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# **Icarus** in the Boardroom

The Fundamental Flaws  
in Corporate America and  
Where They Came From

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## Introduction

Americans have always loved risk-takers, the man or woman with ambition and vision who goes for broke. “Boldness of enterprise is the foremost cause of its rapid progress, its strength and its greatness,” Tocqueville wrote as he surveyed the nation’s business landscape well over a century ago. Although American business and financial life reminded this French observer of “a vast lottery,” he marveled at the extent to which Americans “encourage and do honor to boldness in commercial speculations.”<sup>1</sup>

In Tocqueville’s era, adventurers set out for the western frontiers to launch trading operations or speculate on land. Closer to home, they invented the steamer, the cotton gin, and a thousand lesser-known inventions. Jay Gould, who became the most famous of the post–Civil War railroad robber barons, got his start by boarding a train to New York to peddle a mousetrap his family had invented.<sup>2</sup> A century later, Hewlett-Packard was started by two friends who hammered out their vision night after

night in a Silicon Valley garage, and a subsequent generation of high-tech whizzes raced to create the next “killer app,” or what business writer Michael Lewis labels the “New New Thing.” “The U.S. has the world’s most diverse and efficient capital markets,” Thomas Friedman wrote in 1997, “which reward, and even celebrate, risk-taking.”<sup>3</sup>

True risk-taking is a gamble. The entrepreneur literally takes a chance. Unfortunately, even the most talented entrepreneur can overstep his or her bounds, taking one risk too many and losing it all. Indeed, the very qualities that make brilliant innovators special—self-confidence, visionary insight, the ability to think outside the box—may spur entrepreneurs to take misguided risks in the belief that everything they touch will eventually turn to gold.

Throughout this book, I characterize these qualities as “Icaran,” based on a legendary risk-taker named Icarus whom many of us remember from a high school reading list.

In ancient Greek lore, Icarus was the son of Daedalus, a famous architect who constructed an elaborate labyrinth at the behest of Minos, the King of Crete, to house a ferocious monster known as the Minotaur. The labyrinth was so intricate and subtly constructed that even Daedalus and Icarus could not figure out how to escape. After days of wandering into one dead end after another, Daedalus “made a pair of wings,” as an Anglo Saxon poet later put it, “contrived of wood and feathers and a cunning set of springs.” As they prepared to test the wings they would use to escape, Icarus’s father repeatedly warned him not to fly too close to the sun. The feathers of his wings were attached to their wood frame by wax, which would melt if he flew too high.<sup>4</sup>

At first, Icarus heeded the warnings he had been given. But as he became acclimated to the wings and reveled in his newfound freedom, Icarus thought less and less about the risk, and more

and more about the majesty of his powers. He continued to soar upward, ever closer to the sun, until the wax softened, his feathers gave way, and Icarus crashed down into the sea.

In a famous poem depicting the Icarus myth, W. B. Auden imagines the hubristic youth splashing into the ocean within sight of a farmer and a large ship. Neither pay much heed to Icarus's tragic fall. The farmer continues to work, "and the expensive delicate ship that must have seen / Something amazing, a boy falling out of the sky, / Had somewhere to get to and sailed calmly on."<sup>5</sup>

Auden obviously is exaggerating for poetic effect, but the failure of an ordinary American entrepreneur is similar in some respects. When a would-be innovator with a visionary idea puts every dollar he or she has or can borrow into an Internet innovation, but the dream collapses, it isn't headline news. Even if the entrepreneur loses everything, the failure may not ripple much further than a few family and friends.

Put Icarus in the boardroom and everything changes. The ability to tap huge amounts of capital in enterprises that adopt the corporate form, together with the large number of people whose livelihood depends in one way or another on the business, means that the stakes are extraordinarily high if Icarus is running a major corporation. An Icaran executive who takes excessive or fraudulent risks with a large corporation may jeopardize the financial lives of thousands of employees, investors, and suppliers of the business.

As American corporations expanded in the nineteenth century, their size and complexity not only increased the stakes; it also multiplied the opportunities for mischief. Once lawmakers permitted a corporation to hold the stock of other corporations, managers could tuck some of the assets of a business in one corporation and other assets elsewhere. This organizational flexi-

bility often serves legitimate purposes, but it also can be used to mislead investors about the financial health of the business and just what it is up to. Both in the 1920s and with Enron in our era, investors continued to pump money into companies that were headed for a fall, long after the company's misguided risks would have been obvious were it not for their intentionally and mystifyingly complex corporate structure. Only in retrospect did investors learn that the corporate house was full of false doors and hidden rooms.

Although we rightly pride ourselves on the competitiveness of the American markets, competition increases the odds of spectacular corporate failures. In other countries—Germany, for instance, and much of Asia—it is not unusual for one or a small group of corporations to dominate their industry. Americans, by contrast, have always rebelled against concentrated economic power, in favor of industries with a multitude of competing firms. “We entirely disapprove of the incorporation of companies,” a trade union representative complained in 1835, “inasmuch as we believe their tendency is to eventuate in and produce monopolies, thereby crippling the energies of individual enterprise, and invading the rights of smaller capitalists.” In this kind of marketplace, the success of a business innovator is sure to attract competitors—the more spectacular the success, the fiercer the efforts to get a piece of the pie. Although some innovations can be patented, many, such as financial innovations or novel business strategies, usually cannot. As competitors enter their market, innovators often see their lavish profits begin to slip away. All too often, the innovators respond by taking increasingly misguided and even illegal risks as they attempt to replicate their early success.<sup>6</sup>

These three factors—excessive and sometimes fraudulent risks, competition, and the increasing size and complexity of the corporation—have been at the heart of a series of devastating crises that have punctuated American corporate and financial

life for the past hundred and fifty years. The first came with the 1873 collapse of financial genius Jay Cooke, who pioneered a new strategy for selling government debt during the Civil War; the Great Depression saw the crash of utilities magnate Samuel Insull; and the new century brought still another wave of corporate scandals. Throughout the book, I will refer to crashes that fit this pattern as Icarus Effect failures.

Underneath and in between the scandals is an ongoing cat-and-mouse game between regulators and the leaders of America's largest corporations. Ever since the first large-scale corporations emerged in the nineteenth century, the task of regulators has been to rein in the three factors that can lead to Icarus Effect failures, as these tendencies are manifested in each succeeding era. Congress and state lawmakers sometimes target the first, risk-taking, directly, as when they impose penalties for misbehavior, but they also empower market "watchers" such as accountants or securities analysts to scrutinize the decision making of corporate executives. The second factor, competition, is regulated either by increasing the amount of governmental intervention, as with railroad-rate regulation in the nineteenth century and utilities regulation in the twentieth; or by decreasing it, as with the more relaxed antitrust scrutiny and extensive deregulation of recent years. With corporate size and scope, the final factor, lawmakers attempted at first to impose direct size restrictions, then later focused on limiting the complexity of interrelated corporate structures that were made possible once corporations were permitted to own the stock of other corporations.

Although strict regulation can rein in the Icaran tendencies in American corporate and financial life, it also undermines flexibility and innovation. In every generation, American corporate leaders have responded by simply evading existing regulation or by lobbying for changes that give business more flexibility to expand or take advantage of technological innovations. In the nineteenth century, growing businesses chafed at the strict rules that limited

the amount of capital they could raise. Larger companies, they argued, are more efficient and produce goods more cheaply than smaller ones. In our era, corporations use complex financing techniques to circumvent regulatory restrictions of various kinds. An insurance company that wishes to insure a larger amount of risk than regulators or its own shareholders will allow can set up a special new entity to assume the risk. This is one illustration of the financial rocket science known as structured finance.

It is a simple fact of interest-group politics that corporate executives wield extraordinary influence over the political process both at the state and federal levels under ordinary circumstances. Corporate managers are intensely interested in the regulatory landscape, and they are backed by the huge coffers of the corporation itself. As a result, they usually get what they want. Ordinary Americans, by contrast, are much less likely to focus on the issues at stake and do not have nearly the same access to political decision makers. Few Americans entertained President Grant in their homes, as Jay Cooke did in the 1870s; nor have many of us received endearing notes from President Bush like the birthday and Christmas cards he once penned to “Kenny Boy,” Enron’s Ken Lay.

The efforts by American business to sidestep regulatory oversight can quickly spiral out of control, setting the stage for a devastating breakdown in corporate and financial oversight. The most dramatic collapses have occurred in times of market euphoria, often after a period of technological and financial innovation. Unlike in Auden’s poem, the result of a true Icarus Effect scandal is far from an “unimportant failure.” Thousands of jobs are lost and thousands of lives ruined when an Insull or Enron implodes. And for every Insull or Enron—for every Icarus Effect scandal writ large—there are other companies that follow the same Icarus Effect script. The headline scandals invariably reflect a broader crisis in American business life, a pervasive failure to keep the three Icaran tendencies in check.

As devastating as these failures are, they also have a silver lining. When the empire created by an erstwhile financial genius comes crashing down in a wave of scandal, ordinary Americans awaken from their slumber. Their outrage has often galvanized public opinion in favor of sweeping corporate reforms that would be politically inconceivable—political nonstarters—in a more placid corporate and financial environment. Our most important corporate regulation has always been enacted in the wake of stunning Icarus Effect collapses.<sup>7</sup>

The importance of scandals doesn't mean that lawmakers disappear after the crisis passes, of course. They continue to tinker with corporate and financial regulation, particularly at the state level. But these interim changes usually have corporate America's fingerprints all over them. It is only when scandals handcuff America's corporate leaders that lawmakers take direct aim at the Icaran tendencies in America corporate life.<sup>8</sup>

Corporate scandals are not unique to America, of course. Just about every country with large corporations has had its share of corporate scandals. But the scandals of other countries have tended to take different forms. In Japan, for instance, many of the most notorious scandals have involved rogue traders and midlevel insiders. In 1997 and 1998, executives at fourteen major companies (including Japan Air, Toshiba, and Hitachi) were arrested for paying thugs—sokaiya—to squelch discussion at their annual shareholders' meetings. In each case, the payments were made by a midlevel employee who did not derive any personal profit from the payments. In America, by contrast, spectacular failures usually start at the top and can be traced back to an Icaran executive who kept gambling even after his fortune or skill ran out, using the size and complexity of the corporation to disguise his flight. America's widely held companies and vibrant stock markets seem to be a particularly congenial environment for, and at times even to invite, Icaran excesses.<sup>9</sup>

To understand the three Icaran tendencies—risk-taking, com-

petition, and corporate size and complexity—as well as the historical tug-of-war between regulators and corporate leaders, we need to start with the origins of the American corporation. In chapter 1, I describe the dramatic surge in incorporations in the nineteenth century. Unlike partnerships, corporations were difficult to dissolve, which protected businesses against the possibility that death or a falling out would force a dissolution. By the second half of the century, corporations also provided limited liability. Limited liability meant that shareholders generally could not be held responsible for the corporation's debts, which made corporate stock a very attractive investment. The first businesses to take advantage of this by tapping large amounts of capital from investors were the railroads, the nation's first large-scale corporations. The rise of the railroads also brought the first true Icarus Effect failure, the devastating collapse of Philadelphia banker Jay Cooke and his vast Northern Pacific Railroad project. Cooke's failure, and the excesses of the railroad robber barons, not only led to specific legislative reforms, but also propelled the coalition of farmers and small business owners that became known as American Populism into the national spotlight.

Chapter 2 chronicles the rise of the great corporate trusts of the Gilded Age, as John D. Rockefeller and other business titans outmaneuvered the efforts of state regulators to limit the size and scope of the railroads and other corporations. If the corporate-trust movement had continued, it might, in rather perverse fashion, have eliminated the Icaran tendencies in America's large-scale corporations. Great trusts such as Rockefeller's Standard Oil and Andrew Carnegie's steel empire cut off competition in their industries. The absence of competition removes the pressure to take risks and thus decreases the threat of Icarus Effect failures, since the monopoly business can earn large profits without any serious encroachment from competitors. The prospect of concentrated economic power has always drawn resistance in this country, however. Teddy Roosevelt's trust-

busting campaign tapped into the resistance and signaled that there were limits to the amount of concentration that would be tolerated. Although Roosevelt abandoned the effort to directly restrict corporate size, his trust-busting campaign reflected a renewed commitment to industry competition.

The decades leading up to the 1929 stock-market crash saw the most important shift in corporate structure in American business history. Whereas the shareholders of even the largest corporations had actively managed the company and served as its directors in the nineteenth century, the emergence of corporate giants at the end of the century led to a separation of ownership and control. Shareholding became widely diffused, and shareholders played little role in the management of many of the nation's largest corporations. In some industries, J. P. Morgan & Co. and other investment banks continued to seek to combine the principal competitors in order to "rationalize" (their euphemism for forging a monopoly) competition. In the utilities industry, corporate leaders like Samuel Insull manipulated the corporate form, creating complex structures of parent and subsidiary corporations that enabled them both to maintain control with a small ownership stake and to raise money from investors who didn't understand the distinctions among the interrelated corporations.

Although Insull is largely forgotten today, the spectacular Icarus Effect collapse of his Chicago-based utilities empire personalized the need for sweeping reform. After campaigning in 1932 against "the Ishmael or Insull whose hand is against every man's," Franklin D. Roosevelt and the New Dealers restructured American business and financial regulation with a series of reforms that targeted each of the Icarus Effect factors. As described in chapter 3, the securities reforms of 1933 and 1934 required extensive disclosure, added antifraud provisions, and reinforced the role of accountants and securities analysts as watchers, all of which made it more difficult for Icaran executives

to take excessive risks. New Deal banking reforms ended the monopoly of Morgan and the Money Trust over American finance; this and aggressive antitrust enforcement reinvigorated competition in some industries, while others settled into a competitive equilibrium. Although the New Dealers' principal curative for abuses of corporate size and complexity was disclosure, they intervened more directly in the utilities industry, forcing a complete restructuring of the industry under the so-called death penalty provision included in the Public Utilities Holding Company Act of 1935.

The New Deal reforms brought both an increasing federalization of corporate regulation and a shift from the rigid, per se rules that lawmakers had used in the nineteenth century to a more nuanced approach to regulation. Like corporate America, corporate and financial regulation had also come of age.

For the next several decades, the Icaran tendencies in American corporate life seemed to go into remission. As described in chapter 4, this all changed in the 1970s and 1980s, thanks to a takeover boom fueled by the junk-bond operation pioneered by Michael Milken and Drexel Burnham Lambert, together with deregulation and decreased antitrust scrutiny. These changes reinvigorated the Icaran tendencies in American corporate life. Managerial risk-taking returned after an era when corporate leaders had functioned more like bureaucrats than entrepreneurs, and competition was reintroduced into industries like telecom and utilities. The 1980s also saw the first hints of the financial innovations which would create new opportunities for manipulation of the corporate structure in the decade that followed.

The final three chapters shift from history to the present. Milken's 1989 indictment and incarceration brought Drexel crashing down in Icarus-like fashion. But Milken's fall differed from previous Icarus Effect failures in important respects and served principally as foreshadowing of the scandals that later fol-

lowed. Chapter 5 chronicles the rise of charismatic CEOs like Enron's Ken Lay and Bernie Ebbers of WorldCom, the role of continued deregulation, and the use of innovations such as structured finance—the “sale” of assets to separate but often related business entities—to evade regulation and mislead investors. Chapter 6 focuses on the corporate-responsibility legislation that was enacted in response to the outrage provoked by the collapse of Enron and WorldCom and by the crisis of confidence in corporate America. The new legislation attempted to remedy the conflicts of interest that discouraged directors, auditors, and securities analysts from reining in Icaran risk-taking and manipulation. But it did little to alter the underlying incentives for corporate leaders to take excessive risks and left the other two Icarus factors—the competitive structure of industry and the misuse of corporate size and complexity—largely untouched. Chapter 7 explains why the powder keg is still very much in place. Corporate culture continues to reward managers who are willing to take risks and don't second guess the genius of the decisions they make. The competitive structure of important industries is still in turmoil. And regulators have not yet caught up to innovations that companies use to move assets and liabilities around a web of corporate entities.

For much of American business history, the risks posed by the Icaran tendencies in American business and financial life were, for most ordinary Americans, somewhere off in the distance. Although Jay Cooke's principal innovation was to market government debt and then railroad bonds more broadly than ever before, only a few Americans had extra savings to invest in stock or bonds. Even for wealthy investors, the investment of choice was real estate, not the stock market. By the end the nineteenth century, increasing numbers of upper- and upper-middle-class Americans ventured into the stock markets, and this trend intensified in the roaring twenties, when millions of ordinary Americans bought stock or bonds. But for much of the twentieth cen-

tury, the stock market was still viewed primarily as the playground of the rich.

Not any more. For the first time, more than half of all Americans now own stock, either directly or through mutual funds. This in itself is a stunning development. Equally remarkable is the fact that much of this stake is retirement money and other savings, not money that Americans have intentionally put at risk. The most obvious victims of the Enron and WorldCom collapses, after all, were the thousands of men and women whose retirement portfolios were wiped out. As I argue in the final chapter, these developments have enormous implications for the next generation of corporate reform. Any effort to correct the Icaran tendencies in corporate America must account for the stake that millions of Americans now have in the market.

The long history of Icarus Effect scandals, and of the ever-evolving skirmish between regulators and corporate leaders, is no longer simply a fascinating and at times heart-wrenching historical tale. It is a tale that involves more of us than ever before. The story you are about to read is your story too.