Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption

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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—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.

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> "[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]

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 hy 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 academic lingo: High levels of non-cash compensation are often viewed as evidence of large agency costs within a firm and justification for regulation or corporate governance reforms. A recent article in *Forbes* magazine summed up the prevailing attitude: "Crony Capitalism: 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. 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—later on, when Kozlowski was granted hundreds of millions of dollars in cash compensation and loan forgiveness—

1. Ben Stein, *Climbing Above It All (in a Private Jet, of Course)*, N.Y. TIMES, June 20, 2004, § 3, at 5.
2. Elizabeth MacDonald, *Crony Capitalism*, FORBES, June 21, 2004, at 140–46.
3. *See* Anthony Bianco et al., *The Rise and Fall of Dennis Kozlowski*, BUS. WK., Dec. 23, 2004, at 64–77; Colleen DeBaise, *Executives on Trial: Newest "Tyco Gone Wild" Video Is Out, and Jurors See $6,000 Shower Curtain*, WALL ST. J., Nov. 26, 2003, at C1; Mark Maremont, *Executives on Trial: Next Evidence for Kozlowski Jurors: Party Video*, WALL ST. J., Oct. 28, 2003, at C1.

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that 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 for what will likely be remembered as one of the greatest periods of corporate excess in American history."[4]

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 by ostentation."[5] At least, this is what the prosecution in such cases hopes.[6] 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 Rolls-Royces.[7] And

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4. *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2172 (2004). A search of the Westlaw database reveals literally hundreds of articles published in the past two years describing the pay practices at firms as dominated by greedy, self-interested, rent-seeking managers. *See* Lucian Arye Bebchuk, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785–87 (2002) (concluding that management power over the executive pay-setting process, rather than market forces or arm's-length bargaining, explains current forms and amounts of compensation). A few examples of the legion of articles include: Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 10–11 (2002) (noting that public regulation may be inappropriate when these scandals show all "the ways greed can overcome judgment and morals"); David Millon, *Why is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 914–15 (2002) (lamenting the "exceptionally lavish" benefits received by executives at Enron and WorldCom); 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, 24 (2003) (criticizing the greed of managers and corporate governance generally as not including "a model of human behavior that takes account of . . . altruistic behavior"); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAWYER 1371, 1371 (2002) (Vice Chancellor of the Delaware Court of Chancery describing Enron scandal as "a tale of greed").

5. *See* Guilt by Ostentation, ProfessorBainbridge.com, http://www.professorbainbridge.com/2004/04/guilt_by_ostent.html (Apr. 7, 2004).

6. This certainly appears to be the case in the Martha Stewart and Kozlowski trials. *See* Alex Berenson, *Overcompensating: In Fraud Cases, Guilt Can Be Skin Deep*, N.Y. TIMES, Feb. 29, 2004, § 4, at 4; Leslie Eaton, *Web of Friends and Business Blurs Stewart's Glossy Image*, N.Y. TIMES, Feb. 29, 2004, § 1, at 1; *see also* Barry Meier, *Looking To Add a Bit of Glamour to Adelphia Trial*, N.Y. TIMES, Mar. 8, 2004, at C1 (describing the prosecution's attempts to show that the Rigas family greedily used Adelphia resources for their own purposes, such as chartering the corporate jet to transport a Christmas tree).

7. *See* Gregory Zuckerman & Cassell Bryan-Low, *With the Market Up, Wall Street High Life Bounces Back, Too*, WALL ST. J., Feb. 4, 2004, at A1. There have been similar pieces over the years: George Anders et al., *Inside Wall Street: Merger Whiz Kids: Wall Street Prodigies Seek Money and*

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when times turn bad, the *Journal* strikes a tone of lamentation as perks and conspicuous consumption decline.[8] 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 Gekko (Ivan Boesky's fictionalized alter-ego) that "greed is good,"[9] 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 in investment banking or corporate law 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: Her savings enable her to retire or downshift her career to a less high-powered industry where her reputation may not follow her.[10] 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 are great enough, there is no reason not to cheat. With enough savings in hand, the employee does not care whether she is fired and blackballed from other firms; she has become immune to reputational

Power as They Build Careers, WALL ST. J., June 2, 1986, § 1, at 1; Patrick McGeehan, *Now Suddenly Rich, Wall Streeters Spark a Very Fancy Boom*, WALL ST. J., Apr. 10, 1997, at A1.

8. *See* Mitchell Pacelle et al., *The Market Bounceback: When Stocks Shimmy, New York Shakes*, WALL ST. J., Oct. 29, 1997, at B1; Anita Raghavan, *Nickel and Dime: Wall Street Sweats the Small Stuff*, WALL ST. J., Oct. 27, 2003, at A1; Erin White & Teri Agins, *Sellers of Big Ticket Items Brace for Less Splurging*, WALL ST. J., Oct. 2, 2001, at B1.

9. WALL STREET (20th Century Fox 1987).

10. 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.

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constraints on her behavior.[11] 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 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.[12] 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 I) 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—an element of 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

11. In Wall Street and Silicon Valley patois, these savings are referred to as "fuck-you money." *See* The Masher, *Jet Blue and "Fuck You" Money*, ALTERNET (June 26, 2001), http://www.alternet.org/columnists/story/11099/ ("[T]o be rich, you need what Silicon Valley types call 'fuck you' money: a minimum of $10 million to be able to generate a work-free $500,000 a year.").

12. 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.

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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 remains dependent upon the firm from one period to another.[13] 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 suboptimal incentivization packages and can be symptomatic of executive overreaching. 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 deter 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 I 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 legal literature. This Part broadly addresses all types of perks—including run-of-the-mill, non-extravagant perks—many of which are provided for reasons other than to reduce savings and buttress

13. 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.

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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 II 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 III explores how in-kind compensation and corporate loans can be used to prevent reputational failings caused by high savings, as well as how pre-hire sorting, inculcation of preferences, and signaling via corporate culture can further align the incentives of firm and employee. Part IV discusses normative implications of this theory, including the dark side of "corporate heroin" and appropriate policy reforms.

I. THE CONVENTIONAL WISDOM

A. THE CRITICS

The prevailing wisdom among corporate observers is that perks are bad (especially "excessive" perks, although "excessive" is not typically defined). There are two primary objections. The first is that the separation of ownership and control—the classic "agency problem"[14]—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 suggest weak corporate governance.[15] The second objection is that perks are inefficient and perhaps counterproductive incentives for employees.

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

14. Adam Smith, in *The Wealth of Nations*, first described the different and conflicting incentives of ownership and management. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 31 (Regnery Publ'g 1998) (1896). 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 J. FIN. ECON. 305 (1976).

15. *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem* 10–11 (Nat'l Bureau of Econ. Research, Working Paper No. 9813, 2003), *available at* http://www.nber.org/papers/w9813 (noting that the efficiency grounds for offering perks are unclear, and that the primary purpose is "to make [the amount of executive] pay less salient").

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perquisites] that are not shared by other investors because of their control over decisionmaking."[16] Lucian Bebchuk and Christine Jolls extend this thinking, claiming that perks are evidence of high agency costs because executives may "provide themselves with various perks not germane to their job responsibilities."[17] 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)."[18] The accepted wisdom is that perks "are attractive to management but are of no interest to shareholders" and in fact are value-destroying.[19]

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 at these firms and have presented this as evidence of a kind of rot rampant in American corporate governance. The picture that these scholars paint is one of greedy CEOs motivated by pure self-interest and focused more on creating a lavish lifestyle for themselves than on 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."[20] The search for causes of frauds at Enron, WorldCom, and other firms is a cottage industry whose main output seems to be what could be described normatively only as an anti-greed view of corporations. For example, John Coffee blames the slew of corporate meltdowns on the moral and ethical lapses of management and market gatekeepers, like lawyers and securities

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16. George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1113 (2004).

17. Lucian Aryé Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. ECON. & ORG. 487, 487–88 (1999).

18. BRIAN J. HALL, INCENTIVE STRATEGY II: EXECUTIVE COMPENSATION AND OWNERSHIP STRUCTURE (Harv. Bus. Sch. Note 902-134, Oct. 11, 2002), *available at* http://harvardbusinessonline.hbsp.harvard.edu/b01/en/common/item_detail.jhtml?id=902134.

19. Joseph J. Lemon, Jr., *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 1 (Apr. 2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=529822. Yermack conjectures that "these managers [may] run their firms inefficiently, tolerating waste, excess overhead, or uncompetitive cost structures." *See id.* at 29. 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.

20. Douglas Litowitz, *Are Corporations Evil?*, 58 U. MIAMI L. REV. 811, 811 (2004).

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professionals, who were all lured by the siren song of greed.[21] 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]."[22] None of these articles examines perks in depth or offers any potential counterarguments 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"[23] 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 [the] experience of being controlled is likely to assume a punitive quality over time."[24] Perks are typically referred to as "bribes," and critics point to anecdotal evidence suggesting that companies suffer a backlash from incentive-rich environments.[25] 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.[26] The argument is that firms that use perks and other non-cash benefits to motivate employees will necessarily create a climate of greed and fear, in which purely self-interested employees will rise to the top and potentially valuable employees will be forced out by the overly competitive environment. "Greed" is thus linked explicitly to excess and wrongdoing, since the winners of the benefits lottery are more likely to engage in misconduct or to manipulate the corporate form to maintain their greed. 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.[27]

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21. John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 269–71 (2003).

22. *See* BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 122 (2003).

23. Alfie Kohn, *Why Incentive Plans Cannot Work*, HARV. BUS. REV., Sept.–Oct. 1993, at 54.

24. *Id.* at 58.

25. Teresa M. Amabile, *Rethinking Rewards*, HARV. BUS. REV., Nov.–Dec. 1993, at 37, 43 ("But the more they [give] you, the more they think they own you.").

26. *Id.*; *see also* EDWARD DECI & RICHARD RYAN, INTRINSIC MOTIVATION AND SELF-DETERMINATION IN HUMAN BEHAVIOR 35–37 (1985) (noting that freedom, individual autonomy, and a feeling of self-determination are necessary conditions for effective motivation).

27. A few legal articles express puzzlement at the size and scope of perks typical in corporate America. *See, e.g.*, Stewart J. Schwab & Randall S. Thomas, *What Do CEOs Bargain For?: An Empirical Study of Key Legal Components of CEO Employment Contracts* (Vanderbilt L. & Econ. Working Paper No. 04-12, 2004), *available at* http://ssrn.com/abstract=529923. Schwab and Thomas describe the litany of perks in CEO employment contracts—such as use of company aircraft, country

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The typical solution offered by these scholars involves linking pay to seniority[28] or other group-based metrics[29] or a focus on "intrinsic human motivations," with fuzzy concepts like "[s]atisfaction and respect" being the best incentives for high performance.[30] Compensation experts offer vague recipes for motivation, such as Alfie Kohn's "Three C's" framework: choice, collaboration, and content,[31] with a focus on empowering workers and creating a happy work environment, or they 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 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-

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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 of this nature." *Id.*

28. This is, in fact, a deferred compensation mechanism, as we describe in Part III.A.

29. *See, e.g.*, Egon Zehnder, *A Simpler Way to Pay*, HARV. BUS. REV., 3-9 (Apr. 2001) (describing how seniority-based pay at a large consulting firm reduced turnover to 2% compared with industry average of 30%).

30. Andrew M. Lebby, *Rethinking Rewards*, HARV. BUS. REV., Nov.-Dec. 1993, at 42, 42.

31. Alfie Kohn, *For Best Results, Forget the Bonus*, N.Y. TIMES, Oct. 17, 1993, § 3, at 15.

32. HALL, *supra* note 18, at 11 ("[S]trong ethical norms and behaviors represent an important and powerful check on necessarily imperfectly designed and enforced incentive schemes.").

33. *See* SMITH, *supra* note 14, at bk. 1, ch. 2. ("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.").

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, 36 (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 the Congress Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, 107th Cong. (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 judicial opinions. 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, e.g.*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *In re* Walt Disney Co.

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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 . . . so do social context and the quality we call '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, because the eco-

Derivative Litig., 825 A.2d 275 (Del. Ch. 2003). 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 1100–02, 1132.

40. *Id.* at 1132.

41. *See* Stout, *supra* note 4.

42. *Id.* at 25.

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

44. *See, e.g.*, 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); BARBARA LEY TOFFLER & JENNIFER REINGOLD, FINAL ACCOUNTING: AMBITION, GREED, AND THE FALL OF ARTHUR ANDERSEN (2003); Coffee, *supra* note 21, at 269–70; John Cassidy, *The Greed Cycle: How the Financial System Encouraged Corporations To Go Crazy*, THE NEW YORKER, Sept. 23, 2002, at 64; David Streitfeld & Lee Romney, *Enron's Run Tripped by Arrogance, Greed; Profile: A Lack of Discipline and a Drive To Bend Rules Were Key Factors in the Meltdown*, L.A. TIMES, Jan. 27, 2002, at A1.

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).

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nomic consequence of the loans are not disclosed in ways 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, $14 million for home furnishings, $13 million to buy a yacht, and $5 million for a diamond ring.[47] The outrage at these apparently indefensible excesses (we will offer a defense in Part III below) grew to the point where President George W. Bush called for an end to corporate loans in a speech at the New York Stock Exchange,[48] and an anti-corporate loan provision was quickly added to the pending Sarbanes-Oxley legislation.[49] Section 402 of the Sarbanes-Oxley Act now specifically prohibits loans to executive officers of public companies.[50]

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 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."[51] 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 on-site car

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46. *See* Bebchuk & Fried, *supra* note 15, at 10–11 (criticizing loans as "stealth compensation" due in part to inadequacies of disclosure).

47. *See* Theresa Howard, *Tyco Puts Kozlowski's $16.8M NYC Digs on Market*, USA TODAY, Sept. 18, 2002, at 3B; Mark Maremont et al., *Executives on Trial: Mistrial Scuttles Possible Guilty Verdicts in Tyco Case*, WALL ST. J., Apr. 5, 2004, at A1.

48. President George W. Bush, Remarks on Corporate Responsibility at the Regent Wall Street Hotel, New York, N.Y. (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.").

49. About a week later, Senator Feinstein made the following remarks on the Senate floor: "Under an amendment sponsored by Senator Schumer and myself, company loans to executive officers are now prohibited, sharply limiting the types of 'hidden' compensation that can be offered to executives without being fully disclosed to shareholders." 148 CONG. REC. S6762 (daily ed. July 15, 2002) (statement of Sen. Feinstein).

50. *See infra* notes 151–61 (discussing treatment of corporate loans over time).

51. Jeffrey Pfeffer, *Six Dangerous Myths About Pay*, HARV. BUS. REV., 76 Reprint 109–11 (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.

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detailing, a putting green, "and, of course, the masseur."[52] 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 III.

In addition, recent empirical work by Raghuram Rajan and Julie Wulf suggests that while "perks may be a form of excess" in some firms, "a 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.[53] 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, organizational structure, productivity) against three common perks (company plane, chauffer service, and club memberships), to conclude that there is "no direct relationship" between measures of governance and access to these perks.[54] 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 offering alternative explanations of their consequences) are quite rare in the legal literature, which makes it worth recounting some of the standard arguments 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 benefits from perks that exceed their costs. These may be benefits the firm would not 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.[55] 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 hierarchical or flat organization in ways that compensation cannot because perks are generally more observable than salaries to other employees.[56] A firm

52. *60 Minutes: Working The Good Life* (CBS television broadcast, Apr. 20, 2003), *available at* http://www.cbsnews.com/stories/2003/04/18/60minutes/main550102.shtml; *see* Pfeffer, *supra* note 51, at 116.

53. *See* Raghuram G. Rajan & Julie Wulf, *Are Perks Purely Managerial Excess?*, 2–8 (Nat'l Bureau of Econ. Research Working Paper No. 10494, 2004), *available at* http://www.nber.org/papers/w10494.

54. *Id.* at 25.

55. *Id.* at 4.

56. *See, e.g.*, FRED HIRSCH, SOCIAL LIMITS OF GROWTH 27 (1976) (developing concept of "positional goods" and noting that they are "valued in part for their scarcity and social exclusiveness").

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looking to foster a collegial atmosphere might provide the same fringe benefits to all employees (like free massages or on-site doctors) while a firm 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.[57] Firms might also use particular types of perks to create or reinforce a particular firm culture.[58] 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 in researching companies, Peters and Waterman were continually struck by the "dominant use of story, slogan, and legend."[59] On the other hand, firms that want to emphasize 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).[60]

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, firms may choose to offer in-kind compensation that is replete with information from the firm about what

57. 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 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.

58. 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 symbols of the company's macho, risk-taking culture." McLEAN & ELKIND, *supra* note 22, at 122. 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.

59. THOMAS J. PETERS & ROBERT H. WATERMAN, JR., IN SEARCH OF EXCELLENCE 75 (1982).

60. For example, Intel proudly reports that the CEO "works in a cubicle," that there are "no reserved parking spaces," that there are "no executive dining rooms," and that "execs fly coach." *See* Robert Levering & Milton Moskowitz, *The 100 Best Companies To Work For*, FORTUNE, Jan. 10, 2000, at 82; Robert Levering & Milton Moskowitz, *The 100 Best Companies To Work For*, 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 ST. J., Apr. 12, 2004, at R11.

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is valued.[61]

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 whisk 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."[62] Anecdotal evidence suggests that this "ego premium" is fairly inelastic to wealth. Multimillionaire Martha Stewart routinely submitted receipts to be reimbursed by her firm for minuscule 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) exceeded the marginal financial benefit to her, so an ego premium of sorts may well have made up the difference.[63] 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 retirement, is the corner office, the attractive secretary, the limos, expense accounts, and corporate jets."[64]

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

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61. 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 nonviolent 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*, FORTUNE, Feb. 4, 2002, at 72. It would be hard for Patagonia to achieve similar results with cash or employment advertisements.

62. MCLEAN & ELKIND, *supra* note 22, at 123.

63. 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. As of 2002, Stewart owned almost two-thirds of the firm's class A shares and 100 percent of its class B shares, giving her almost 95 percent voting control of the firm. *See* Chris Isidore, *Martha's Net Worth Sinks*, CNN/MONEY (June 24, 2002), http://money.cnn.com/2002/06/24/news/companies/martha_holdings/.

64. Interview with a corporate headhunter (July 11, 2004).

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instant gratification, and so on.[65] According to this school of thought, the primary reason people engage in mental accounting is to impose "financial self-control."[66] 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, 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 and entertainment)[67] and generous exclusions for employer-provided health insurance and pension contributions swallow the rule for most employees.[68] 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 forty percent tax bracket.[69] 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 tax rates (like America) and high rates (like Europe): European executives enjoy more fringe benefits than their American counterparts.[70] So tax breaks may drive a significant proportion of

65. Christine Jolls, *Behavioral Economic Analysis of Redistributive Legal Rules*, *in* BEHAVIORAL LAW AND ECONOMICS, 288, 294 (Cass R. Sunstein, ed., 2000).

66. Cass R. Sunstein, *Introduction* to BEHAVIORAL LAW AND ECONOMICS, *supra* note 65, at 1, 6-7.

67. *See* 26 C.F.R. § 1.132-6 (2004). While perks are generally considered taxable income, gross income does not include (1) no-additional-cost services; (2) qualified employee discounts; (3) working condition fringe benefits; or (4) de minimis fringe benefits. *See* I.R.C. § 132 (2000) and Temp. Treas. Reg. § 1.132-1T (as amended in 1989).

68. *See, e.g.*, I.R.C. § 404(a) (2000); I.R.C. § 106 (2000). *See generally* STEPHEN A. WOODBURY & WEI-JANG HUANG, THE TAX TREATMENT OF FRINGE BENEFITS (1991).

69. 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% 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.

70. *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. While the precise mechanism by which this shielding is accomplished is not obvious, this theory is described in Brian R. Cheffins, *Will Executive Pay Globalise Along American Lines?*, 11 CORP. GOV. 1, 9 (Jan. 2003) S.E. Gross & P.L. Wingerup, *Global Pay? Maybe Not Yet!*, COMPENSATION & BENEFITS REV., July–Aug. 1999, at 25, 29–30, as well as in numerous media accounts. 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.

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perks, especially the nonextravagant perks discussed in this Part.[71]

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.

II. HOW SAVINGS CAUSES THE FAILURE OF REPUTATION

Even without the potential productivity and tax advantages discussed in the preceding Part, we 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.

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 often 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 (that is, a good reputation), the client will be more likely to

71. 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.

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deal with the banker.[72] 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.[73] Reputation allows the agent to bond herself to act in the principal's interest.[74]

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.[75] 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.[76]

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

72. 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.

73. 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 a top U.S. investment bank.)

74. 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 J. FIN. 57, 75 (1994); *see also* Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1062 (1990) (finding that underwriter reputation is maintained by marketing the IPO only of firms expected to have low price run-up variance); Andrew McLennan & In-Uck Park, The Market for Liars: Reputation and Auditor Honesty 19-20 (Oct. 2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=422701 (finding that "honest" auditors charge higher fees and earn more profits). In addition, Chemmanur and Fulghieri show that "the ability of financial intermediaries to acquire a reputation for veracity mitigates the moral hazard problem in information production." Chemmanur & Fulghieri, *supra*, at 76.

75. 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.

76. For a discussion of final period problems and optimal retaliation strategies, see ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 216–17 (2000).

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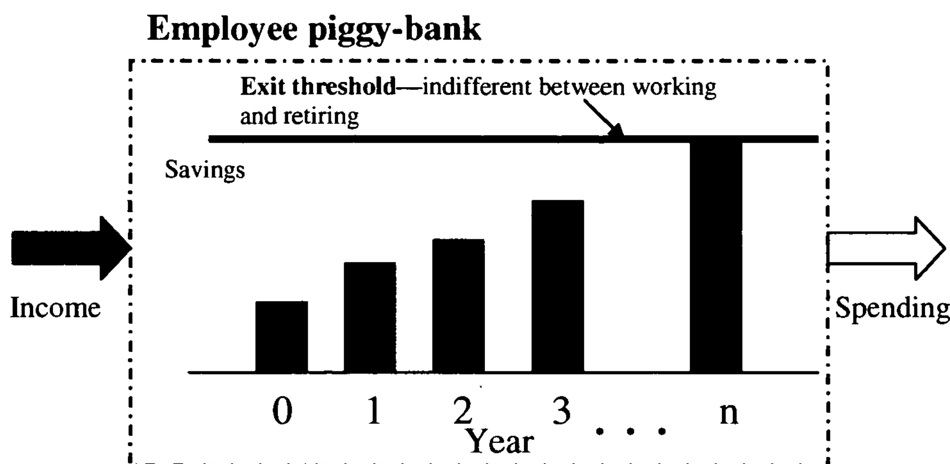

Figure 1 shows a simple model of employee savings. The black arrow on the left depicts income paid to the employee, some of which is saved (the black bars), and some of which is spent (the white arrow on the right). Over time, the employee's total accumulated savings can rise, as depicted by the increasing 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.

an employee accumulates wealth by saving, the employee becomes able to quit her job and retire, which she will do if she would derive 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 (that is, wealth) makes the employee less likely to desire employment in the future.[77] A wealthier person, all things being equal, chooses to increase her consumption of leisure.[78] If a worker cannot choose to reduce her hours,[79] the employee has a

77. 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* GEORGE J. BORJAS, LABOR ECONOMICS 39 (1996). 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.

78. *See* N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS 469–72 (South Western 3d. ed. 2003). Studies done of people who win the lottery show that winners are more likely to leave the labor force than non-winners and that the likelihood of leaving increases with the amount of money won. *See* BORJAS, *supra* note 77, at 39.

79. 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

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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.

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.[80] 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),[81] only to see 43% 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% of those with known destinations)[82] and are searching for a better quality of life—that is, fewer 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

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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 (for example, moving from Sullivan & Cromwell to Davis Polk). For other, greater shifts, however, there is probably no significant reputational 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.

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

81. *See* Law Office Management & Administration Report, *Nearly One in 11 New Associates Leaves (But NALP Data Show What Firms Can Do)*, L. OFF. MGMT. & ADMIN. REP., May 1998, at 2. According to the executive director of NALP, it generally takes three years for an associate to start making money for the firm. Jenna Ward, *Survey Studies Attrition Rate of Associates*, THE RECORDER, Mar. 12, 1998. In 1998, the managing partner of Brobeck estimated that, after two years of employment, the firm had invested $200,000 in each associate. Cynthia Cotts, *How Firms Keep Their Associates on the Job*, NAT'L L.J., June 8, 1998.

82. *See* Amy Delong, *Retaining Legal Talent*, 29 CAP. U. L. REV. 893, 896 (2002); NALP Foundation, Executive Summary, *Keeping the Keepers: Strategies for Associate Retention in Times of Attrition*, *available at* http://www.nalpfoundation.org/webmodules/articles/anmviewer.asp?a=61 (last visited June 16, 2005) (reporting that while associates largely choose private practice based on salary, "[n]umerous associates reported that they had taken substantial cuts in pay in order to achieve a more balanced lifestyle, and even those who had not yet made such a dramatic move indicated their willingness to earn less for the chance at having a life outside of the law office").

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leave the firm.[83] 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 technology startup that finances itself partly by granting its employees large equity stakes, such as Google, faces the prospect of losing many of its employees to early retirement or some form of career-downshifting once it goes public and those employees become multi-millionaires.[84]

Even worse than the employee retention issue, however, is 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 the 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.[85]

83. The average law school debt, according to a NALP survey of law associates, was $60,000 as of 1998. Jenna Ward, *Survey Studies Attrition Rate of Associates*, RECORDER, Mar. 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.

84. See Kevin J. Delaney and Joann S. Lublin, *Google Goes Public: They're All Rich—Now the Problems Start*, WALL ST. J., Aug. 20, 2004, at C3 (describing the incentive problems that Google faces with its newly rich employees: "[W]hen you're a millionaire, you say, 'Why should I work nights and weekends?'").

85. 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?* (George Mason L. & Econ. Researcb Paper No. 04-50, 2004), *available at* http://ssrn.com/abstract=615281. Horan and Johnsen argue 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 a manager's savings level and create incentives for the manager to use index funds (that is, cheat) and to bank much of the salary instead of spending it on

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Similarly, a top corporate executive could "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 (that is, they put the employee above her exit threshold), the banker or executive would not care about her future reputation, and would cheat.[86]

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,[87] meaning that the employment relationship is never instituted in the first place.[88] 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.[89]

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. There are limits on the enforceability

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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 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 simply by paying in a perk that cannot be "cashed in."

86. 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. Civil suits against Grubman are still pending, so it remains to be seen whether his cheating strategy proves profitable in the long run. *See A Federal Judge Gave a Green Light to Civil Suits Against Citigroup, It's [sic] Chairman Sanford Weill and Former Analyst Jack Grubman*, CORP. FIN. WK., Dec. 13, 2004, at 7, *available at* 2004 WLNR 15863441.

87. 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* COOTER & ULEN, *supra* note 76, at 217–18.

88. 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.

89. 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.

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of contractual commitments to work; courts will not generally enforce the type of contracts that would force retention.[90]

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. Verifying "cheating," in its 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 undoubtedly is done in some instances: Firms pay managers bonuses, for example, based on verifiable performance metrics such as earnings per share. Benchmarking, however, has its limits, because, as one prominent labor economist stated, "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."[91] The possibility of defining an appropriate and effective metric to reduce cheating, and one that is not susceptible to manipulation or itself an incentive to certain types of cheating, is probably illusory. 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 cheated egregiously. Again, there is the difficulty of specifying all acts of prohibited cheating (even greater than in the private contracting case because the law is applicable to all firms), and the difficulty of having to verify tbat an instance of cheating actually took place. An additional problem is that lawsuits against employees for disloyalty, which are public, imply negative things about the firm as well, leading to underenforcement of private rights. This underenforcement 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 that plague private enforcement, and the difficulty in setting penalties at levels to create optimal deterrence all limit the effectiveness of regulatory solutions.

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90. 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" (that is, purporting to endure more than five years, or covering long geographical distances) absent extraordinary circumstanccs. *See, e.g.*, Rochester Tel. Mobile Commc'ns, Inc. v. Auto Sound Sys., Inc., 583 N.Y.S.2d 327 (App. Div. 1992).

91. James M. Malcomson, *Individual Employment Contracts*, 3B HANDBOOK OF LABOR ECONOMICS 2291, 2337 (Orley Ashenfelter & David Card eds., 1999). Such schemes surely motivate certain behavior, but unfortunately they often "motivat[e] the *wrong* behavior." *Id.* (quoting EDWARD E. LAWLER III, STRATEGIC PAY: ALIGNING ORGANIZATIONAL STRATEGIES AND PAY SYSTEMS 58 (1990)).

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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, because the very purpose of reputation constraints is 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 keep savings below the exit threshold—either by reducing savings or increasing the threshold—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."[92] The problem of excessive liquidity is the focus of the next Part, where we describe several compensation mechanisms that firms can, and do, employ to prevent managers from bailing out at will.

III. 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 likely would have been discovered; 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. The use of a corporate jet or even an especially expensive meal are examples. Third, employers can try to lead 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 more easily observed. This allows the firm extra time to determine whether the employee has cheated or not and puts off the final period

92. Coffee, *supra* note 21, at 308. 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. *Id.*; *see infra* Part III.A.

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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 linking compensation to future, firm-specific behavior (such as remaining employed with the same firm), deferred compensation also helps to solve the retention problem, providing disincentives to poaching by rival firms.[93]

The paradigm case of deferred compensation is a simple promise to pay some amount of cash in the future, with the understanding that the firm may withhold payment if it determines that the employee has behaved improperly. Various forms of deferred compensation are evident in practice, such as steep wage profiles,[94] deferred bonuses,[95] grants of restricted stock or options whose vesting is contingent upon future employment,[96] and, indeed, the well-known (but now largely prohibited)[97] corporate loan that is forgiven in the future.[98]

The advantage of deferred compensation is that it does not alter the employee's spending or consumption behavior as perks and conspicuous consumption do,[99] 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:

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93. 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.

94. 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* Edward P. Lazear, *Retirement from the Labor Force*, *in* 1 HANDBOOK OF LABOR ECONOMICS 305, 320-22 (Orley Ashenfelter & Richard Layard eds., 1986); *Age and Productivity: Over 30 and over the Hill*, ECONOMIST, June 26, 2004, at 60.

95. "[Sixty-three] of the 100 largest industrial firms in the United States have bonus plans with . . . provisions [for optional deferral at the compensation committee'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 & Ross Watts, *Incentive and Tax Effects of Executive Compensation Plans*, *in* FOUNDATIONS OF CORPORATE LAW 164, 166 (Roberta Romano ed., 1993).

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

97. The Sarbanes-Oxley Act forbids loans to directors and executive officers. *See* Sarbanes-Oxley Act of 2002, § 402, 15 U.S.C.A. § 78m(k) (West Supp. 2005). Because of the usefulness of loans as deferred compensation schemes, we believe that this is a serious mistake, as discussed herein.

98. Because 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. A notorious example of lending from corporation to executive is the millions of dollars in loans and loan forgiveness that Tyco awarded to Dennis Kozlowski in 1999, while he was still CEO. *See* Bianco et al., *supra* note 3, at 74–75; *see also* CHRISTOPHER BYRON, TESTOSTERONE INC.: TALES OF CEOS GONE WILD 311–12 (2004). Our analysis suggests 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.

99. *See infra* Part III.B–C.

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First, when can the deferral be paid, and second, what compels the firm to pay in good faith?

Because 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 cheating would not be detected until three years after it occurs, that payment cannot be made until three years after the employee has quit the firm or final period cheating will not be deterred. 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.[100]

For example, suppose that an investment banker will quit and retire to the Bahamas once she reaches a level of accumulated wealth of $5 million and that the market wage for such an employee is $1 million cash per annum.[101] Furthermore, in each year, the employee can choose to either behave or cheat (such as by pushing through inadvisable deals); if she behaves, she simply gets 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. Finally, suppose that it takes three years for cheating to be discovered, because some time is necessary to determine whether a deal was good or bad, 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 Year 1: The employee could choose to cheat in Years 1, 2, and 3, earning $1.8 million in each of those years for a total of $5.4 million. Her cheating would not be discovered until after Year 3, and by that time her accumulated wealth of $5.4 million exceeds her exit threshold of $5 million—meaning that cheating would be the preferable strategy for her. Knowing this, the firm will choose not to hire her in the first place if the costs to the firm of her wage and cheating exceed the benefits of employing her.

Deferred compensation can help to solve this problem; the firm can defer enough of the employee's wage so as to keep the employee below her exit threshold until the firm can determine whether or not she has cheated. Here, the firm could pay the employee $500,000 in each of the five years, terminate her,

100. Lazear, *supra* note 94, at 322, makes exactly this point.

101. 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 for three years after the fact.

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and then make a deferred cash payment in year 8 of $2.5 million.[102] If the employee tried to cheat in any of her five years of employment, the firm would discover it by Year 8 and be able to withhold the deferred cash; thus, the most the employee could make through a strategy of cheating is $4.9 million (by cheating in Years 3, 4, and 5, for total wages of $2.5 million and total cheating bonus of $2.4 million), whicb is below her exit threshold of $5 million. The rational choice for the employee, then, would be to behave in all five years, receiving total wages of $2.5 million in Years 1 through 5, plus the deferred amount of $2.5 million in Year 8, for a total of $5 million.[103] 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 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."[104] *If*, however, the firm is a repeat player,[105] and *if* cheating is observable to other employees in the labor market,[106] then there may be a reputational check on cheating of tbis 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.[107] But even taking the non-extreme scenario, where 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. Because the risk premium that employees

102. This deferred wage amount could take the form of, among other things, a corporate loan that is forgiven in the future at the discretion of the firm.

103. For simplicity, we are not taking into account the time value of money. While this would affect the actual numbers, it does not affect the basic analysis or the conclusions.

104. Lazear, *supra* note 94, at 320; *see also* Smith & Watts, *supra* note 95, at 167 ("[I]t might be thought that the forfeiture provision would enable the firm to cheat its managers out of their deferred compensation.").

105. We would point out that even potentially immortal firms may face end-game situations, especially when financial distress arises.

106. 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 by the firm 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, because this would be the only way that a firm could identify itself as a non-cheater. Both these outcomes, however, undermine the incentive purpose of deferred compensation.

107. "[A]n 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 believed they had been promised and as a result no longer trusted promises for the future." Malcomson, *supra* note 91, at 2353.

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would require grows with the amount of deferred compensation, we would expect that deferred compensation would tend to have diminishing marginal returns.

This may be why, in practice, deferred compensation is not used as extensively, nor deferred for as long a period (that is, 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 no cash, and instead be compensated entirely in corporate loans to be forgiven at retirement, at the firm's discretion, in the absence of employee cheating.[108] But real world practices fall far short of this. For example, restricted stock grants are often eviscerated in this regard.[109] 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, precipitating the final period problem that the deferral was designed to prevent.[110]

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 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 section, 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

108. One of the authors has put this arrangement forward to his students as a hypothetical compensation arrangement for them at a law firm. Unsurprisingly, 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.

109. 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, *supra* note 18, at 14.

110. Dennis Kozlowski provides a good example of this. *See* Bianco et al., *supra* note 3, at 76.

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until later periods. This is useful because perks can give employees incentives 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 III.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. There is a solution at hand, however: Even though the market has set a benchmark for the amount of utility that the investment banker must receive, the firm has discretion over the form in which 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 provides the banker with significant utility but does not allow the banker to save.

More particularly, suppose that the banker 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.[111] 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 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.

So long as the high surplus is greater than $1.5 million, however, the firm would choose to pay $500,000 in cash and $1 million in perks.[112] The banker

111. This supposition essentially says that the firm believes the employee to have fixed expenditures of $500,000 per year.

112. In certain circumstances, however, the firm would prefer to pay all cash; for instance, in this example the firm would pay all cash where LowSurplus – $1,000,000 > HighSurplus – $1,500,000 and LowSurplus – $1,000,000 > 0. So, for instance, if LowSurplus is $1.2 million, and HighSurplus is $1.6 million, then the firm's profit from paying all cash is $0.2 million, as opposed to profit of $0.1 million

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would be indifferent between that compensation package and $1 million in cash, satisfying the benchmark wage constraint. 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.[113] 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.[114] Everyone is made better off through the liberal use of perks.[115]

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, while her market wage should only equal $1 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, or they relieve the employee of expenses and enable him 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 perks to 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

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from paying perks and cash. Whether perks are a useful strategy or not depends, therefore, on the cost of cheating; in this example, if the cost of cheating is only $0.4 million, perks are not cost-efficient.

113. 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 enougb to move beyond subsistence status. For an example of an economic modeling of such a poverty trap, see Vicky Barham et al., *Education and the Poverty Trap*, 39 EUR. ECON. REV. 1257, 1267–68 (1995).

114. Competing firms could "poach" the employee by offering more cash. In this specific situation with identical firms, that would not happen because the incremental dollar paid by the competing firm would destroy all the surplus it might gain from the employee. In a more complex world, however, we might suppose that poaching is a problem. This is discussed in Part III.D below.

115. While here we bave 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, sucb 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.

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perks are efficient is whether they are "germane" to an employee's job function.[116] While it 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 IV 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, earmarked for a particular purpose, such as buying a fancy house or car.[117] This has the advantage of allowing the employee to choose the sort of perk she most prefers and to enjoy present utility, wbile also preventing savings and maintaining tbe threat of firm retaliation—by non-forgiveness of the loan—if the employee misbehaves in the future.[118]

Another cost of perks may be an increased likelihood of attracting employees with high future discount rates. Perks are more attractive to higb-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,[119] it creates an additional cost. We believe this could be offset through the combination of perks with deferred compensation (such as a steep

116. Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. ECON. & ORG. 487, 487–88 (1999). Although Bebchuk and Jolls do admit that non-germane perks may sometimes be efficient, they believe that this will not obtain in most cases, concluding that "permitting value diversion imposes a cost on shareholders that may reduce ex ante share value." *Id.* at 501.

117. The firm would have to be careful that the employee does not use the loan to choose a perk that is highly fungible with her savings.

118. This sort of hybrid is especially useful, we think, 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 spend it and then die, evading repayment when cheating is detected. On the other hand, pure deferral, with no loan, does no good, because, 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 othcr 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.

119. It is hard to say whether such an effect is likely. From casual observation, though, we think that much of the corporate fraud of 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 hased on discount rates.

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wage profile or deferred bonus);[120] 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 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 these benefits less than cash, it would be more efficient if the firm and employee could find a way to reduce the employee's level of saving, despite high cash compensation. One way to do this would be to increase the amount of money the employee would desire to have in savings before quitting 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. This not only saves the firm money, but it also increases the amount of work 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 desire very large sums of money or who 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 to attract those who value such things most highly.[121] 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.[122] Some corporate programs feature lifestyle-oriented events such as consultations with personal image advisors and wine or scotch tastings.[123] Again, these will appeal most to material-oriented individuals.

After hiring, the firm can encourage employees to aspire to greater and greater amounts of wealth, and to consume lavishly in the short-term, by using perks to "addict" them to conspicuous consumption. For example, the "Zagat

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120. A corporate loan would not work because a high-discounter would spend the loan immediately and not worry about subsequent insolvency.

121. *See* NALP FOUNDATION, THE SIGNIFICANCE OF SUMMER PROGRAMS: LAW STUDENTS AND LEGAL EMPLOYERS REPORT (2003).

122. *See* Delong, *supra* note 82, at 898; *see also* David Leonhardt, *Law Firm Plans Radical Revision of Summer Program for Students*, N.Y. TIMES, Aug. 1, 2000, at C1.

123. *See* Delong, *supra* note 82, at 897.

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culture" in New York law firms—which is largely institutionalized through summer associate perks—encourages associates to patronize the city's most expensive restaurants in order to gain the respect of their peers.[124] 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 her subordinates. We might even hypothesize that part of the reason the most demanding jobs—those at 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.[125] Over time, employees may become "addicted" to such a level of consumption and find it difficult to "withdraw," as it is often hard to descend to a lower standard of living.[126] Among other things, one's social network, which is usually comprised of persons consuming at similarly high levels, ceases to function if the employee fails to maintain a high level of consumption. This adds a distinct cost to socioeconomic moves.

Other ways of encouraging consumption are even more permanent. Firms might encourage employees to get married and start families, as these obligations increase the employee's demand for present consumption. An odd example of this point is the adoption subsidies currently many firms now provide: Companies like Eli Lilly provide employees who do not have children up to $10,000 to adopt some.[127] Firms may also provide childcare, maternity/ paternity leave, and similar benefits, which encourage all employees to have children, as employees with more dependents are less able to retire early. At the other extreme, firms might adopt policies that tend to break up families that have already formed; serial polygamy is, after all, one of the highest forms of conspicuous consumption, because it requires supporting several families at once. 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, to get out of the business early, she will have to have earned eight times the total pay she would have otherwise required. There is anecdotal evidence that firms in industries characterized by high variable compensation—such as law, investment banking, and consulting—are notoriously filled with multiple divorcees.[128] 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."[129] And as one account of the

124. Michael D. Goldhaber, *Greedy Movement Comes of Age*, NAT'L L.J., May 10, 1999, at A1 (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").

125. The fact that Manhattan has been able to retain so many firms in the wake of 9/11, despite the increasingly portable nature of "knowledge work," lends support to this claim.

126. Gibson Cromwell & Charles Peters, *Golden Handcuffs*, WASH. MONTHLY, Nov. 1995, *available at* http://www.findarticles.com/p/articles/mi_m1316/is_11_27/ai_54469064.

127. Matthew Boyle, *How the Workplace Was Won*, FORTUNE, Jan. 8, 2001, at 139.

128. *See, e.g.*, MCLEAN & ELKIND, *supra* note 22, at 123.

129. Heard from a partner of the firm.

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Enron meltdown suggests, the company created a culture of promiscuity: "[I]n Enron's work-hard, play-hard culture, the scent of sex was unmistakable; affairs flourished inside the company."[130]

All of this, while perhaps enjoyable, has the effect of reducing savings and may increase the employee's overall demand 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, hence avoiding 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 a long-term employment relationship.[131]

It might be expected, for instance, that an employee elects to drive a certain type 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.[132] Or there may be certain posh suburbs, expensive restaurants, or fashion designers that an employee is expected to spend her money on. Contrary to the conventional wisdom that agents wear expensive clothes and drive fancy cars in order to impress principals, it may well be that principals *require* their agents to engage in such consumption, because spending money on these items increases an agent's reliance upon the future relationship with her principal. On a darker note, employees can signal their commitment by neglecting their family life and allowing their families to break up; indeed employees who spend too much time attending to family may signal that they are not committed to the firm long-term.[133]

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130. MCLEAN & ELKIND, *supra* note 22, at 123.

131. For an excellent exploration of such signaling models, see ERIC POSNER, LAW AND SOCIAL NORMS (2000).

132. *See, e.g.*, Dave Moore, *Baby Beemer Breaks Out*, PRESS (Christchurch, N.Z.), Mar. 27, 2004, at 1, *available at* 2004 WLNR 5023071. 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 RES. 736, 737, 740 (1991) ("Products can help in the creation and management of identities at the group and society levels . . . hy serving as unambiguous announcements of role and position.") (citations omitted).

133. For example, Ron Perelman famously fired his former CFO, Fred Tepperman, for neglecting morning coffee meetings in favor of caring for his wife who had been stricken with Alzheimer's and "would awake confused and crying." Perelman reportedly commanded Tepperman: "Institutionalize her. And Fred, don't look so sad. The bankers will be concerned." John Moody, *Corporate Creep Show:*

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A colorful analogy for exactly this sort of behavior can be found in the court of Louis XIV. Louis adopted extravagantly expensive fashions, which his courtiers were required to emulate. The courtiers thus spent all of their money on these fashions and became entirely dependent upon Louis' allowances to them.[134] In that case, as in the above examples, the employee destroys value through extravagant and wasteful consumption, which serves to bind 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 be that employees who engage in such behaviors are only doing what the firm or client 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."[135] Lay and Skilling drove fancy cars and built mansions in Aspen, Colorado and tiny Houston neighborhoods. 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 .... Many built new homes and bought vacation properties or ranches."[136] According to the special report 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.[137]

Even negative stories from cases like Enron support our general point that perks and excess consumption 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. We consider this question in Part IV. However, we first wish to point out that, from a social perspective, it is possible that the level of perks in society is currently too low; indeed, perks 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

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Revlon's Billionaire Head Ron Perelman and One of His Former Executives Take a Nasty Tussle to Court, TIME, July 17, 1995, at 39.

134. *See* The Splendors of Versailles: Student Supplement: Customs (Oct. 28, 1998), *at* http://splendors-versailles.org/index2.html.

135. MCLEAN & ELKIND, *supra* note 22, at 122–23.

136. *Id.*

137. *See The Role of the Board of Directors in Enron's Collapse*, Report of the Subcommittee on Investigations of the Committee of Government Affairs of the U.S. Senate, 107th Cong., 2d Sess., July 8, 2002, at 52–54 (concluding that Enron was "a culture driven by compensation"), *available at* http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf; William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 4, at 26–27, *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.

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that perks and other savings-reducing technologies[138] may be underprovided. Paying in perks and reducing employee savings not only reduce cheating in the present period but also serve to deter cheating in past and future periods. That is, because an employee may work at more than one firm during her career, deterrence occurs at firms other than the one that provided the perk. This makes perks a public good. Moreover, competition among firms may lead to "poaching" of employees, whereby one firm steals a highly perked employee with low savings (who will hence be more valuable in the future) away from another firm by offering the employee a higher proportion of cash compensation. This is essentially a free-rider problem, in that one firm can exploit the expenditures of another. These effects can potentially lead to a suboptimal equilibrium at which firms provide a lower level of perks than is socially beneficial.

Consider a simple three-period model, in which an employee (E) works and saves in each period. In periods 1 and 2 she works for either of two firms, Firm A or 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 become reputation-proof. The result is that she will maximize her welfare by cheating if and only if she calculates that she can save adequately in the two periods. 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 compensates E with a package of perks and cash that significantly reduces the employee's savings from what they would be if she were paid entirely in cash. This reduction in savings lessens the likelihood that she will reach her exit threshold and become immune to reputational harms from cheating. Now, however, suppose E were to depart Firm A for Firm B in period 2, and suppose that Firm B pays more cash and fewer perks. The fact that Firm A paid E primarily in perks still has an effect in period 2, because E's savings are cumulative from period to period. Firm A has incurred extra expense (it would always be cheaper to pay the market wage exclusively in cash) to reduce the likelihood of cheating, but that expenditure is now partially redounding to Firm B's benefit: Firm B receives an employee with a low level of savings without having paid perks to the employee itself. Because Firm A knows that it will not capture all the benefits from the perks it pays out, Firm A will provide fewer perks than it would if it were the only firm in a given industry and less than would be socially desirable to deter cheating.

138. The argument developed in this section on perks also applies to conspicuous consumption mechanisms. Since deferred compensation has the potential to eliminate poaching, it may not be subject to a free-rider problem.

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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, hence allowing E 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 calculates that she will not be able to save enough money to become immune from reputational harms, then E will 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 can see that individual firms are not able to capture the full value of the perks they provide. Thus, from a social welfare perspective, we should expect firms to underprovide these perks.[139] Underprovision becomes worse, bowever, when we consider that firms may intentionally seek to free-ride off of the perks provided by other firms. Firms may seek to poach employees who, all else being equal, are highly perked. While all firms would be better off if they could agree to a higher level of perks, both free-riding and a "prisoner's dilemma" lead them to provide perks at a suboptimal level.[140] Therefore, even though perks are still prominent in the overall compensation packages provided in many industries, we can say that, as a normative matter, they ought to be even more prominent.

Several reforms might help to increase the use of perks.[141] One way to do so is to change the public discourse about perks. Instead of using perks as evidence of corporate abuse, prosecutors, the media, and academics could highlight the benefits of perks so as to make them more socially acceptable. While this may seem superficial, our review of the literature on perks suggests a form of groupthink that perpetuates a negative view of perks and contributes to impeding their use.[142] Beyond our own modest efforts to bighlight the benefits of

139. Because paying in perks results in fewer employees being able to save enough to retire early, this form of "payment" should increase the overall level of labor being supplied, thus adding an additional public good element to paying in perks.

140. 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 in which firms 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 notoriously open at the recruiting stage about the perks they provide.

141. We leave the empirical question of whether underprovision is significant enough to warrant reform for another day.

142. This conclusion is based on the near-unanimous criticism of perks and other forms of in-kind compensation among academics in law and the other social sciences. For an overall review of the literature, see Part I.A, *supra*. Not only are non-cash payments predominately condemned, they are criticized in almost all cases with pejorative modifiers, such as "excessive," "lavish," and "outrageous." In most of these cases, the work is not about perks or compensation, so the author does not address the merits of including in-kind compensation as part of the compensation mix but instead merely parrots

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perks and to look at them in a different light, we offer no specific plan to implement a discursive change. We leave it to others to carry the arguments forward, pro and con.

Another, perhaps more effective, way to increase the use of perks is to give perks more favorable tax treatment. As discussed above, perks already *do* receive favorable tax treatment, either as business-related expenses or de minimis benefits.[143] Reducing or eliminating the tax on in-kind benefits, as well, would no doubt increase the demand for this type of compensation by employees. As the difference 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 to levels such as those seen in many European nations might have the same effect.) 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 fifty percent of the cost of the perks.[144] While it is likely that employers are less sensitive to tax changes than employees, increasing the deductibility of perks would undoubtedly result in more perks.

Finally, the free-rider problem could potentially be reduced through increased use or improved enforcement of employment contracts. For example, increased use or improved enforcement of employment contracts with non-compete clauses might be used to reduce poaching and may reassure firms that their investments in preventing cheating with perks will not be captured by other firms. This potential reform has obvious drawbacks, however, as courts are very cautious about using equitable relief to force an employee to work against her will for a specific employer. There is a rich literature on the tradeoffs inherent to these contracts, and we need not repeat the arguments here.[145] Suffice it to say that use of non-compete clauses is likely to be an insufficient solution to the free-rider problem given the tendency of most state courts to err on the side of under-enforcement of these contracts except in a narrow set of circumstances.[146]

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the standard criticism. This uniformity of opinion and language suggests a herd mentality about a conventional wisdom.

143. I.R.C. § 132(a) (2000).

144. *See* Omnibus Reconciliation Act of 1993, Pub. L. No. 103-66, §13,209, 107 Stat. 312 (1993) (codified at I.R.C. §274(n) (2000)).

145. *See, e.g.*, Eric A. Posner & George G. Triantis, *Covenants Not To Compete from an Incomplete Contracts Perspective* (Chi. Law Sch. John M. Olin Law & Econ. Working Paper No. 137, 2001), *available at* http://ssrn.com/abstract=285805 (arguing that courts should enforce covenants not to compete only when renegotiation of the employment contract is impossible); KENNETH J. MCCULLOCH, TERMINATION OF EMPLOYMENT: EMPLOYER AND EMPLOYEE RIGHTS 40,011–12 (1984).

146. *See supra* note 90 and accompanying text. These contracts are generally enforceable only if they are: (1) bargained for in exchange for separate consideration; (2) limited in time and geographic reach; (3) necessary to protect the reasonable and legitimate business interests of the employer; and (4) not unreasonably harsh on the employee or unfair to the public at large. *See* Kathryn J. Yates, Note, *Consideration for Employee Noncompetition Covenants in Employments at Will*, 54 FORDHAM L. REV. 1123, 1125 (1986).

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Any decision to encourage the use of more perks (more "good" perks, that is[147]) must confront their potential downside. There are two primary objections that must be overcome. First, the process by which perks are decided on and implemented must provide an effective brake on the potential for abuse. We believe that increased transparency and improved governance can provide such a brake. Second, there is fear that the extravagant perks we argue can be effective may lead to destructive tendencies among employees and firms. It is to these issues that we now turn.

IV. POLICY AND NORMATIVE IMPLICATIONS

Thus far, we have focused on the benefits of savings-reducing mechanisms and how "paying in perks" may be more efficient than paying cash compensation. But there are downsides to the use of these mechanisms, 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) from the abuse or misuse of these perks.

In this Part, we will first propose some guidelines to help decisionmakers (be they corporate boards or judges) better distinguish good perks—that is, perks that provide useful incentives at reasonable costs—from bad perks—that is, perks that are rightfully condemned as giveaways. We then move on to discussing the downsides of both perks and cultures of conspicuous consumption and suggest some reforms that can help minimize the harms 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; in fact, some perks can be destructive in and of themselves, 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 non-fungible; that is, perks cannot be easily convertible to cash, as that would enable the employee to save.[148] For example, paying an employee's regular hairdresser is both non-extravagant and fungible, because the employee would normally pay for this service herself; the employee simply pockets the amount of the transfer in cash. Thus, this type of perk—what we call a "bad" perk—may be evidence of stealth, abuse, or ignorance. On the other hand,

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147. For a discussion of good versus bad perks, see Part IV.A.1, *infra*.

148. As discussed *supra* Part I, there may be valid reasons—such as economies of scale, increased productivity, or furtherance of a coherent firm culture—for paying for fungible perks. Although courts and boards would need to consider these reasons as well, these considerations have already been discussed extensively in other literature, *see, e.g.*, Rajan & Wulf, *supra* note 53, and therefore we do not reconsider them here.

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paying for a complete professional makeover, which the employee would not purchase for herself, would not be fungible with savings, and could constitute a good perk.

In the context of durable goods—which continue to exist from period to period—the perk can be considered "good" only if it does 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 the employee misbehaves. For example, suppose a firm purchases an extravagant item, such as an antique umbrella stand, for one of its executives. If the executive actually acquired ownership of the umbrella stand, the executive would either enjoy its benefits even after he was fired or would liquidate the umbrella stand for cash. The purchase of such items for the employee's permanent benefit, therefore, constitutes a bad perk. Similarly, perks that are contractually guaranteed, and cannot be revoked, do not serve any legitimate, incentive-creating purpose.[149] Without some ability to discipline the employee for cheating discovered in the future, it would be cheaper and more efficient to pay any earned benefits in cash.

These definitions of "good perks" and "bad perks" are fairly simple, but they sometimes lead to counter intuitive conclusions. For example, the much-pilloried Sardinian extravaganza thrown by Tyco CEO Dennis Kozlowski for his second wife has characteristics of a good perk, because it is unlikely Kozlowski would have spent $2 million of his own money for the bash, and because he couldn't convert the party to cash that he could then save.[150] In contrast, money received to defray Kozlowski's or his daughter's rent, or Martha Stewart's hairdresser appointment—expenses that seem relatively modest and, perhaps, intuitively reasonable—would be bad perks, since these are things that Kozlowski and Stewart would have to pay for themselves, and thus are indistinguishable from receiving cash.

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,[151] but the practice grew enormously as modern state law allowed their more liberal use over the

149. For example, after Terrence Murray retired as CEO of FleetBoston Financial, he was contractually guaranteed the use of the company jet for 150 hours per year, a chauffeur-driven car, and an assistant *for life*. *See* Joann S. Lublin, *How CEOs Retire in Style*, WALL ST. J., Sept. 13, 2002, at B1.

150. 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 IV.B.

151. *See, e.g.*, Leigh v. Am. Brake Beam Co., 205 Ill. 147, 151 (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.

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past several decades.[152] Although commonly used until banned by recent federal legislation, academics, the media,[153] and the case law[154] have roundly criticized their use. For example, Lucian Bebchuk and Jesse Fried claim that corporate loans are inefficient (especially when at "favorable interest rates")[155] 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.[156] Other scholars assume that loans unrelated to specific corporate tasks are per se inefficient and evidence of wrongdoing.[157] These arguments found particular resonance in the political sphere in the wake of the alleged misuse of corporate loans at firms like Tyco.[158] Initial corporate reform bills—what would become the Sarbanes-Oxley Act—proposed requiring increased disclosure for corporate loans.[159] 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.[160] The practice is now illegal.[161]

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152. Nearly all states permit corporate loans by statute, subject to approval by shareholders or directors. *See* DEL. CODE ANN. tit. 8, § 143 (2001) ("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 other assistance may reasonably be expected to benefit the corporation.").

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

154. 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 Cent., Inc., 435 N.E.2d 712, 722–23 (Ill. App. Ct. 1982); *see also* Wash. Nat'l Trust Co. v. W.M. Dary Co., 568 P.2d 1069, 1072 (Ariz. 1977) (invalidating loan to corporate officer at below-market rate of 4% on grounds it was inherently unfair to the corporation); Maxwell v. N.W. Indus., Inc., 72 Misc. 2d 814, 821 (N.Y. Gen. Term. 1972).

155. 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)).

156. *See* Bebchuk & Fried, *supra* note 15, at 10–11.

157. Barnard, *supra* note 151, at 274 ("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.").

158. *See* Tim McLaughlin, *Execs' Trial Centers on Tyco Loans*, STAR-LEDGER (Newark), Sept. 24, 2003.

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

160. *See* Bush, *supra* note 48 ("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.

161. *See* Sarbanes-Oxley Act of 2002, § 402, 116 Stat. 745, 787 (codified at 15 U.S.C.A. § 78m(k) (West Supp. 2005)).

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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.[162] 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.[163] 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.[164]

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 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 such loans from the mix of compensation choices firms may use.

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162. This is also a highly controversial statement if you believe popular accounts. *See, e.g.*, Elizabeth MacDonald, *Crony Capitalism*, FORBES, June 21, 2004, at 140–46 (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).

163. Although we believe that firms are best positioned to decide how to provide effective oversight, we can hazard a guess as to what might work effectively. The firm could earmark the loan for specific uses, such as the purchase of a home or company stock, or require the employee to submit proof that she spent the loan proceeds on property or goods that have the desirable "anti-savings" effects we identify.

164. *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.").

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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 (for instance, by 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."[165] This problem is less likely in other industries with similar final-period problems, such as 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 perks, like the use of corporate jets and the size of expense accounts for top managers.[166] 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.[167] While we do not share the

165. Interview conducted by authors on July 20, 2004.

166. 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 (1994).

167. 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 approve all significant components of executive compensation. *See* NYSE § 303A.05; NASD Rule

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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 a 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.[168]

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.[169] A recent study of CEO employment contracts in securities filings finds that they are "quite specific about the types and quantities of perquisites given," and that about 40% mentioned the use of a company car, 25% membership in a country club, and less than 10% use of a company aircraft.[170]

However, there are reasons why disclosure may be inadvisable. If savings reduction is a public good, as described above in Part III.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.[171] 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.[172]

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 specifi-

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4350(c)(3). While perks are not specifically enumerated in these rules, corporate advisors advocate such oversight as best practice. *See, e.g.*, Wendy J. Hilburn, *Counseling the Compensation Committee*, 1395 PLI/CORP. 1017, 1022 (2003).

168. These modest (and incomplete) proposals are similar to those offered by other commentators in other contexts. *See, e.g.*, Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937 (1993).

169. 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 terms of employment contracts must be disclosed as well. 17 C.F.R. § 229.402(b)(2)(iii)(C)(1), (h) (2005) (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 perquisites by type and amount. Some commentators believe that the current disclosure rnles are wholly inadequate and that they allow self-serving executives to camouflage excessive pay and benefits. *See, e.g.*, Bebchuk & Fried, *supra* note 15. 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.

170. Schwab & Thomas, *supra* note 27, at 35.

171. *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).

172. 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.

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cally passed on the merits of a case questioning the excessiveness of perks.[173] 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.[174] As several Delaware judges recently opined, the role for courts is primarily procedural—that is, making sure that boards exercise considered judgment when approving compensation for senior executives.[175] 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

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173. *See* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569 (2001); 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); Charles M. Elson, Courts and Boards: The Top Ten Cases, Am. Law Inst.—Am. Bar Ass'n Continuing Legal Educ., Nov. 12, 1998; *see also* Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252–55 (1983).

174. *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 5.03 (1994).

175. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Goverance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 999–1001 (2003), Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1388 (2002); Roundtable Moderated by Charles Elson, *What's Wrong with Executive Compensation?*, *in* HARV. BUS. REV., Jan. 2003, at 76 (remarks of E. Norman Veasey, Chief Justice of the Supreme Court of Delaware) ("If directors claim to be independent [and are] disingenuous or dishonest about it, it seems to me that the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith.").

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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.

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,[176] 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 Article), 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

176. *See* Stout, *supra* note 4.

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issue—the 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.[177]

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;[178] 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.

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

177. We leave to others to explore how tax policy could be used to mitigate the negative effects we briefly identify here. We note, however, that tax policy plays an important role in determining the amount of perks and other in-kind compensation firms use as part of the compensation mix. For example, high marginal income tax rates and favorable treatment of fringe benefits would likely increase the use of perks, while low capital gains taxes and perks being taxed at higher marginal rates would likely provide the opposite incentives. Therefore, any change to the tax code designed to achieve increased investment and savings might have the unintended consequence of decreasing the attractiveness of using in-kind compensation.

178. To cite one of many examples, the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C.), requires corporate officers to certify the veracity of corporate financial statements (§ 302) and provides for greatly increased penalties for fraudulent disclosures (§ 906—up to $5 million in fines and twenty years in prison). For a discussion of the new criminal penalties under Sarbanes-Oxley, see Symposium, *In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 271.

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become immune to reputational or retributive penalties. While these tools are a powerful augmentation of a firm's ability to police its employees, they can also have a downside, since they can lead to undesirable employee behavior when inappropriately or excessively implemented. Thus, such compensation schemes are not foolproof, 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 powerful tools can provide.

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