumulated wealth where the employee is indifferent between employment and unemployment. Above the threshold, the employee prefers to retire, while below it, the employee prefers to remain employed. At or above the threshold, the employee is indifferent to being fired and blackballed.

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non-winners, and that the likelihood of leaving increases with the amount of money won. See George J. Borjas, LABOR ECONOMICS, at 39.

[77] We believe it is generally true that employees cannot reduce hours in the industries that we consider in this paper. Investment bankers, corporate law associates, and CEOs can rarely choose to work part-time. Doing so would require hiring an additional employee, which potentially creates free-rider problems (two bankers on a deal would each choose to shirk), or may result in decreased productivity (one banker running the deal 100 hours a week may be more "in control" than two bankers running the deal fifty hours a week). One possibility (which we do not explicitly address in this paper, but which we do not believe would change the basic results) is that, instead of retiring completely, employees may downshift from one job to a less demanding, lower paying job. There may still be reputational constraints between such jobs (for example, the lawyer who leaves the large corporate firm for academia probably has some reputation carry-over between jobs), though the extent of this reputational linkage is probably less than between nearly identical jobs within the same industry (e.g., moving from Sullivan & Cromwell to Davis Polk). For other, greater shifts, however, there is probably no significant reputation constraint, as where the investment banker leaves Wall Street to open a restaurant. To generalize from these examples: if there is a negative correlation between the pay difference between jobs and the degree of reputation linkage between jobs, then we could conceptualize our model as one in which increasing levels of saved wealth enable increasing degrees of escape from reputational constraints. While interesting to consider, this would not appear to affect our analysis.

An employee who is indifferent between employment and unemployment (or, even worse, an employee who prefers unemployment) can no longer be disciplined through the firing and blackballing mechanism: she just doesn't care. Obviously, this has implications for the firm that wishes to retain its employees, since if it is costly—in terms of recruitment expenses, training, or administrative costs—to replace an existing employee with a new one, then employees who save past the exit threshold will leave the firm and force the firm to bear these costs.[78] For example, consider the market for legal talent: top corporate law firms face large recruitment and start up costs per entry-level associate recruited (up to $100,000 per associate recruited),[79] only to see 43 percent depart within three years. While many of these associates leave for comparable firms, a significant percentage of turnover consists of those who downshift careers (some 56.7 percent of those with known destinations),[80] searching for a better quality of life—i.e., less hours of work—once their law school loans are paid off. A principal driver of the decision to work at a large firm is debt; conversely, law associates who have saved enough to pay their debts tend to leave the firm.[81] We might suppose that a law firm that could reduce savings could decrease turnover, while those that fail to reduce savings suffer greater attrition. Generalizing from the law context, we might suppose that the same is true for many sorts of firms. For example, a tech startup that finances itself partly by granting its employees large equity stakes, such as Google, faces the prospect of

[78] If there were no costs to replacing and retraining employees, then firms would not care about employee turnover.

[79] See Law Office Management & Administration Report, Nearly One in 11 New Associates Leaves (But NALP Data Show What Firms Can Do), May 1998. According to the executive director of NALP, it generally takes three years for an associate to start making money for the firm. See Jenna Ward, Survey Studies Attrition Rate of Associates, The Recorder, March 12, 1998. The managing partner of Brobeck, Phleger once estimated that, after two years of employment, the firm had invested $200,000 in each associate. See Cynthia Cotts, How Firms Keep Their Associates on the Job, The National Law Journal, June 8, 1998

[80] See Amy Delong, Retaining Legal Talent, 29 Cap. U. L. Rev. 893, 896 ("Each of these transitions would most likely present a significant reduction in the hours demanded of the associate").

[81] The average law school debt, according to a NALP survey of law associates, was $60,000 as of 1998. See Jenna Ward, *Survey Studies Attrition Rate of Associates*, THE RECORDER, March 12, 1998. This raises an interesting question as to whether a law school could actually improve the desirability of its students by *raising* tuition, since this would saddle students with a higher average debt load. This added anti-savings would tend to lengthen the tenure of entry-level hires, making them more attractive to firms.

losing many of its employees to early retirement or some form of career-downshifting once it goes public and those employees become multi-millionaires.[82]

Even worse than the employee retention issue, however, is that of employee cheating. When an employee becomes indifferent to being fired and blackballed, the firm loses its chief tool to constrain employee behavior. So, once the employee reaches her exit threshold, the threat of being fired no longer affects her decision-making. If the employee has any opportunity at all to divert cash-flows from firm to herself, to shirk on the job, to accept kickbacks, or otherwise enrich herself at the firm's expense, the employee will exercise that opportunity. Final period cheating problems are exacerbated where the employee's compensation has a large variable component, such as commissions, deal fees, tie-ins, or stock options that may be manipulated in the short term. The employee can, by cheating, provide an immediate boost to her income and savings. If this boost puts the employee above her exit threshold, then she will cheat, and be entirely immune from any reputational penalties the firm could otherwise bring against her. For example, if an investment banker's compensation is commission-based, such as receiving a set percentage of the total value of an acquisition, the banker has the ability to temporarily boost her immediate compensation by advising a client to complete an acquisition that the banker knows to be bad.[83] Similarly, a top corporate executive could

[82] See Kevin J. Delaney and Joann S. Lublin, *Google Goes Public: They're All Rich – Now the Problems Start*, WALL ST. J., August 20, 2004 (describing the incentive problems that Google faces with its newly-rich employees: "when you're a millionaire, you say 'Why should I work nights and weekends?'"); see also nn. [___] infra and accompanying text.

[83] The analytical solution we develop in this paper may also apply in other related contexts. For example, Bruce Johnsen of George Mason University Law School, believes that the anti-savings analysis augments the arguments in defense of soft dollar brokerage he and Stephen Horan have developed. *See* Stephen M. Horan & D. Bruce Johnsen, *Does Soft Dollar Brokerage Benefit Portfolio Investors: Agency Problem or Solution?*, unpublished manuscript on file with authors. Horan and Johnsen argue in their paper that proposals to require fund managers to pay for research out of their own pockets rather than passing on the cost to shareholders are misguided, noting that commission payments are positively related to risk-adjusted performance; in other words, soft dollar research payments represent a solution to an agency problem, not a symptom of one. The argument we develop reinforces this conclusion because attempts to limit soft dollar brokerage would dramatically increase fund manager compensation and opportunities for cheating. If these fees are eliminated, fund managers' fees would increase at a multiple Johnsen estimates would be up to four times the manager's salary. This would increase the manager's savings level and create incentives for the manager to use index funds (i.e., cheat) and to bank much of the salary instead of spending it on research. In volatile markets, the "cheating" might not be discovered until the manager has reached the savings threshold and retired to the Bahamas.

Note that this sort of cheating is a special subset of the more general case we develop. In this example, the failure to spend the money in a particular way is the cheating, just as it would be cheating for an executive to fly coach instead of first class, pocketing the difference, with the result that the executive "manage earnings" or selectively release good news in order to temporarily boost the price of the company's stock, allowing the executive to exercise those options at a higher price. If these short-term gains are high enough (i.e., they put the employee above her exit threshold), the banker or executive would not care about her future reputation, and would cheat.[84]

Thus, where the mix of savings and the gains to the employee from cheating is such that the employee who cheats will end up above her exit threshold, and therefore feel no pain from reputational penalties, we predict that the employee will choose to cheat. The employee exploits the final period of employment to do whatever enriches her the most. If the firm can anticipate when this final period will occur, it is possible that the cooperative relationship could unravel completely,[85] meaning that the employment relationship is never instituted in the first place.[86] Even if not, both the firm and the employee could be made better off if, ex ante, it were possible to bind the employee not to cheat.[87]

B. Shortcomings of Contract and Regulation

We might suppose that the firm and employee would attempt to draft a contract that binds the employee to the firm (to solve the retention problem) and that punishes the employee for cheating. For reasons of public policy that we will not go into here, there are limits on the enforceability of contractual commitments to work—but to make a long

shows up exhausted at an important meeting. The significant difference between the airfare and soft dollar examples is the magnitude of money involved. Firms may discourage this type of cheating by mandating and monitoring certain types of expenditures, or by simply paying in a perk that cannot be "cashed in."

[84] In the securities advisory sphere, for instance, Jack Grubman, once Salomon Smith Barney's star research analyst, cheated investors by publishing "buy" ratings on stocks that he privately told valuable clients not to buy. While Grubman was fined $15 million and banned from securities work by the SEC, Grubman made more than the amount of the fine in a single year (reportedly above $20 million), and hence may well have come out far ahead. *See* Dan Ackman, *Weill-Grubman Dealings Were Child's Play*, FORBES.COM, Nov. 14, 2002, available at http://www.forbes.com/2002/11/14/cx_da_1114topnews_print.html (last visited July 14, 2004). Civil suits against Grubman are currently still pending, so it remains to be seen whether his cheating strategy proves profitable in the long run. *See* Grubman Civil Complaint ___.

[85] If the cheating is of small enough degree that the employment relationship would still yield a positive surplus, then the firm could solve the unraveling problem if it can commit not to fire preemptively the employee. Also, if the firm is unable to determine when, exactly, the employee would surpass her savings threshold, it is possible that unraveling would not occur. See Dixit, supra n. __, at __.

[86] It is possible that, as a halfway measure, the employee is given less responsibility – meaning less overall ability to cheat – than would be optimal if it were possible for the employee to commit herself not to cheat.

[87] This applies to the retention problem as well: if an employee can bind herself not to leave the firm early, the surplus generated from this can be used to make both employee and firm better off.

story short, courts will not likely enforce the type of contracts that would force retention.[88]

Other problems plague contracts that attempt to limit cheating. Drafting a contract that covers every possible instance of employee malfeasance is not practicable. And in order for a contract to be enforceable by the firm, the firm would have to be able to prove that "cheating," however it is defined, actually occurred. The verifiability in court of "cheating" in a general, inchoate sense is probably impossible or unduly expensive, meaning that the parties would be forced to draft a contract contingent upon readily observable/verifiable benchmarks. This is undoubtedly done in some instances: firms pay managers bonuses, for instance, based on verifiable performance metrics, such as earnings per share. However, benchmarking has its limits since, as one prominent labor economist describes, "the objective measures of performance available are often such poor measures of the performance firms really care about that use of formal related pay schemes can be counterproductive."[89] The attempt to define an appropriate and effective metric to reduce cheating, and one that is not susceptible to manipulation or is itself not an incentive to certain types of cheating, is probably illusive. In the case of an earnings-per-share metric, the manager might meet or exceed the target in order to maximize her bonus in the current period, but this is of little value to the firm if it comes at the expense of share value in the future — in such a case, maximization of the benchmark is itself cheating.

As an alternative to private contracting, the law could step in to provide a right of action against employees who have egregiously cheated. Again, there is the difficulty of specifying all acts of prohibited cheating (even greater than in the private contracting case since the law is applicable to all firms), and the difficulty of having to verify that an instance of cheating actually took place. An additional problem is that lawsuits against an employee for disloyalty, which are public, probably imply negative things about the claimant as well, leading to underenforcement of private rights. This underenforcement

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[88] Even the most ironclad non-compete agreements are forced to be limited in duration and geographical scope. Courts in New York, for instance, will generally not enforce non-compete agreements that are "unreasonable" (i.e., purporting to endure more than five years, or covering long geographical distances) absent extraordinary circumstances. *See Gimper v. Giacchetta*, 633 N.Y.S. 2d 614 (1995).

[89] [___] Malcomson, Individual Employment Contracts, HANDBOOK OF LABOR ECONOMICS, Ch. 35, at 2337. Such schemes surely motivate certain behavior, but unfortunately they often "motivat[e] the wrong behavior." Id.

problem also limits the effectiveness of public law solutions to cheating. While the SEC and other government or quasi-government actors (e.g., the NYSE or NASD) provide some brake on cheating, the limits of prosecutorial resources, the problems of observability/verifiability that plague private enforcement, and the difficulty in setting penalties at levels to create optimal deterrence, all limit the effectiveness of regulatory solutions. So, while regulation provides a solution to some of the most egregious and obvious instances of cheating, such as outright theft or fraud, for less clear-cut cases of subtle deception, disloyalty, or shirking, regulatory solutions are inadequate.

So, while contract and regulation may prove useful to an extent, they still leave large gaps in the ability to constrain employee behavior. But this is not surprising, since the very purpose, so to speak, of reputation constraints are to permit cooperative behavior in those instances where contract or regulation are insufficient to reach efficient outcomes. What is needed, then, is some way to buttress the role of reputation, to shore it up where it would otherwise fail.

We believe an answer is at hand: as outlined above, reducing or eliminating the ability of employees to save forces employees to rely upon their reputation and upon the firm's good graces. In other words, what is needed is a way to reduce savings, so as to prevent employees from cashing out and shipping off to the Bahamas. As John Coffee noted in his diagnosis of the problem after Enron, "the real problem . . . is not equity[-based] compensation, or even excessive compensation, but rather excessive liquidity that allows managers to bail out at will."[90] This problem is the focus of the next Part, where we describe several mechanisms of savings reduction that firms can, and do, employ to prevent managers from bailing out at will.

Part IV. How Perks, Greed, and Cultures of Conspicuous Consumption Help Strengthen Reputation

We posit that there are three main ways in which firms can solve the final period problems outlined above. First, the firm can withhold payment until such time as cheating

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[90] John C. Coffee Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 308 (2003). Coffee rightly identified the problem, but his proposed solution – "holding periods and retention ratios" – is likely insufficient because of the limitations on deferred compensation – essentially, the limits on contract – that we describe below.

would be revealed; this takes the form of deferred compensation (such as corporate loans which may be forgiven later on). Second, an employer can pay a high degree of in-kind compensation (or perks) that are not fungible with savings; such perks provide the employee with utility, but not with the ability to save; this may be the use of a corporate jet or even an especially expensive meal. Third, employers can invest in causing their employees to spend more or desire more consumption. This includes hiring "greedy" people, "addicting" current employees to higher levels of consumption through perks, and forcing employees to consume at high levels through signaling games. We examine each of these mechanisms in turn.

A. Deferred Cash and Corporate Loans

The firm can defer payment of compensation to some later point where cheating can be better observed. This allows the firm extra time to determine whether the employee has cheated or not, and puts off the final period problem until a time in the future. It also requires the employee to stay with the firm at least until the deferred compensation actually vests in the employee, or else forfeit the deferred amount. By making compensation linked to future, firm-specific behavior (such as remaining employed with the same firm), deferred compensation also helps to solve the retention problem, by providing disincentives to poaching by rival firms.[91]

The paradigm case of deferred cash is a simple promise to pay some amount of cash in the future, with the understanding that the firm may withhold payment if the firm determines that the employee has behaved improperly. Since employees may have liquidity constraints, in that they require a certain amount of money up front to maintain an acceptable standard of living, we might expect to see (and, in fact, before Sarbanes-Oxley, often did see) deferred compensation take the form of the corporate loan, where the firm loans the employee an amount of cash, with the understanding that the loan will be forgiven at some point in the future if cheating has not occurred. Various forms of deferred compensation are evident in practice, such as steep wage profiles,[92] deferred

[91] Firms wanting to attract employees from other firms with substantial deferred compensation will be required to make the employees whole by adding the deferred compensation amount to the starting compensation package.

[92] This is where pay is graduated according to seniority, not productivity: junior employees are underpaid and senior employees are overpaid. Junior employees are, in effect, "owed" higher wages in the future (when they become senior) to make up for their underpayment in the past and present. See Lazear,

bonuses,[93] grants of restricted stock or options whose vesting is contingent upon future employment,[94] and, indeed, the well-known (but now largely prohibited)[95] corporate loan that is forgiven in the future.[96]

The advantage of deferred compensation is that it does not alter the employee's spending or consumption behavior, as perks and conspicuous consumption do (which we will discuss in the next sub-Parts), while, at the same time, it can deter cheating and improve retention. So, just on those facts, we might suppose that deferred cash would be a very attractive compensation strategy. However, two questions crop up right away, which, when answered, place limits on the usefulness of deferred compensation: first, when can the deferral be paid, and what compels the firm to actually pay in good faith?

Since the employee has no reason not to cheat once she is past her exit threshold, deferral of compensation must be held back beyond the time that cheating can be observed. For instance, if a deferred payment would put the employee above her exit threshold, and if cheating cannot be detected until three years after the fact, the deferred compensation cannot be paid until three years after the employee has quit the firm in order to avoid final period cheating. To extend the useful life of the employment relationship, then, deferred compensation must be deferred until *after* the employee has retired; to pay such amounts before retirement is only to push back the cheating problem to a later period. To put it another way, last round performance is not guaranteed unless there is some adequate future punishment hanging over the employee's head.[97]

Retirement from the Labor Force, HANDBOOK OF LABOR ECONOMICS, CH. 5, at 320; *Age and Productivity: Over 30 and Over the Hill*, THE ECONOMIST, June 26, 2004, at 60

[93] "[Sixty-three] of the 100 largest industrial firms in the United States have bonus plans with … provisions for [optional deferral at the Board's discretion], and forfeiture of any installments not yet paid if and when the compensation committee finds that the manager committed 'any act of omission or commission prejudicial to the interests' of the firm." Clifford Smith and Ross Watts, Incentive and Tax Effects of Executive Compensation Plans, FOUNDATIONS OF CORPORATE LAW (Roberta Romano, ed.), at 166-167

[94] Thus, if the firm were to fire the employee, the stock or options would not vest.

[95] The Sarbanes-Oxley Act forbids loans to directors and executive officers. See Sarbanes Oxley Act, Section 402. Because of the usefulness of loans as deferred compensation schemes, we believe that this is a serious mistake, as discussed herein.

[96] A notorious example of lending from corporation to executive is the tens of millions of dollars in loans and loan forgiveness that Tyco awarded to Dennis Kozlowski in 1999, while he was still CEO. See Polek, supra at __; ___, TESTOSTERONE INC.: CEOS GONE WILD, at 311. Our analysis, as we discuss herein, would suggest that the *timing* of Tyco's forgiveness is the problem: payment of deferred compensation *prior to* the ability of the firm to observe all cheating only pushes back, without eliminating, the final period problem.

[97] Lazear, supra n. __, at 322, makes exactly this point.

Furthermore, one might suppose that unraveling is actually more likely to occur with deferred compensation, since there is greater certainty that a one-time lump sum payment would put the employee above her exit threshold[98] than if the money was doled out as services were rendered; firms would have a greater ability to predict and preempt.

For example, suppose that, once an investment banker acquires sufficient wealth, $5 million, she will quit and retire to the Bahamas. The market wage for such an employee is $1 million cash.[99] In each year, the employee can choose to either behave or cheat (such as by pushing through inadvisable deals); if she behaves, she gets simply her $1 million wage, whereas if she cheats, she gets an extra $0.8 million in (unearned) bonuses, for a total of $1.8 million per year. Assuming in this case it takes three years for cheating to be discovered, since some time is necessary to determine whether a deal was a good or a bad deal, and what the role of the banker's inside information was. Now, if the firm pays the employee strictly in cash, the firm can anticipate that the employee may cheat as soon as in year 1: the employee could choose to cheat in years 1, 2, and 3, and not being discovered until after year 3, the employee would have netted $5.4 million before she is fired, pushing her above her exit threshold of $5 million. Deferred compensation can help to solve this problem: the firm can terminate the banker at year 5, paying her less salary than it takes to get the employee to her exit threshold (in this case, less than $2.6 million over those five years), and hold off paying her the balance until year 8.[100] In this way, the firm can be assured that the employee has not reached her exit threshold until the firm can be reasonably sure no cheating has taken place. Then, if no cheating has occurred, the firm can deliver to her the balance ($2.4 million plus some amount) that she is owed. Under such a plan, the employee would have a choice between (a) cheating in any three consecutive years but not reaching her exit threshold (i.e., receiving some amount in cash less than $2.6 million as a salary and getting $2.4 million

[98] This assumes that the deferral has limited the employee's past liquidity and consumption, which is not necessarily true.

[99] Or, taking into account some degree of variable compensation, an *expected* yearly wage of $1 million for an employee that does not cheat. The exact level of compensation itself could fluctuate from year to year, depending on various factors, such as market conditions, effort, and competence; this would make it difficult or impossible for the firm to observe cheating indirectly through the total level of compensation paid to the employee. For simplicity, though, we will treat the market wage as a set $1 million per year, and assume that the firm cannot observe the cheating three years after the fact.

[100] What is more likely is that the firm would *loan* her the money, to satisfy her liquidity needs, with the understanding the loan is to be forgiven in the future if the firm determines that no cheating has occurred.

in cheating bonuses), and being fired and blackballed once her cheating is discovered, and (b) behaving for all five years, receiving $5 million, and being indifferent between employment and retirement.[101] In (a), where the employee ends up below her exit threshold, the employee is worse off than in (b), where the employee is just at her exit threshold.[102] So, the moral of the story is that deferring a great enough amount of cash compensation until after retirement can avoid the final period problem.

Or can it? With a modicum of reflection, it appears that this arrangement has only shifted the final period problem to the other party, the firm. If contracts regarding cheating are hard to draft or enforce, then the firm's promise to pay in the future is subject to the same contractual difficulties as would be a contract in which the employee agrees not to cheat. So the risk of firm opportunism shifts from the employee to the firm: the firm can renege on its promise to pay, even where the employee has not cheated. As the labor economics literature recognizes, the greater the amount of deferred compensation, "the greater the firm's incentive to act opportunistically and renege on the promised future wage."[103] However, *if* the firm is a repeat player,[104] and *if* cheating is observable to other employees in the labor market,[105] then there may be a reputational check on cheating of this sort, since the firm would have to compensate employees for the risk of unfair forfeiture, or might not even be able to utilize the deferred compensation mechanism at all.[106] But even taking the nonextreme scenario, where

[101] Actually, the firm could pay her any amount less than $2.6 million in an up-front cash wage: since the most the employee can garner from cheating before being discovered is $2.4 million, paying her less than $2.6 million still keeps her below her savings threshold and, therefore, honest.
[102] For simplicity, we are not taking into account the time value of money, nor are we taking into account the fact that the employee who works for five years enjoys less leisure than the employee who simply cheats for three. While these considerations would affect the actual numbers, they do not affect the basic analysis.
[103] Lazear, supra n.__, at 320. See also Clifford Smith and Ross Watts, Incentive and Tax Effects of Executive Compensation Plans, FOUNDATIONS OF CORPORATE LAW (Roberta Romano, ed.) at 167 ("it might be thought that the forfeiture provision would enable the firm to cheat its managers out of their deferred compensation.")
[104] We would point out that even potentially immortal firms may face end-game situations, especially when financial distress arises.
[105] For other employees who cannot directly observe cheating, the search costs in determining whether an employee did a good job after the fact may be prohibitive. If so, then opportunistic behavior becomes indistinguishable from good behavior, and, at the extreme, a firm would choose always to cheat, or else would choose never to deny deferred compensation, since this is the only way that a firm could identify itself as a non-cheater. Both these outcomes, however, undermine the incentive purpose of deferred compensation.
[106] An anecdote of breach and reprisal: "an example of employee retaliation is … an episode at First Boston Bank in which a group of highly paid traders quit because they were paid bonuses smaller than they

cheating is somewhat observable and firm reputation functions somewhat well, employees would have to be compensated for the increased risk of opportunism that they bear, with the risk increasing as the amount of deferral, and the gains from firm opportunism, grows larger. Since the risk premium that employees would require grows with the amount of deferred compensation, we would expect that deferred compensation would tend to be of diminishing marginal returns.

This may be why, in practice, deferred compensation is not used as extensively, nor deferred for as long a period (i.e., until well into retirement), as we might expect from the preceding analysis. In an ideal world, where the risk of firm opportunism is nil, we would expect to see that employees would be paid cash of zero, and instead be compensated entirely in corporate loans that are to be forgiven at retirement, at the firm's discretion, in the absence of employee cheating.[107] But real world practices fall far short of this. For example, restricted stock grants are often eviscerated in this regard.[108] Investment banks and law firms pay year-end bonuses, rather than deferring such bonuses for longer periods. Similarly, where corporate loans are used, compensation committees often allow forgiveness at a time prior to retirement, which precipitates the final period problem that the deferral was designed to prevent.[109]

While useful to prevent some instances of cheating, corporate loans and other deferred cash schemes are not without their shortcomings. In theory, there are some significant costs to using deferred compensation, and accordingly, in practice, deferred

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believed they had been promised and as a result no longer trusted promises for the future." Malcomson, supra n.__, at 2353

[107] One of the authors has hypothetically put this arrangement forward to his students as a possible compensation arrangement for them at a law firm. Unsurprisingly, and perhaps correctly, all the students thought this was a bad idea, principally because they would not trust their employers.

Another reason for the inefficiency of such a compensation scheme is that it deters not just cheating, but also employee turnover. Deterring turnover may not always be efficient: that is, the option to leave may be worth more to the employee than it is to the firm (for example, a banker might fear he will grow to hate New York and want to live in L.A.). We might expect that employees and firms could bargain around this contingency when it occurs, but the possibility of firm hold-up, in a situation analogous to that of unfair forfeiture, crops up. Alternatively, firms could loosely agree among themselves to buy out the deferred compensation of employees who wish to relocate from one firm to another (net outlays would be expected to be zero, after all); to our knowledge, this does happen in the corporate executive and investment banking world. Similarly, employees moving from one firm to another generally retain their seniority, which translates into their position along the steep wage profile.

[108] Most senior executive contracts include "accelerated vesting when an executive retires, ensuring that the horizons of equity incentives for virtually every executive planning . . . retirement are quite short." Hall at 14.

[109] Dennis Kozlowski provides a good example of this. See Polek, supra n.__.

compensation appears to be limited. Failure to defer enough compensation for a long enough period of time leads to final period problems on the employee side, while deferring larger amounts of compensation for very long periods of time increases the risk of opportunism by the firm. As we will illustrate in the next Part, perks, while still reducing savings, are not subject to these shortcomings, which can make them a very important element in the overall compensation scheme.

B. Perks

Paying employees in perks is a little bit like paying them in heroin: it delivers a tremendous amount of utility in the short term, none of which can be saved until later periods. This is useful since perks can incentivize employees to work harder, but do not allow employees to save for future periods and escape reputational retribution.

Consider again the investment banker from the example in Part IV.A. If paid in cash, she can earn enough through her salary and through cheating so that she reaches her exit threshold of $5 million in three years. If firm opportunism is a problem, then it may not be possible for the firm to ensure good behavior by deferring compensation until after the term of her employment; a system of corporate loans and forgiveness just won't work here. However, there is a solution at hand: even though the market has set a benchmark in terms of utility that the investment banker must receive, the firm has discretion in what form that utility will be delivered. The firm can pay less cash so long as it makes up for the resulting loss of utility, and we might suppose that the firm would choose a form of in-kind compensation that must be used up right away, so as to deter savings. This would take the form of the familiar perk—such as corporate jet use—which provide the banker with significant utility, but which do not allow the banker to save.

More particularly, suppose the banker has a utility function given as U_b = Cash + 1/2 * Perks, where the least she will work for is U_b = 1 million. She values a dollar in perks the same as fifty cents in cash, meaning that she always prefers cash to perks, which makes sense since she can always buy the substance of the perk herself with cash, and because cash also enables her to save for the future. Now, suppose that the firm expects that at any amount of cash above $500,000, the employee will save significantly, and eventually reach her exit threshold and cheat. But if cash is $500,000 or less, the employee will stay permanently (or at least indefinitely) and will not cheat. Suppose that where the employee cheats, the firm enjoys low surplus, whereas when the employee does not cheat, the firm enjoys a high surplus. Then the firm's expected utility function from paying the banker is U_f = HighSurplus – Perks – Cash, where the amount paid in cash is $500,000 or less. If the amount paid in cash is above $500,000, the firm derives little expected surplus from the employment relationship because of the final period problem, and its utility function is simply U_f = LowSurplus – Perks – Cash.

Depending on what the two surplus levels are, the firm may or may not choose to employ the banker. If the low-surplus is, on a per year basis, less than the market wage of $1 million, and the high surplus is less than $1.5 million, then the firm would choose not to employ the banker at all. It would cost more to employ the banker than it would benefit the firm.

However, so long as the high surplus is greater than $1.5 million, the firm would choose to pay $500,000 in cash, and $1 million in perks. The banker would be indifferent between that compensation package and $1 million in cash, satisfying the benchmark wage constraint. However, the difference is that the banker will not be able to save to the point that she need no longer rely on the firm for her income, becoming reputation-proof.[110] In this way, the firm avoids a final period problem, and will have the benefit of the banker's loyal services into the indefinite future.[111] Everyone is made better off through the liberal use of perks.[112]

To the uninformed outsider, it will appear that the employee is being paid in excess of her worth. In the example above, the banker receives $1.5 million in perks and cash, since that is what it costs the firm, while her market wage should only equal $1

[110] This situation is conceptually similar to subsistence "poverty traps" that occur among the poor, such as migrant laborers, where the worker is unable to save or borrow enough to move beyond subsistence status. For an example of an economic modeling of such a poverty trap, see Barham, Boadway, Marchand, Pesticau, *Education and the Poverty Trap*, 39 EUROPEAN ECONOMIC REVIEW 1257, ___ (1995).

[111] One issue that arises is that competing firms could "poach" the employee by offering more cash. In this specific situation with identical firms, that would not happen since the incremental dollar paid by the competing firm would destroy all the surplus. In a more complex world, however, we might suppose that poaching is a problem. This is discussed in Part IV.D below.

[112] While here we have presented an example where the firm makes a profit, we could have achieved the same result modeling this behavior in a competitive labor market where the employee receives the full marginal product per year as her annual wage, such that employer profits are zero. At long-run equilibrium, where employees will cheat, the employee's wage is given as low surplus (a firm expecting cheating will only be prepared to pay a low wage), whereas without cheating, the wage is high surplus. The employee and firm could both be made better off by binding the employee not to cheat, which could be accomplished by paying her in perks.

million. This extra half-million might appear to be a windfall to the banker, but in reality it provides a benefit only to the firm that employs her. Perks may also appear extravagant and wasteful, which one might take to be evidence of high agency costs or abuse on the employer or employee's part. However, it is precisely because perks are extravagant that they are useful to the firm. Perks must be something that the employee would not choose to purchase herself; that is, perks cannot be fungible with cash, since fungible perks can be converted to cash at little or no cost, and that enables the employee to save. For instance, paying the employee's rent that she would have paid anyhow would not constitute a useful perk, but paying for an especially lavish apartment would (to the extent that it exceeds what the employee would have paid for herself). So we might expect that perks would appear extravagant—such as Kozlowski's $2 million birthday-bash in Sardinia—because these are the sorts of things that are not fungible with savings. This helps explain why a firm might be willing to fly its employees first class or via corporate jet, but would not be willing to let its employees fly economy and pocket the difference in fares, since the payment is less valuable (and may even have negative value) to the firm if the employee can save it.

This conclusion runs counter to the perks-as-stealth-compensation argument by Bebchuk and Jolls. The test they implicitly propose to determine whether perks are efficient is whether they are "germane" to an employee's job function.[113] While this obviously captures a subset of efficient perks, our analysis shows that it is too narrow, in that some extravagant perks completely unrelated to an employee's specific work can be effective at striking an efficient employment bargain. We discuss the characteristics of good and bad perks in Part V below.

Obviously, payment in perks is costly. If cheating were not a problem in the above example, the firm would be able to save $500,000 by paying in cash. There may, however, be ways in which the firm can reduce the cost of paying employees in perks. Firms could utilize a deferred compensation and perk hybrid: the firm might lend the employee a sum of money, and earmark that money for a particular purpose, such as

[113] Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J. L. ECON. & ORG. 487, 487-8 (1999).

buying a fancy house or car.[114] This has the advantage of allowing the employee to choose the sort of perk she most prefers and to enjoy present utility, while also preventing savings and maintaining the threat of firm retaliation—by nonforgiveness of the loan—if the employee misbehaves in the future.[115]

Another cost of perks may be that there is an increased likelihood of attracting employees with high future discount rates; perks are more attractive to high discounters because they value savings less than low discounters. High discounters are more likely to cheat than low discounters because they value the future less than low discounters, and hence are relatively undeterred by future retribution. Accordingly, if perks-based compensation results in more high-discounters being hired,[116] this represents an additional cost of paying in perks. We believe this could be offset through the combination of perks with deferred compensation (such as a steep wage profile or deferred bonus):[117] high-discounters are averse to deferred compensation, while low-discounters are not. If future discounting presents a significant problem, then this is another reason to expect that compensation packages will involve a mix of perks and deferred compensation.

But the point remains that perks are expensive, and once the employee is adequately perked, paying yet more in perks yields little benefit. So, at least beyond a certain point, perks, like deferred compensation, are of diminishing marginal returns. We

[114] The firm would have to be careful to make sure that the employee does not use the loan to choose a perk that is highly fungible with her savings.
[115] This sort of hybrid is especially useful, we think, in the post-retirement context, where an employee, such as a CEO, has retired. Because of the time-lag involved in detecting cheating, it would be necessary to defer any vesting compensation until the time-lag has elapsed. Suppose, however, that the ex-CEO is relatively advanced in years, and that the time-lag is relatively long. A loan would not be useful, since the ex-CEO could use up the loan and then die, evading repayment when cheating is detected. On the other hand, pure deferral, with no loan, does no good, since, again, the ex-CEO may expect to die relatively soon, and thus have a high discount rate on the deferred amount. Deferred perks, on the other hand, provide a middle ground: the ex-CEO is allowed to enjoy utility right away, while the firm retains the ability to yank the perks if it turns out that the ex-CEO cheated, which would subject the ex-CEO to the threat of severe privation.
[116] How likely is this contingency? It is hard to say. From casual observation, though, we think that much of the corporate fraud that occurred in the 1990s occurred not because the perpetrators were future discounters, but because they thought they would get away with it. Firms do, in fact, have devices at their disposal to screen against future discounting: the hiring of MBAs and JDs, for instance, may be partly an attempt to sort based on discount rates.
[117] A corporate loan would not work because a high-discounter would spend the loan immediately, and not worry about subsequent insolvency.

turn next to another compensation mechanism—conspicuous consumption—that firms may also use.

C. Design of Employees' Utility Functions

1. Greed and Addiction

Perks and deferred compensation are expensive options: because the employee values them less than cash, it would be more efficient if the firm and employee could find a way to make the employee less likely to save, despite high cash compensation. One way to do this is to increase the amount of money that the employee would require before being willing to quit the firm. In the example above, if the banker required $40 million, instead of $5 million, to retire early, cash compensation would be more effective and the firm could remunerate the banker with a larger proportion of cash.[118] This not only saves the firm money, but also increases the amount of work that the firm is able to squeeze out of the employee during her lifetime.

How would the firm do this? The first possibility is through sorting at the hiring stage. The firm would look for people who have a desire for very large sums of money, or who have tastes that demand large amounts of consumption. For example, law firms give summer interns a taste of the good life, with exorbitant lunches and after work events in posh surroundings, presumably in order to attract those who value such things most highly.[119] Law firm summer programs almost always feature an event at a partner's residence in order to show potential associates what they might aspire to in terms of largesse.[120] Some corporate programs feature lifestyle-oriented events such as consultations with personal image advisors, or wine and scotch tastings. Again, these will appeal most to material-oriented individuals.

After hiring, the firm can encourage employees to either aspire to greater and greater amounts of wealth, and to consume lavishly in the short-term, by "addicting" them to conspicuous consumption through perks. "Zagat culture" in New York law firms, for instance, which is largely institutionalized through summer associate perks, compels

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[118] Michael Lewis recounts that $40 million was talked about on Wall Street as the point beyond which even investment bankers would not need any more money and could safely retire. See MICHAEL LEWIS, LIAR'S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET, at ___ (Penguin 1990).
[119] See NALP Foundation, Summer Associate Program Significance, at ___.
[120] See Delong, supra n. __, at 898. See also David Leonhardt, Law Firms Plans Radical Revision of Summer Program for Students, NY Times, August 1, 2000.

associates to patronize the city's most expensive restaurants in order to gain the respect of their peers.[121] The boss who takes her subordinates to expensive restaurants, out golfing, for a ride in her Porsche, or for afternoon cognac and cigars on a slow day tends, through doing so, to instill a desire for those comforts in the subordinates. We might even hypothesize that part of the reason that the most demanding jobs—top tier law and securities firms—tend to be found in Manhattan is that Manhattan allows employees to squeeze the greatest amount of consumption into the shortest possible timeframe.[122] Over time, employees may become "addicted" to such a level of consumption, from which it is difficult to withdraw, since it is difficult to descend to a lower standard of living.[123] Among other things, one's social network, which comprises persons consuming at similarly high levels, ceases to function if the employee fails to maintain that level of consumption, adding a distinct cost to socio-economic moves.

Other ways of encouraging consumption are even more permanent. Firms might encourage employees to get married and start families, since this increases the employee's demand for present consumption. An odd example of this point is the adoption subsidies that many firms now provide: companies like MBNA and Eli Lilly provide employees who can't have children up to $20,000 to adopt some.[124] Or firms may subsidize or provide childcare, maternity/paternity leave, and similar benefits which encourage everyone to have children, since employees with more dependents are less able to retire early. At the same time, firms might impose on employees lifestyles that tend to break up families that have already formed; serial polygamy is, after all, one of the highest forms of conspicuous consumption, since it requires supporting several families at one. The top executive who pays support to three ex-spouses will have seven-eighths of her income already earmarked for her multiple families, meaning that she will have to have earned eight times the total pay she would have otherwise required to get out of the business early. There is anecdotal evidence that firms in industries with high

[121] Michaeil Goldhaber, Greedy Movement Comes of Age, The National Law Journal (p. A1), May 10, 1999 (describing, among other things, "a Free Meal Contest, with awards given for most Zagat Guide points accumulated, highest average Zagat points per restaurant and most celebrities spotted.")
[122] The ability of Manhattan to retain many firms in the wake of 9/11 and the rise of technologies that allow work – especially knowledge work – to be done anywhere, lends support to this claim.
[123] Cite [acclimation models]
[124] Matthew Boyle, *How the Workplace was Won*, 143 FORTUNE at 139 (Jan. 8, 2001) (MBNA provides $20,000; Eli Lilly provides $10,000).

compensation/high variable compensation, like law, investment banking, and consulting, are notoriously filled with multiple divorcees, often from corporate cultures that tolerate intrafirm romances. At one well-known law firm, for instance, a widely repeated aphorism (even by partners) is that the firm's initials stand for what might be paraphrased as "Won't Stay Married."[125] And as one account of the Enron meltdown suggests, the company created a culture of promiscuity: "in Enron's work-hard, play-hard culture, the scent of sex was unmistakable; affairs flourished inside the company."[126]

All of this, while perhaps enjoyable, has the effect of reducing savings, and may also serve to increase the employee's overall utility for high levels of wealth. In either case, the final effect is the same: the employee will be less able to accumulate sufficient wealth to enable her to depart the firm, which avoids a final period problem.

2. Signaling

The firm might not leave it up to the employee to choose a high level of immediate consumption for herself. Instead, the firm could compel a high level of observable consumption from its employees, and thus render the employees more dependent upon their future paychecks than they otherwise would have been. This serves as a signal—from employee to firm—that the employee values the longer-term relationship with the firm.[127]

It might be expected, for instance, that an employee drive a certain sort of car—perhaps the same model, or a slightly less fancy one, that the boss drives—in order to signal that the employee is committed to the firm for the long term (in fact, BMW makes a line of automobiles of gradated expense that are meant to be marketed to those at various stages on the corporate ladder; entry-level employees in the "executive segment" are meant to purchase, of course, "entry-level" BMWs[128]). Or there may be certain posh suburbs, expensive restaurants, or fashion designers that one is expected to spend one's

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[125] Heard from a partner of the firm.

[126] BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON, 123 (2003).

[127] For an excellent exploration of such signaling models, see Eric Posner, LAW AND SOCIAL NORMS, ___.

[128] See, e.g., Dave Moore, *Baby Beemer Breaks Out*, THE CHRISTCHURCH PRESS, 2004 WL 71556178, ____, ___, at __. On the general topic of role signaling through consumption, see Susan Fournier, *A Meaning-Based Framework for the Study of Consumer-Object Relations*, 18 Advances in Consumer Research at 737, 740 ("Products can help in the creation and management of identities at the group and society levels … by serving as unambiguous announcements of role and position. (Prentice 1987; Solomon 1985, 1988).")

money on. Contrary to the conventional wisdom that agents will wear expensive clothes and drive fancy cars in order to impress principals, it may well be that the principal will require that his agent engage in such consumption, because having spent money on these things increases the agent's reliance upon the future relationship with the principal. On a darker note, employees can signal their commitment by neglecting their family life, and allowing their families to break up; employees who spend too much time attending to family, conversely, show that they are not long-term committed to the firm.[129]

A colorful analogy for exactly this sort of behavior can be found in the court of Louis XIV, where Louis adopted extravagantly expensive fashions, which his courtiers were required to emulate. The courtiers thus spent all of their money, and became entirely dependent upon Louis' allowances to them.[130] In that case, as in the above examples, the "employee" destroys value through extravagant and wasteful consumption, which serves to binds herself to the firm (or sovereign, as the case may be). Again, with reference to the recent outcries against greed in the corporate and securities world, it may well be that employees who engage in such behaviors are only doing what the firm or client actually compels them to do.

In this way, Enron was a modern day French court and Chairman Ken Lay a modern day Sun King. Lay and his aide-de-camp, CEO Jeff Skilling, created a "culture of excess" that, according to one executive, "could spoil you pretty well." Lay and Skilling drove fancy cars and built mansions in tony Houston neighborhoods and Aspen, Colorado. Their minions followed suit—"At bonus time, there was a rush on Houston's luxury car dealerships; flashy wheels . . . were de rigueur for top earners, . . . [and] [m]any built new homes and vacation properties."[131] According to the special report

[129] For example, Ron Perelman famously fired his chief lieutenant, Fred Tepperman, for neglecting morning coffee meetings in favor of caring for his wife who had been stricken with Alzheimers and would awake "confused and crying." Perelman reportedly commanded Tepperman : "[i]nstitutionalize her. And Fred, don't look so sad. The bankers will be concerned." *See* John Moody, *Corporate Creep Show: Revlon's Billionaire Head Ron Perelman and One of His Former Executives Take a Nasty Tussle to Court,* TIME MAGAZINE, July 17, 1995, at 39.

[130] See http://splendors-versailles.org/StudentGuide/Customs/index.middleFrame.html [Moliere]

[131] BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON, 123 (2003).

prepared by the board of directors after Enron was wiped out, Enron's senior leadership created a culture of spending to excess that permeated the ranks of top executives.[132]

Even these negative stories of perks and consumption, from cases like Enron, support our general point that they are effective tools for motivating and retaining employees. Perks are powerful drugs that can have positive effects; the downside is that perks, improperly used, can have bad effects as well, a question we consider in Part V. However, we first wish to point out that it is quite possible that perks are currently at levels that are too low, from a social perspective; they may be "public goods," a subject to which we now turn.

D. Are Perks Public Goods?

Despite their usefulness as an incentivization tool, there is reason to believe perks and other savings-reduction technologies[133] may be underprovided. Paying in perks and reducing employee savings reduces cheating not just in the present period, but also serves to deter cheating, from an ex ante perspective, in past and future periods as well. Since the employee may often switch firms, deterrence occurs at firms other than the one that provided the perk, which makes perks look like a public good. Furthermore, competition among firms may lead to "poaching" of employees, where one firm steals away an employee by offering a higher proportion of cash compensation. This is essentially a free-riding problem, where one firm can exploit the expenditures of another. These effects have the potential to lead to a sub-optimal equilibrium where firms pay a lower level of perks than is socially beneficial.

Consider a simple three period model, where an employee (E) works and saves in each period. In periods 1 and 2 she works for either of two firms, Firm A and Firm B, and in period 3 it is revealed whether she cheated in prior periods. She gets some additional benefit from cheating, but when her cheating is discovered in period 3, she suffers a severe penalty if she has not saved enough money to make her reputation-proof. So, if

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[132] *See* William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 4, at __, available at http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf (Feb. 1, 2002); *see also Nobody Went Like Enron*: *Failed Energy Firm Spent Freely on Luxury and Image*, J. REC. (Okla. City), Feb. 28, 2002, at 19, available at 2002 WL 4934187.

[133] The argument developed in this sub-section on perks also applies to conspicuous consumption mechanisms. Since deferred compensation has (potentially) the ability to eliminate poaching, it may not be subject to a free-rider problem.

and only if she calculates that she can save adequately in the two periods, she will maximize her welfare by cheating. If she cannot save adequately to become reputation-proof, she will not cheat.

If Firm A were the only firm in the game, Firm A would simply pay the market wage in periods 1 and 2 with a combination of perks and cash that maximizes its utility. But it becomes significantly more complicated when there is a possibility that the employee may switch firms. Suppose that in period 1, Firm A is compensating employee E with a package of perks and cash that significantly reduces the employee's savings from what they would be if she was paid in all cash. This reduction in savings lessens the likelihood that she will reach her exit threshold where she becomes immune to reputational harms from cheating. Now, however, in period 2 suppose she were to depart Firm A for Firm B, and suppose that Firm B pays more cash and less perks. The fact that Firm A paid her in perks and cash still has an effect in period 2, since her savings is cumulative from period to period. Firm A has incurred extra expense (it would always be cheaper to pay the market wage in just cash) to reduce the likelihood of cheating, but now that expenditure is partially redounding to Firm B's benefit instead: thus, paying an employee in perks reduces the likelihood of current period cheating, but also reduces the likelihood of future period cheating as well. Knowing this, Firm A will provide fewer (costly) perks than it would if it were the only firm in a given industry, and less than would be socially desirable to deter cheating.[134]

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[134] More formally: suppose firms derive a benefit (B_i) in the period *i* in which the employee works for that firm, which is a positive function (but of diminishing marginal returns) of the total perks paid to the employee ($B = B(P_1 + P_2)$), where P_i is the dollar value of perks paid to the employee in period *i*. If Firm A were the only firm, we could write its utility function as $U_A = B_1(P_1 + P_2) + B_2(P_1 + P_2) - P_1 - P_2 - C_1 - C_2$, which means that Firm A's utility is the benefit from employing the employee at a given level of total perks, minus the dollar amount of the total compensation (perks and cash) paid the employee. Since the employee must be paid an exogenously-set market wage in each period (*W*), Firm A will set total perks so as to maximize its utility function subject to the budget constraint $W = xP_i + C_i$, where *x* is a number between zero and one that expresses the employee's valuation of perks relative to cash. We find that Firm A will pay a level of perks (*P**) in each period such that $B'(2P^*) = \frac{1-x}{2}$. In comparison, where the employee works for Firm A in period 1 and Firm B in Period 2, we could write Firm A's utility function as $U_A = B_1(P_1 + P_2) - P_1 - C_1$, since Firm A will only receive the benefit of, and will only receive the costs of, employing the employee in period 1. Maximizing with respect to P1 only, we can find that Firm A would pay a level of perks (P^α) such that $B'(P^\alpha + P_2) = 1 - x$. Assuming Firm B is identical to Firm A, we can rewrite this as $B'(2P^\alpha) = 1 - x$. Since 1-x is positive, $B'(2P^*) < B'(2P^\alpha)$, and since B is of diminishing marginal returns, we can conclude that the level of perks

Similarly, the payment of perks in any given period can also reduce the incidence of cheating in past periods. Suppose that E is working for Firm A in period 1, which does not pay any perks, allowing her to save a great deal of money. However, suppose that, for exogenous reasons, E knows that she will have to move and seek employment with Firm B in period 2, which pays almost completely in perks. E knows that she will not be able to save any money when she is working at Firm B, whereas if she were to work for Firm A in period 2 as well, she would have saved enough money to cheat. If E's calculations lead her to find that she will not be able to save enough money at Firm A in period 1 in order to become immune from reputational harms, then E will tend to refrain from cheating at both Firm A and Firm B. The fact that Firm B is paying in perks in period 2 has deterred cheating in both periods 1 and 2, benefiting both Firms A and B.

From this simplified analysis, we should expect that firms would tend to under-provide perks from a social welfare perspective, since individual firms are not able to capture the full value of the perks that they pay.[135] Underprovision becomes worse, however, when we take into account that firms may intentionally seek to free ride off the perks of other firms. While all firms would be better off if they could agree to a higher level of perks, a "prisoner's dilemma" and free-riding lead them to provide perks at a sub-optimal level.[136] Therefore, even though perks are still quite prominent in the overall compensation package in many industries, we can say that, as a normative matter, there ought to be even more.

If this underprovision is significant,[137] several reforms may help increase the use of good perks.[138] One obvious way to increase the use of perks is to change the public discourse about perks. Instead of prosecutors, the media, and academics using perks as evidence of corporate abuse, the benefits can be highlighted so as to make them more

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paid under competition ($2P^{\alpha}$) is less than the socially optimal level ($2P*$) where one firm captures all the benefits.

[135] There is an additional public good element to paying in perks as well, in that it should also increase the overall level of labor being supplied, since fewer employees are saving enough to retire early.

[136] We see some attempts at cartel-like signaling when it comes to providing perks. Each year, Fortune magazine publishes a "100 Best Companies to Work For" issue that firms use to primarily pitch the perks they offer to employees. In addition, firms recruiting MBAs or lawyers for high-powered positions in industries where cheating may be a problem are open and notorious at the recruiting stage about the perks they provide.

[137] We leave the empirical question to another day.

[138] Firms can address the underprovision problem by trying to make perks firm specific. This might include using corporate loans or providing perks that must be jointly consumed with co-workers.

socially acceptable. While this may seem superficial, our review of the literature on perks suggests a form of groupthink that perpetuates the negative view of perks, and contributes to impeding their use. We offer no specific plan to implement a discursive change beyond our own modest efforts to highlight the benefits of perks and to look at them in a different light. We leave it to others to carry the arguments forward pro and con.

Another, perhaps more effective way, is to give good perks more favorable tax treatment. To a large extent, as discussed above, perks already do receive favorable tax treatment, either as business-related expenses or de minimis benefits.[139] Reducing or eliminating tax on in-kind benefits would no doubt increase the demand for this type of compensation by employees. As the delta between the tax rate on cash and that on perks increases, we will see more payment in perks. (Of course, raising the personal income tax rate on cash compensation, such as to levels seen many European nations, may have the same effects.) On the other side of the same coin, the tax treatment of providing perks could be reformed to encourage their use. For example, tax reforms in 1993 reduced the deductibility of certain perks as business expenses to 50 percent of the cost of the perks. While it is likely that employers are less sensitive to tax changes than employees, increasing the deductibility of perks will undoubtedly result in more perks.

Finally, the free-rider problem could be reduced through increased enforceability of employment contracts. For example, increased use or improved enforcement of employment contracts with noncompete clauses might reduce poaching, and therefore help ensure that firms' investments in preventing cheating with perks will not be captured by other firms.

All that said, any decision to encourage more perks (more "good" perks, that is), must confront the potential downside from perks. There are two primary objections that must be overcome. The first is the process by which perks are decided and implemented. We believe that increased transparency and improved governance can provide an effective brake on the potential for abuse. The second is the possibility that the extravagant perks we think can be so effective will lead to destructive tendencies among employees and firms. It is to these issues that we now turn.

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[139] I.R.C. § 132(a).

V. Policy and Normative Implications

So far, we have focused on the good things about these savings reduction mechanisms: how they may be more efficient than paying cash compensation. But there are downsides as well. The analogy to heroin is apt not only because there are benefits (to the provider) from paying in perks but also because there may be significant harms (to the recipient, and ultimately the provider) as well from the abuse or misuse of perks.

In this Part, we will first propose some guidelines that will help decision makers (be they corporate boards or judges) better distinguish from good perks and bad perks, that is, perks that provide useful incentives at reasonable costs and those that are rightfully condemned as give aways. We then move on to a discussion the downsides of perks and cultures of conspicuous consumption, and some reforms that we think can help minimize the harms that these can cause.

A. Good and Bad Compensation

1. Perks

Not all perks are created equal. Perks are, in the abstract, not necessarily good for firms or employees, and in fact, some perks can be themselves destructive or symptomatic of large agency costs or other wrongdoing. In other words, there are both "good" and "bad" perks. But how is one—say a board member or judge—to tell the difference?

Our theory provides a place to start. Good perks will generally be extravagant and nonfungible, since perks must be something that the employee would not choose to purchase herself; that is, perks cannot be easily convertible to cash, since that would enable the employee to save.[140] For example, paying an employee's regular hairdresser is fungible, since employees would normally have to pay this themselves, meaning that the employee simply pockets the amount of the transfer in cash. Thus, this type of perk—what we call "bad" perks—may be evidence of a stealth, abuse, or ignorance. On the other hand, paying for a complete professional makeover, which the employee would not

[140] As discussed in Section II, there may be valid reasons – such as economies of scale, increased productivity, or instituting a coherent firm culture – for paying fungible perks. Courts and boards would need to consider these reasons as well, but because these reasons have already been discussed in other literature (e.g., Rajan and Wulf, supra __), we do not reconsider them here.

purchase for herself, would not be fungible with savings, and could constitute a good perk.

For perks that are durable goods, which continue to exist from period to period, to be good they must not vest permanently in the employee. Ultimate ownership must remain with the firm, so that the utility of the perk can be withdrawn in the event that the employee misbehaves. Suppose a firm purchases an extravagant item, such as an antique umbrella stand, for an executive. If the executive actually acquires ownership of the umbrella stand, the executive will enjoy its benefits even after he is fired, or he could always liquidate the umbrella stand for cash. So the purchase of such items outright, for the employee's permanent benefit, constitutes a bad perk. Similarly, perks that are contractually guaranteed, and cannot be revoked, do not serve any legitimate incentive purpose.[141] Without some ability to discipline the employee for cheating that is discovered in the future, it would be cheaper and more efficient to pay any earned benefits in cash.

These definitions of good and bad are fairly simple, but they sometimes lead to counter-intuitive conclusions. For example, the much-pilloried Sardinian extravaganza thrown by Tyco CEO Kozlowski for his (second) wife has characteristics of a good perk, since it is unlikely that he would have spent $2 million of his own money for the bash, and since he couldn't convert the party to cash that he could then save.[142] In contrast, money received to defray Kozlowski's or his daughter's rent, or Martha Stewart's hairdresser appointment—which seems perhaps relatively modest and intuitively reasonable—would be bad perks, since these are things that Kozlowski and Stewart would have to pay for him- or herself, and thus they are indistinguishable from receiving cash.

[141] For example, after Terrence Murray retired as CEO of FleetBoston Financial, he was contractually guaranteed the use of the company jet for 50 hours per year, a chauffer-drive car, and a corner office with assistant *for life*. Joann S. Lublin, *How CEOs Retire in Style*, WALL STREET J., Sept. 13, 2002, at B1.

[142] However, since non-fungibility is a necessary, but not sufficient condition for being a good perk, concluding that the party was in the end a good perk requires more analysis. After all, the decision to spend $2 million may have been made unilaterally by Kozlowski without the necessary board oversight or may be excessive even in light of the potential benefits. But this really cuts more to the matter of overall levels of compensation and independent board oversight, which we discuss below in part V.B.

2. Corporate Loans

We think it is also possible to tell good from bad corporate loans. Corporate loans have fallen in and out of favor over the past century—they were considered *ultra vires* at common law and in early corporate codes,[143] but the practice grew enormously as modern state law allowed their more liberal use over the past several decades.[144] Although commonly used until banned by recent federal legislation, academics, the media,[145] and the case law[146] have roundly criticized their use. For example, Lucian Bebchuk and Jesse Fried claim that corporate loans are inefficient (especially when at "favorable interest rates")[147] and they are used primarily to camouflage the amount of total compensation to "reduc[e] the saliency of managers' compensation" in the eyes of shareholders.[148] Other scholars assume that loans unrelated to specific corporate tasks are per se inefficient and evidence of wrongdoing.[149] These arguments found particular resonance in the political sphere in the wake of the alleged misuse of corporate loans at firms like Tyco.[150] Initial corporate reform bills—what would become the Sarbanes-Oxley Act—proposed

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[143] *See, e.g., Leigh v. American Brake Beam Co.*, 205 Ill. 147, 151, 68 N.E. 713, 715 (1903) ("A corporation cannot make loans of money unless the exercise of its chartered powers ordinarily includes such loans."); for a general discussion of the history of corporate loans, *see* Jayne W. Barnard, *Corporate Loans to Directors and Officers: Every Business Now a Bank?*, 1988 WISC. L. REV. 237, ___ (1988).

[144] Nearly all states permit corporate loans by statute, subject to approval by shareholders or directors. *See* DGCL § 143 (1983) ("Any corporation may lend money to, or guarantee any obligation of, or otherwise assist any officer or other employee of the corporation or of its subsidiary, including any officer or employee who is a director of the corporation or its subsidiary, whenever in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation.").

[145] *See, e.g.*, Gary Strauss, *Execs Reap Benefits of Cushy Loans*, USA TODAY, Dec. 24, 2002, at 1B.

[146] Judicial criticism was largely limited to loans where the interest rate was below the prevailing market rate for similar loans. Courts in these cases occasionally readjusted the interest rate upwards to match the market rate. *See, e.g,,Romanik v. Lurie Home Supply Center, Inc.*, 105 Ill. App. 3d 1118, 1133-34, 435 N.E.2d 712, 722-23 (5th Dist. 1982); *see also Maxwell v. Northwest Indus., Inc.*, 72 Misc. 2d 814, 821, 339 N.Y.S.2d 347, 356 (1972); *Washington Nat'l Trust Co. v. W.M. Dary Co.*, 116 Ariz. 171, 174, 568 P.2d 1069, 1072 (1977) (loan to corporate officer at below market rate of 4% was inherently unfair to the corporation).

[147] Special scholarly scorn is reserved for below-market interest rate loans. *See* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1203 (2003) (concluding that the only fair loans are those where the interest rate is greater than the firm's weighted average cost of capital (WACC)).

[148] *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, NBER Working Paper Series, Working Paper 9813, at 10-11 (July 2003), available at http://www.nber.org/papers/w9813.

[149] Jayne W. Barnard, *Corporate Loans to Directors and Officers: Every Business Now a Bank?,* 1988 WISC. L. REV. 237, ___ (1988) ("Loans made to facilitate the purchase of stock, or payment of personal financial obligations, college expenses or income taxes, on the other hand, do not advance specific corporate purposes.").

[150] *See*, Tim McLaughlin, *Execs' trial centers on Tyco loans,* THE STAR-LEDGER, Sept. 24, 2003, at ___.

requiring increased disclosure for corporate loans.[151] But as the outrage over the bankruptcy of Enron and WorldCom continued to grow, the president gave a speech condemning the practice of corporate loans, and soon thereafter, Senator Feinstein offered an amendment to ban them altogether.[152] The practice is now illegal.[153]

This ban is a case of severe overreaching. Encouraging an employee to borrow is good, since repayment obligations hanging over an employee's head make her more dependent upon her future paychecks.[154] In this regard, loans are properly viewed as useful "anti-savings," into which the employee may be profitably induced to enter with subsidized interest rates or some likelihood of forgiveness in the future. Forgiving loans at or before the retirement of the employee, however, can largely nullify the anti-savings effect of the loan unless some oversight is in place to make sure the employee has consumed it all. Furthermore, arranging ahead of time (either explicitly or through past practice) that loans will be forgiven in their entirety is simply a transfer of dollars from firm to employee without any corresponding future benefit accruing to the firm. Thus, corporate loans that are later forgiven may be either good or bad, depending upon the length of deferral or whether the loan was earmarked for a certain sort of consumption.[155]

Subsidized loans present a slightly different picture. Often, these are earmarked for a particular purpose, such as buying a house. Subsidization may be useful insofar as it can encourage an employee to spend more than the employee would have chosen to spend. For example, a $1 million subsidized loan to buy a house induces the employee who would have preferred only a $300,000 home to spend more than would have been

[151] *See* S. 2673, 107th Cong. (2002) (requiring only "8K reporting within 7 days of the making of covered loans.").

[152] *See* Remarks of President George W. Bush at New York Stock Exchange, July 9, 2002, available at http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html ("And I challenge compensation committees to put an end to all company loans to corporate officers."). Notably, the president called for firms to ban the practice, not the government. He nevertheless signed the ban into law.

[153] *See* Sarbanes-Oxley Act of 2002, §402, 116 Stat. at 787 (codified at 15 U.S.C.A. §78m (West Supp. 2003).

[154] This is also a highly controversial statement if you believe popular accounts. *See, for example,* Elizabeth MacDonald, *Crony Capitalism*, FORBES, June 21, 2004, at 140-6 (describing loans to CEOs as in "bad taste" and proposing that "[d]irectors should give serious thought to just giving the boss a pay raise, if he's really hard up, and knocking off the monkeyshines" of corporate loans).

[155] *See, e.g.,* JOHN TARRANT, PERKS AND PARACHUTES, 239-40 (1985) ("Sometimes the front money needed to recruit senior executives is too big to fit under the heading 'bonus.' So the payment is made in the form of a loan, at low interest or perhaps no interest. Since the loan must be repaid, it serves as an effective set of golden handcuffs. However, the loan need not always require repayment.").

her initial preference. In return for a lower interest rate or other favorable terms, the firm receives a debt-laden employee who can be better trusted.

Corporate loans can be improperly used, of course, but they can also be highly effective, valuable to the firm, and fairly easy to monitor. Corporate loans to employees that are earmarked for a specific use and are required to be repaid are a good way of compensating employees because they provide strong incentives to remain with the firm and because the value of the loan is not in question. Alternatively, corporate loans that can be forgiven far enough in the future can also deter cheating. These add value to the firm, and the Sarbanes-Oxley ban sweeps too broadly in eliminating it from mix of compensation choices firms may use.

B. The Dark Side of Perks, and Potential Governance Reforms

It is possible that perks may work too well. For example, since perks are a powerful tool for employers to prevent wealthy employees from retiring, an employee might be willing to misbehave (by say hiding bad news or inventing good news) in order to keep her job and enjoy the benefits of office. This preservation instinct is likely to be especially problematic in situations in which the perk recipient can determine (or greatly influence) the perks she receives. Thus the problem is much more likely to occur in the corporate context, where the recipients of most "excessive" perks—the officers and directors—have great discretion to determine perks as well as their own employment status. The anecdotal evidence and our interviews corroborate this potential weakness of perks. For example, Brian Hall illustrates the value executives place on their office with the story of the CEO of Circon Corporation who "strongly resisted a takeover attempt . . . that would have raised the value of his . . . shares by more than $10 million" because he valued the perks of his employment, such as "a fancy office" with "a private eating terrace," more than the money. As one CEO we talked to put it, "it seems silly when I think about it, but the fringe benefits of corporate life are hard to replicate in retirement—I'll miss the lifestyle as much as the [business] challenge when I'm retired." This problem is less likely in other industries with similar last period problems, like investment banking or law, where perks are typically set by a rotating group of firm partners.

So how do firms prevent the use of perks from being abused, either by self-serving or self-preserving recipients? In the language of our drug dependency analogy, how do firms prevent their heroin addicts from becoming junkies? And how do firms prevent executives from awarding themselves perks that are not justified by the anti-savings analysis we provide.

First, there should be director oversight. Disinterested, well-informed directors should monitor the use of significant of perks, like the use of corporate jets and the size of expense accounts for top managers.[156] At some point, as with all significant compensation issues, the board needs to know how much was paid out, and to whom it went. This proposal is a significant change from current behavior. Prior to the recent batch of corporate reforms, directors exercised little real control over perks taken by management.[157] While we do not share the overall pessimism of some observers that perks are evidence of high agency costs that justify a broad set of governance reforms, it is clear that there is potential for managers to self-award perks that do not serve the purposes discussed in this article. The aggressive use of perks we recommend in this article requires heightened corporate governance standards among employees who can set their own compensation, given the opportunities for stealth and misappropriation.[158]

Second, an increased role of disclosure and investor oversight might be useful. There is already a fair amount of disclosure under current law—significant perks to top executives must be disclosed in SEC filings.[159] A recent study of CEO employment

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[156] This proposal is similar to that proposed by the ALI Principles of Corporate Governance: compensation decisions, including perks, are valid if they are authorized in advance or ratified by disinterested directors in an informed manner or if there has been approval or ratification by disinterested shareholders and the compensation did not constitute waste at the time of the vote. *See* ALI Principles of Corporate Governance § 5.03.

[157] While the Sarbanes-Oxley reforms were silent on the issue of compensation oversight, the listing requirements promulgated by the major stock exchanges go a long way in the direction of increased supervision, requiring a compensation committee composed entirely of independent directors to approval all significant components of executive compensation. *See* NYSE section 303A; NASD Rule 4350. While perks are not specifically enumerated in these rules, corporate advisors advocate such oversight as best practice. *See* Wendy J. Hilburn, *Counseling the Compensation Committee*, 1395 PLI 1017, 1022 (Nov. 2003).

[158] These modest (and incomplete) proposals are similar to those offered by other commentators in other contexts. *See, for example,* Charles M. Elson, *Executive Overcompensation – A Board-Based Solution*, 34 B.C. L. REV. 937 (1993).

[159] Perks given to a corporate officer must be disclosed only if the total exceeds the lesser of 50,000 or 10% of the total of the named officer's annual salary plus bonus, and material employment contracts must be disclosed as well. Items 402, of Regulation S-K. In addition, disclosure of the type of perks constituting the total is required (in a footnote or narrative) only for each perquisite that exceeds 25% of the total

contracts in securities filings finds that they are "quite specific about the types and quantities of perquisites given," and that about 40 percent mentioned the use of a company car, 25 percent membership in a country club, and less than 10 percent use of a company aircraft.[160]

However, there are reasons why disclosure may be inadvisable. If savings reduction is a public good, as described above in Part IV.D, then disclosure of which employees are "perked," and to what degree, enables poaching. Another consideration is that disclosure of compensation appears to lead to increased competition for highly valued employees, possibly to the detriment of shareholders.[161] For example, a CEO who sees what another firm's CEO is receiving in perks may demand the same, even if that would not be appropriate given the particular circumstances.[162]

Third, courts can exercise some oversight, but this is likely to be quite weak and limited to procedural issues. Courts rarely find that compensation decisions violate the business judgment rule or constitute waste, and no court has specifically passed on the merits of a case questioning the excessiveness of perks.[163] This reluctance seems right, as courts are not well positioned to evaluate the merits of specific compensation levels or perks, and, as the ALI has concluded, other factors, such as disclosure and approval by compensation committees, likely provide sufficient oversight.[164] As several Delaware judges recently opined, the role for courts is primarily procedural—that is, making sure

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perquisites by type and amount. Some commentators believe that the current disclosure rules are wholly inadequate, and that they allow self-serving executives to camouflage excessive pay and benefits. *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, NBER Working Paper 9813, available at http://www.nber.org/papers/w9813 (July 2003). The argument for disclosure is much weaker because we show that perks are not necessarily stealth compensation but are more likely an efficient way to augment reputation and deter cheating. Moreover, the free rider/public good problem we identify militates against increased disclosure absent other reforms.

[160] Stewart J. Schwab & Randall S. Thomas, What Do CEO's Bargain For?: An Empirical Study of Legal Components of CEO Employment Contracts, Vanderbilt Law & Economics Working Paper No. 04-12, unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm? abstract_id=529923.

[161] See generally, Ryan Miske, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code,* 88 Minn. L. Rev. 1673 (2004).

[162] Another way of putting it is that the purported "stealth" qualities of perks may work to the firm's advantage by avoiding cutthroat competition in the labor market.

[163] *See* __Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 247-51 (1983); Eric L. Johnson, Note, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste,* 26 J. CORP. L. 145 (2000); Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569 (2001); Charles M. Elson, *Courts and Boards: The Top Ten Cases*, American Law Institute - American Bar Association Continuing Legal Education, November 12, 1998.

[164] *See* ALI Principles of Corporate Governance § 5.03.

that boards exercise considered judgment when approving compensation for senior executives.[165] This type of oversight should apply equally to perks.

C. Problems with Cultures of Conspicuous Consumption

Conspicuous consumption by employees does not present the severity of danger that corporate perks do, since employees are spending their own money and not the company's; dipping into the corporate coffers is generally not an issue. However, there are a number of ways in which encouraging employees to fetishize material comforts might have negative effects.

First, there could come a point where too much spending actually makes employees less trustworthy. As employees begin to live beyond their means, we may expect that employees also begin to become more tempted to cheat as a way to finance their higher standard of living. For example, an employee who is underwater with gambling debt may resort to stealing from the till in order to pay off her bookie. Or a law firm partner who cannot meet her alimony, country club, or second house payments might choose to trade on a client's confidential inside information. So, here, we might suppose that if a firm addicts an employee too quickly to too high a level of consumption, that strategy could well backfire on the firm by encouraging the employee to cheat.

Second, a culture of unabashed greed may reward and encourage employees who have morally questionable characters, or may help to shape employees' characters in ways that we find aesthetically and morally unappealing. Is there a social cost, somewhere down the road, if the bright-eyed, idealistic, and talented students who enter business and law school emerge, say, twenty years later as businessmen and women cynically engaged in a never-ending race for greater and greater degrees of material comfort? It is difficult to say for sure: the Ron Perelmans of the world may be, in the view of most people, unpleasant at best, but whether they represent a necessary cost of well-functioning capitalism is debatable. On a more practical note, however, greed may be correlated with other negative personality characteristics, such as opportunism, egocentrism, and dishonesty, or we might suppose that the proliferation of greedy culture signals to employees that such behavior is socially acceptable.

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[165] *Id* at ___.

Third, a lot of the spending that cultures of conspicuous consumption encourage appears to be, at first glance, socially wasteful, at least to the extent that *ex post* there are other ways in which we would prefer the money to be spent. We might suppose that everyone would be better off if highly compensated employees were encouraged to live modestly, perhaps donating the surplus to good causes or investing in the capital markets, instead of lavishing their swollen paychecks on luxury goods, such as Ferraris and Rolexes, that quickly lose their value. In short, this mode of employee incentivization may fuel a rat race that, while benefiting shareholders, externalizes costs onto society.

Finally, one might object that cultures of conspicuous consumption may discourage value-adding cooperation because of their emphasis on materialistic self-interest. The corporation as cooperative venture, as Lynn Stout postulates,[166] may fail to function as well as it could where employees are engaged in short-sighted and single-minded maximization of near-term consumption. Such employees will tend to shun cooperative efforts where results (and, hence, performance bonuses) are not easily attributable to individual employees. In contrast, if employees are motivated more by soft, qualitative considerations such as friendship, loyalty, or a sense of duty, they may be more willing to undertake cooperative projects where individual effort and effectiveness are not readily observable.

Definitive answers to these problems are not forthcoming (at least not in this paper), though we can venture some qualified guesses as to how they would be resolved. The first and last objections, while presenting difficult empirical questions of how employees are motivated and what makes a corporation work effectively, are probably best left to corporations to figure out for themselves. Shareholders, directors, and employees of the corporation should internalize most, if not all, of these costs, and they are the ones who have the ability to figure out amongst themselves what best minimizes these costs relative to the possible gains. To the extent that a solution makes one group better off than another, the winners can always compensate the losers with part of the surplus

The second and third objections, however, present the possibility of significant externalities that fall outside of the corporation itself. As for the third issue—the

[166] See Stout, supra, n. __.

wastefulness of extravagant spending and the possible crowding out of more socially beneficial activity—we think it is unlikely that a regulatory solution is forthcoming (at least in the corporate law sphere). Personal preferences and the ability of firms and employees to contract for mutually satisfactory compensation are an area into which we do not believe the government can competently intervene. And macroeconomic effects, if any, such as decreased savings or decreased investment in the capital markets, can probably be better countered through tax policy than through substantive corporate law.

On the other hand, we think the issue of dysfunctionally ambitious corporate culture does present a *possible* case for regulation. If the gears of business and corporate law are consistently grinding down society's best people into unrepentant robber barons, there may be a distinct cost that is borne by society as a whole. If (though it's a big if) cultures of excess regularly result in massive meltdowns such as Enron, Adelphia, and Tyco, which can disrupt the wider economy; then the law has an interest in stepping in to limit the proliferation of these cultures. One possible method of regulation is to force corporate executives to internalize some of these costs by making them more readily liable for corporate malfeasance; then, in choosing what sort of culture to implement, corporate CEOs would take care not to generate future Andy Fastows. The recent Sarbanes-Oxley reforms have already placed some of these costs onto top management;[167] whether this has gone too far, or not far enough, is a debate we will not enter into in this paper. It is our hope, however, that our analysis provides a useful framework for considering this question, and others like it, in future scholarship.

VI. Conclusion

Firms can benefit from paying their employees in perks, deferred compensation such as corporate loans, and by encouraging conspicuous consumption. This benefit arises from the way in which these compensation devices foster future dependence upon the firm: employees are unable to save and accumulate wealth from period to period, and thus do not reach the point where they would become immune to reputational or retributive penalties. While these tools are a powerful augmentation of a firm's ability to

[167] *See* [SOX §§ 302 (certification), 802 (broad criminalization of violation of corporate duties), ___(enhanced white collar crime penalties) etc.]

police its employees, they can also have a downside, since they can also lead to undesirable employee behavior when inappropriately or excessively implemented. Thus, such compensation schemes are not fool proof, and oversight is no less important than with ordinary cash compensation. However, we do believe that current legislation and scholarship have taken too extreme a position against these practices and have not recognized the benefits that these very powerful tools can provide.

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