

University of Pennsylvania Carey Law School

## Penn Law: Legal Scholarship Repository

---

Faculty Scholarship at Penn Law

---

12-1-2004

### Icarus in the Boardroom, Introduction

David A. Skeel Jr.

*University of Pennsylvania Carey Law School*

Follow this and additional works at: [https://scholarship.law.upenn.edu/faculty\\_scholarship](https://scholarship.law.upenn.edu/faculty_scholarship)



Part of the [Business Administration, Management, and Operations Commons](#), [Business Law, Public Responsibility, and Ethics Commons](#), and the [Business Organizations Law Commons](#)

---

#### Repository Citation

Skeel, David A. Jr., "Icarus in the Boardroom, Introduction" (2004). *Faculty Scholarship at Penn Law*. 67.  
[https://scholarship.law.upenn.edu/faculty\\_scholarship/67](https://scholarship.law.upenn.edu/faculty_scholarship/67)

This Article is brought to you for free and open access by Penn Law: Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship at Penn Law by an authorized administrator of Penn Law: Legal Scholarship Repository. For more information, please contact [PennlawIR@law.upenn.edu](mailto:PennlawIR@law.upenn.edu).

## **ICARUS IN THE BOARDROOM: INTRODUCTION**

Americans have always loved risktakers, 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 quite literally inventing a better mousetrap, which he took to New York to promote and market. 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 labeled 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>2</sup>

True risk-taking is a gamble. The entrepreneur literally takes a chance. Unfortunately, even the most talented entrepreneur can overstep his 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 will refer to these qualities as “Icaran,” based on a legendary risk-taker named Icarus whom many of us remember from a high school reading list. For those who don’t, he can be quickly described.

\*\*\*\*\*

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 deadend after another, Daedalus “made a pair of wings,” as an Anglo Saxon poet later put it, “[c]ontrived 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.

At first, Icarus heeded the warnings he had been given. But as he acclimated to the wings and began to revel in his new-found 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.<sup>3</sup>

\*\*\*\*\*

In a famous poem depicting the Icarus myth, W.B. Auden imagines the hubristic youth as 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>4</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 she has or can borrow into an Internet innovation, but the dream collapses, it isn't headline news. Even if the entrepreneur loses everything she has, the failure may not ripple much further than her closest 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.

Although we rightly pride ourselves on the competitiveness of the American markets, competition actually can magnify 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. 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. 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.

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 collapse of financial genius Jay Cooke, who pioneered a new strategy for selling government debt during the Civil War, in 1873; the Great Depression saw the crash of utilities magnate Samuel Insull; and the new century brought still another wave of corporate scandals.

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 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 regulatory 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, 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; in our era, they use the complex financial products known as derivatives to circumvent regulatory restrictions of various kinds.

It is a simple fact of interest group politics that corporate executives wield extraordinary influence over the political process both at the state level and in Congress 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 gotten 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 American corporate and financial

life. The most dramatic collapses have occurred in times of market euphoria, often after a time of technological innovation. Unlike in Auden's book, the result of a true Icarus Effect scandal is far from an "unimportant failure." Thousands of lives are destroyed, and the entire economy has sometimes been derailed.

But 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 American awaken from their slumber. Their outrage has often galvanized public opinion in favor of sweeping corporate reforms that would be politically inconceivable— political non-starters— 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. This has been particularly true when the failure involve a corporate hero whose failure seems to many Americans to symbolize a breakdown that pervades all of American corporate life.

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. 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>5</sup>

To understand the three Icaran tendencies-- risk-taking, competition 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 ignited the coalition of farmers and small businessmen that became known as American Populism.

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 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 in the late nineteenth 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 and other investment banks continued to seek to combine the principal competitors in order to "rationalize" competition. In the utilities industry, corporate leaders like Samuel Insull manipulated the corporate form, creating a complex structure of parent and subsidiary corporations that enabled him 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 inspired many of the most important New Deal regulatory reforms. After campaigning in 1932 against "the Insulls and Ishmaels, 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 anti-fraud provisions, and reinforced the role of accountant 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 many industries.

Although the New Dealers' principal curative for abuses of the corporate entity was disclosure, they directly limited the scope of corporations in the utilities industry by 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 that was fuel by the junk bond operation pioneered by Michael Milken and Drexel Burnham Lambert, together with deregulation and decreased antitrust scrutiny. These changes re-invigorated the Icaran tendencies in American corporate life. Managerial risktaking 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 later followed. 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 a 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 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 risk, 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 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. But for much of the twentieth century, the stock market was still viewed 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. 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.

1. Toqueville, *Democracy in America*, Book 3, Chapter XVIII.
2. Thomas L. Friedman, "Dear Dr. Greenspan," *N.Y. Times*, Feb. 9, 1997, at Section 4, p.15.
3. The poem, an old Anglo Saxon account of Icarus, is quoted in H.A. Guerber, *The Myths of Greece and Rome* 222 (New York: Dover Publications, 1993).
4. W.H. Auden, "Musee des Beaux Arts," in *The Norton Anthology of Modern Poetry* 740-41 (New York: W.W. Norton & Company, 2d. ed. 1988).
5. Mark West has argued that reform is usually triggered by exogenous changes such as scandals in nations that do not have jurisdictional competition. Mark D. West, "The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States," 150 *U. Pa. L. Rev.* 527 (2001). West's argument is complementary, though different in some details, to the theme of this book, which is that certain scandals have galvanized American business and financial reform, more of which has come at the federal level (where interjurisdictional, state competition is absent).