THE GREED CYCLE

How the financial system encouraged corporations to go crazy.

BY JOHN CASSIDY

There are many ways to take the measure of what has happened to corporate America in recent years. As good a way as any is to flip through some back copies of the *Financial Times*, which recently published a remarkable series of articles on what it termed the "barons of bankruptcy—a privileged group of top business people who made extraordinary personal fortunes even as their companies were heading for disaster." The *F.T.* examined the twenty-five biggest business collapses since the start of last year. From the beginning of 1999 to the end of 2001, senior executives and directors of these doomed companies walked away with some $3.3 billion in salary, bonuses, and the proceeds from sales of stock and stock options. Some of the names on the list were familiar to anybody who reads the papers: Global Crossing's Gary Winnick ($512.4 million); Enron's Kenneth Lay ($246.7 million); and WorldCom's Scott Sullivan ($49.4 million). However, there were also many names that haven't received much public attention, such as Clark McLeod and Richard Lumpkin, the former chairman and the former vice-chairman, respectively, of McLeodUSA, a telecommunications company based in Cedar Rapids, Iowa. These two corporate philanthropists cashed in stock worth ninety-nine million dollars and a hundred and sixteen million dollars, respectively, before the rest of the stockholders were wiped out.

Even veteran observers have been taken aback by recent events. "It became a competitive game to see how much money you could get," Paul Volcker, the former chairman of the Federal Reserve Board, told me when I visited him at his office in Rockefeller Center a couple of weeks ago. Earlier this year, Volcker tried and failed to rescue Arthur Andersen, Enron's accounting firm, which ended up going out of business. "Corporate greed exploded beyond anything that could have been imagined in 1990," Volcker went on. "Traditional norms didn't exist. You had this whole culture where the only sign of worth was how much money you made."

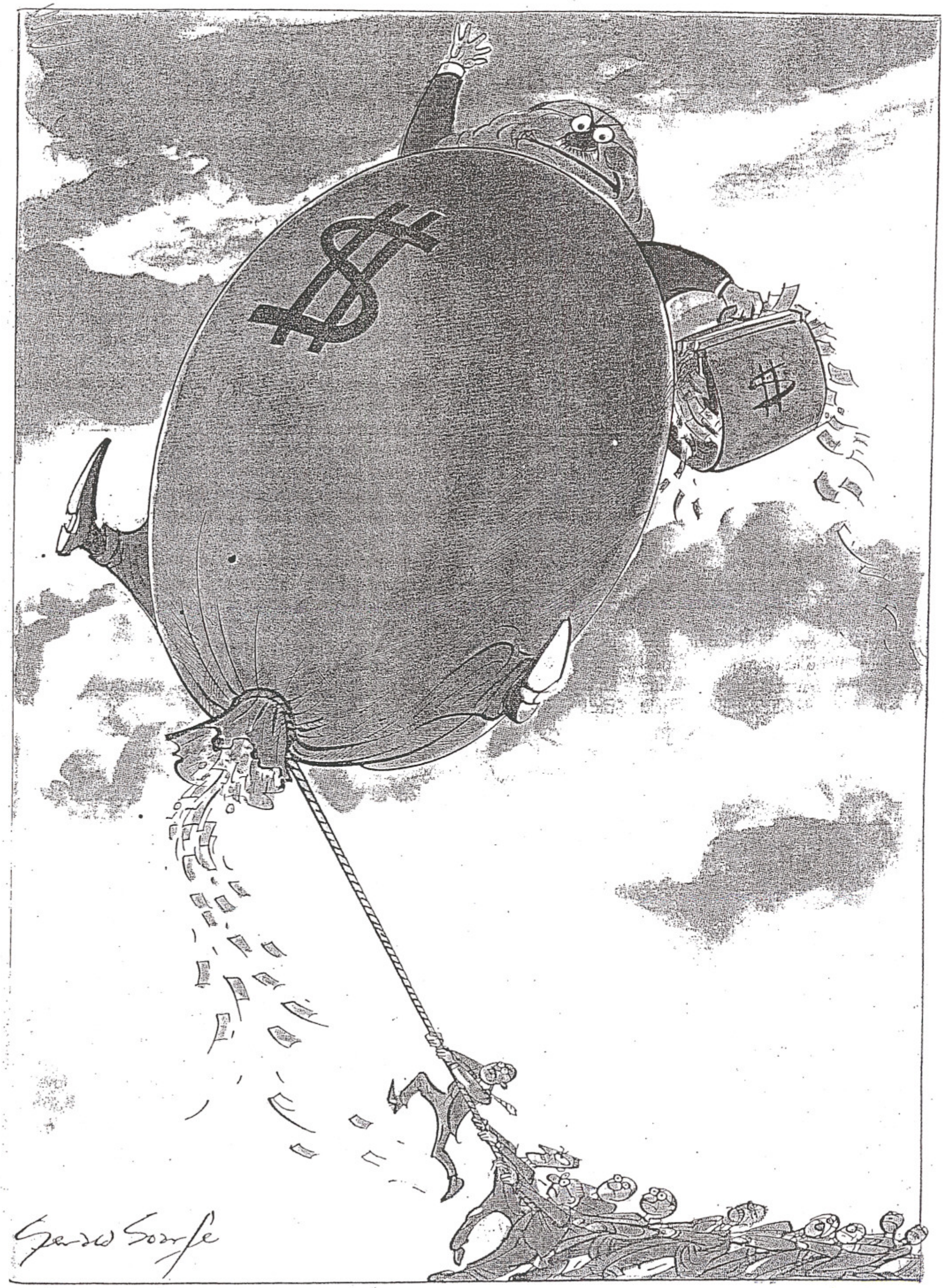
Economists from Adam Smith to Milton Friedman have seen greed as an inevitable and, in some ways, desirable feature of capitalism. In a well-regulated and well-balanced economy, greed helps to keep the system expanding. But it is also kept in check, lest it undermine public faith in the entire enterprise. The extraordinary thing about the last few years is not the mere presence of greed but the way it was systematically encouraged and then allowed to career out of control. Kenneth Lay, in quietly selling stock and exercising stock options worth more than two hundred million dollars shortly before Enron collapsed, wasn't just being a selfish, unscrupulous individual: he was defying the social contract that underpins a system, which, despite its faults, has lasted almost two hundred years.

In 1814, Francis Cabot Lowell, a Boston merchant, founded the first public company, when he built a textile factory on the banks of the Charles River in Waltham, Massachusetts, and called it the Boston Manufacturing Company. Lowell had smuggled a plan of a power loom out of England, and he intended to compete with the Lancashire mills. But he couldn't afford to pay for the construction and installation of expensive machinery by himself, so he sold stock in his company to ten associates. Within seven years, these stockholders had received a cumulative return of more than a hundred per cent, and Lowell had established a new business model. Under its auspices, mankind has invented cures for deadly diseases, extracted minerals from ocean floors, extended commerce to all corners of the earth, and generated unprecedented rates of economic expansion.

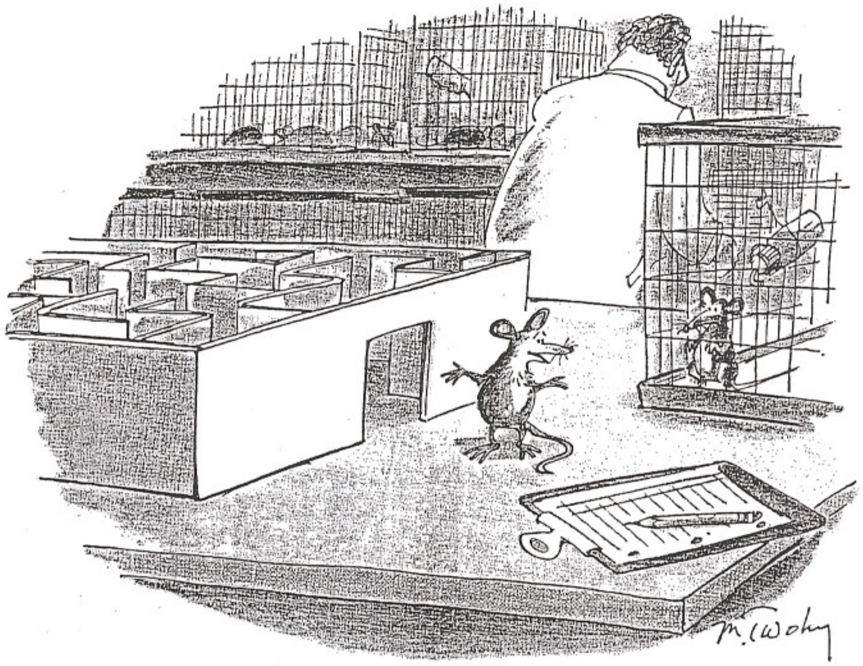
Initially, most economists were skeptical of Lowell's innovation. At the heart of any public company there is an implicit bargain: the managers promise to run the company in the owners' interest, and the stockholders agree to hand over day-to-day control of the business to the managers. Unfortunately, there is no easy way to make sure that the managers don't slack off, or divert some of the stockholders' money into their own pockets. Adam Smith was among the first to identify this problem. "The directors of such companies . . . being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private [company] frequently watch over their own," Smith wrote in "The Wealth of Nations." And he went on, "Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

Smith thought that private companies would remain the normal way of doing business, but technological change and financial necessity proved him wrong. With the development of the railroads, for example, companies like the New York Central and the Union Pacific needed to raise tens of millions of dollars from outside investors to lay track and buy rolling stock. And because the administrative complexity of the railroads was too much for a single entrepreneur to handle, a new class of full-time executives, men like Collis P. Huntington and Edward C. Harriman, emerged to run them. Though the emerging industry attracted dubious financiers like Jay Gould, most of the professional managers were content to collect generous salaries and pensions rather than ha-

GERALD SCARFE



If the past thirty years have demonstrated anything about business, it is that the avarice of corporate leaders is practically unlimited



"I don't usually volunteer for experiments, but I'm kind of a puzzle freak."

bitually attempt to rob the stockholders and bondholders. "It is a strong proof of the marvelous growth in recent times of a spirit of honesty and uprightness in commercial matters, that the leading officers of great public companies yield as little as they do to the vast temptations to fraud which lie in their way," the British economist Alfred Marshall said in 1890.

Alas, by the late nineteen-twenties it was clear that corporate perfidy was prospering in an impressive variety of forms, most of them involving insiders exploiting their position to fleece outsiders. After the stock-market crash of 1929, congressional investigators uncovered widespread insider trading, stock-price manipulation, and diversion of corporate funds to personal use. Then, as now, the revelations of corporate wrongdoing prompted the federal government to respond. The Securities Act of 1933 imposed extensive disclosure requirements on any company wanting to issue stock, and outlawed insider dealing and other attempts to manipulate the market. In 1934, the Securities and Exchange Commission was set up to enforce the new regulations.

Public confidence in business eventually recovered, but the potential conflict of interest at the heart of public companies was never fully resolved. During the nineteen-sixties and early seventies, corporate managers were often cavalier about the interests of stockholders. Back then, the chief executive's compensation was usually linked to the size of the firm he ran—the bigger the company, the bigger the paycheck. This encouraged business leaders to build sprawling empires rather than focus on their firms' profitability and stock price. Many of them spent heavily on perquisites of office, such as lavish headquarters and corporate retreats, and they kept on spending even when their companies ran into trouble.

In theory, the stockholders could have joined together to force out managers, but organizing such a collective effort was costly and time consuming, and it rarely happened. Nor was managerial waste constrained by competition from rival firms that didn't splurge on pink marble for the office bathrooms. Companies like General Motors saw their businesses decimated by foreign competition, but C.E.O.s, such as G.M.'s Roger Smith, rarely suffered. From a stockholder's perspective, something more potent was required to get those who ran the companies to serve the interests of those who owned the companies. When the solution materialized, it would turn out to be more potent than anybody had imagined.

Thirty years ago, two obscure young financial economists provided the spark for reform. Michael Jensen and William Meckling had graduate degrees from the University of Chicago, where Milton Friedman and his disciples taught that there was little wrong with the American economy that more competition wouldn't resolve. During the early seventies, Jensen and Meckling, who were then both at the University of Rochester, tried to apply this idea to the internal workings of the public company. They began with the supposition that senior managers, faced with competition from other firms, would do the best they could for their stockholders, by cutting costs and trying to make as big a profit as possible. "But the more we thought about it the more we realized that what we had been taught in Chicago and believed most of our lives wasn't true," Jensen recalled recently. "It wasn't automatically true that corporations would maximize value."

Jensen and Meckling couched their arguments in the mathematical jargon favored by assistant professors seeking tenure, but the model they came up with had an enormous practical impact. It planted the idea that the most important people in any company are not the employees or the managers but the owners—the stockholders and bondholders. This model provided an intellectual rationale, of sorts, for the controversial explosion in C.E.O. pay that began in the nineteen-eighties; and it justified the widespread adoption of executive stock options.

Jensen and Meckling analyzed the relationship between stockholders and managers as a "principal-agent problem"—a dilemma that arises whenever one party (the principal) employs another (the agent) to do a job for him. It might be a family hiring a contractor to renovate its house, a company hiring a brokerage firm to manage its retirement fund, or even an electorate choosing a government. In all these cases, the same issue arises: How can the principal insure that the agent acts in his or her interest? As anybody who has dealt with a contractor knows, there is no simple solution. One option is to design a contract that rewards the contractor for doing the job well. Municipal-construction projects, for example, have a chronic tendency to overrun, snarling traffic and infuriating the public. So when the City of New York, say, puts out tenders for roadwork, its contracts often include financial incentives for finishing the work early and penalties for being late.

Jensen and Meckling were the first economists to apply this idea to corporations. They argued that there was no perfect way to align the interests of the owners and the managers. In any firm that relied on outsiders for financing, the senior executives would make some damaging decisions. If the firm issued stock, they would waste some of the proceeds on perks like corporate jets. If the firm issued debt, the managers, knowing that the bondholders would be the main losers if anything went wrong, would make too many risky investments. The "agency costs" that the business incurred as a result of these actions were unavoidable. It didn't matter whether the firm was a cosseted monopoly or a company facing extensive competition: managers would destroy value.

Jensen and Meckling had a hard time getting their ideas accepted. "I gave a seminar at the University of Chicago, and it was just a disaster," Jensen recalled. "People were shouting at me, 'How can you say competition doesn't solve all problems?' " Eventually, though, most economists accepted Jensen and Meckling's logic, and they began to ask more questions: How should the performances of senior executives be measured? Was it better to give them money, in the form of salaries or bonuses, or company stock? If some managerial inefficiency was inevitable, how could it be minimized? Principal-agent theory provided a clear answer to these questions: treat chief executives just like plumbers, contractors, or any other truculent agent, and reward them for acting in the best interest of the principal—i.e., the stockholders.

At the time, many chief executives saw their main task as overseeing the welfare of their employees and customers. As long as the firm made a decent profit every year and raised the dividend it paid its stockholders, this was considered good enough. But, once C.E.O.s were viewed as merely the agents of the firm's owners, they were urged to live by a new, simpler credo: shareholder value. Henceforth, economists and management gurus agreed, their overriding aim should be to maximize the value of the firm, as it was determined in the stock market.

The shareholder-value movement soon attracted rich and aggressive investors who used the economists' arguments to justify attacks on corporate America. During the hostile-takeover wave of the nineteen-eighties, controversial figures like T. Boone Pickens and Carl Icahn bought stakes in public companies they considered undervalued and, claiming to represent the ordinary stockholder, often tried to seize control. Since the corporate raiders financed their attacks with borrowed money, their takeovers became known as "leveraged buyouts," or LBOs. In a typical LBO, the acquirer would buy out the public stockholders and run the company as a private concern, slashing costs and slimming it down. The ultimate aim was to refloat the company on the stock market at a higher valuation. Individual raiders weren't the only force behind LBOs: Wall Street firms like Kohlberg Kravis Roberts and Hicks, Muse also got in on the game. Nearly half of all major public corporations received a takeover offer in the eighties. Many companies were forced to lay off workers and sell off underperforming divisions in order to boost their stock price and fend off potential bidders. Raiders were popularly denounced as speculators and predators, which, of course, most of them were. Thomas Eagleton, a Democratic senator from Missouri, called Carl Icahn "a fourteen-karat pirate motivated by one instinct—greed."

Still, many economists defended LBOs as an effective way to overcome the agency problems that Jensen and Meckling had identified. The stockholders who sold out often made considerable profits, and the managers of bought-out companies were usually given large chunks of equity. Senior executives would be forced to run the firms more efficiently, it was argued, because of all the debt that had been taken on, and, if they boosted the value of the firm, they should make a lot of money themselves. Michael Jensen became one of the strongest supporters of LBOs. In 1989, he published an article in the *Harvard Business Review* in which he claimed that the traditional public company had "outlived its usefulness in many sectors of the economy."

This declaration proved premature. When the economy went into a recession during the early nineteen-nineties,

"I've transferred all my vacation time into absurdly long coffee breaks."

many of the firms that had gone private, such as Macy's and Revco, couldn't keep up their interest payments, and the resulting wave of bankruptcies discredited the LBO as a business model. Far from creating value, many LBOs had ended up wiping out the investors and bondholders who financed them. The only people who consistently made money were the stockholders and senior managers who sold out early on. The enduring economic lesson of the LBO era was that unleashing greed wasn't enough to raise efficiency. But the message that corporate America took from its ordeal was quite different: senior executives who converted to the new religion of shareholder value tended to get very rich, while those who argued that corporations ought to consider their employees and customers as well as their stockholders often ended up without a job.

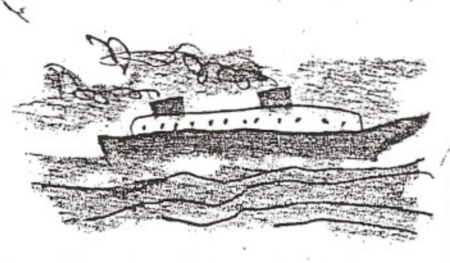
At the same time, corporations came to realize that leveraged buyouts weren't the only way to align the interests of managers and shareholders. There was a much simpler tool available, which didn't involve going to all the trouble of a multibillion-dollar takeover: the executive stock option. Once endowed with a generous grant of these magical instruments, a senior executive would no longer think of himself as a mere hired hand but as a proprietor who had the long-term health of the firm at heart. That was the theory, anyway.

An executive stock option is a legal contract that grants its owner the right to buy a stock in his or her company at a certain price (the "strike price") on a certain date in the future. Take a company with a stock price of fifty dollars that grants its chief executive the right to buy a million shares three years hence at the current market price. Assume the stock price rises by ten per cent each year, so that after three years it is trading at about sixty-six dollars and fifty cents. At that point, the chief executive can "exercise" his option and make the company sell him a million shares at fifty dollars. Then he can sell the shares in the open market, and clear a profit of sixteen and a half million dollars.

The first stock-option incentive plan was introduced in 1950, the year in which Congress decided that recipients of stock options could defer paying tax until they exercised them and sold the shares. Soon thereafter, the Accounting Principles Board, the accounting-industry body that laid down guidelines for how companies calculate their earnings, decided that stock options, unlike salaries and bonuses, would not be counted as a corporate expense. This decision had momentous consequences, since it meant that, from a firm's perspective, executive stock options were free. Companies could issue as many options as they wished, and they wouldn't have to deduct a cent from the earnings they reported to shareholders.

Eventually, this accounting ruling transformed the way corporations paid their senior managers, but at the time it provoked little comment. Back then, executive stock options were still rare. Most senior executives thought that they were too risky and insisted on being paid in cash. This remained true throughout the nineteen-sixties and seventies, except in the technology sector, where firms developing untested products often didn't have enough money to pay high salaries. For young firms, stock options provided a convenient way to maintain the loyalty of valuable employees while conserving cash. If things went well for the company, options could be extremely lucrative: in 1982, after the Dow finally broke out of its decline, Frederick W. Smith, the chief executive of Federal Express, cashed in options worth more than fifty million dollars.

In 1980, fewer than a third of chief executives of public companies were granted stock options. Most firms still depended on bonuses and profit sharing to motivate and reward their senior managers. As the nineteen-eighties progressed, and the Dow tripled, stock options began to look much less risky. Thanks to the startling growth of firms that used them heavily, such as Microsoft and Intel, they also became fashionable. For blue-chip companies, issuing generous packages of stock options to their managers became a way to mimic the technological dynamism and entrepreneurial culture of Silicon Valley.



Yet the real benefit of granting stock options—or so economists insisted—was that they solved the problem of providing incentives to senior executives. Once again, Michael Jensen was an influential figure. In 1990, Jensen and Kevin Murphy, an economist who is now at the University of Southern California, published an article in the *Harvard Business Review* which argued that even after the events of the eighties the compensation that most senior executives received was barely connected to the performance of their firms. In particular, changes in a firm's stock price had little impact on the take-home pay of its chief executive. "On average, corporate America pays its most important leaders like bureaucrats," Jensen and Murphy concluded. "Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?"

By 1994, seven in ten chief executives received option grants, and stock options made up about half of their average take-home pay. In the second half of the nineties, so-called "mega-options"—options grants worth at least ten million dollars—became the norm. In 1997, according to the executive-compensation consulting firm Pearl Meyer & Partners, ninety-two of America's top two hundred chief executives received mega-options, with an average value of thirty-one million dollars. A year later, two Harvard economists, Brian J. Hall and Jeffrey Liebman, took another look at managerial pay and confirmed what anybody who followed the financial pages already knew: C.E.O.s weren't paid anything like bureaucrats. They were paid more like rock stars.

Wittingly and unwittingly, Washington encouraged the great giveaway. During the 1992 election campaign, Bill Clinton and Al Gore made a political issue out of lavish C.E.O. pay. A year later, the new Administration limited to a million dollars the tax deductions that corporations could take for executive salaries. The reform turned out to be counterproductive. Since executive stock options weren't counted as regular compensation, corporations had yet another reason to pay their senior managers less in salary and more in options. In 1994, the Financial Accounting Standards Board (F.A.S.B.), the descendant of the Accounting Principles Board, set out to force companies to deduct the value of the stock options they granted from their earnings. Following an intense lobbying campaign by Silicon Valley companies, several leading members of Congress, including Joseph Lieberman and Dianne Feinstein, threatened to put the F.A.S.B. out of business if it went ahead with the change. The board backed down, and the latest official attempt to control corporate avarice came to an end.

"It may surprise you to know that, contrary to your experience, you're actually very happily married."

The rise of the stock option revolutionized the culture of corporate America. The chief executives of blue-chip companies, who in the nineteen-eighties had portrayed Icahn, Pickens, and their ilk as corporate vandals, now embraced the values of the raiders as their own. For decades, the Business Roundtable, a lobbying group that represents the C.E.O.s of dozens of major companies, had stressed the social role that corporations played in their communities, as well as the financial obligations they owed their stockholders. In 1997, the Business Roundtable changed its position statement to read, "The paramount duty of management and board is to the shareholder."

In many cases, the C.E.O.s turned into corporate raiders themselves, albeit internal raiders. Companies like I.B.M., Xerox, and Procter & Gamble, acting on their own volition, fired tens of thousands of workers. Their chief executives insisted that the "downsizing" was necessary to compete effectively, and that was sometimes true. But once the C.E.O.s were in possession of mega-options, they had another motivating factor: an enormous vested interest in boosting their firms' stock price. For the first time, they had an opportunity to create fortunes on a scale hitherto reserved for industrial pioneers like Rockefeller, Morgan, and Gates. In 1997, Michael Eisner, the chairman and chief executive of Walt Disney, earned five hundred and seventy million dollars. A year later, Mel Karmazin, the chief executive of CBS, exercised options worth almost two hundred million dollars.

The scattered protests at these startling payouts notwithstanding, many economists credited the doctrine of shareholder value for reinvigorating American business. In spite of fears that downsizing would devastate communities, the economy thrived, and the total number of jobs in the country increased. Far from being pilloried, ruthless businessmen ended up being lauded. In 1996, one of the most cutthroat, Albert (Chainsaw Al) Dunlap, wrote a best-selling book, "Mean Business," in which he defended the cost-cutting tactics he had perfected at companies like American Can and Scott Paper. "The most important person in any company is the shareholder," Dunlap declared. "I'm not talking here about Wall Street fat cats. Working people and retired men and women have entrusted us with their 401Ks and pension plans for their children's college tuition and their own long-term security. If we're not concerned about them every step of the way, they're screwed."

As long as the economy kept expanding and the stock market kept going up, most Americans were content to avert their eyes from the lopsided manner in which the rewards of the long boom were being distributed. For those who looked closely, though, there was already evidence that executive stock options were sometimes being abused.

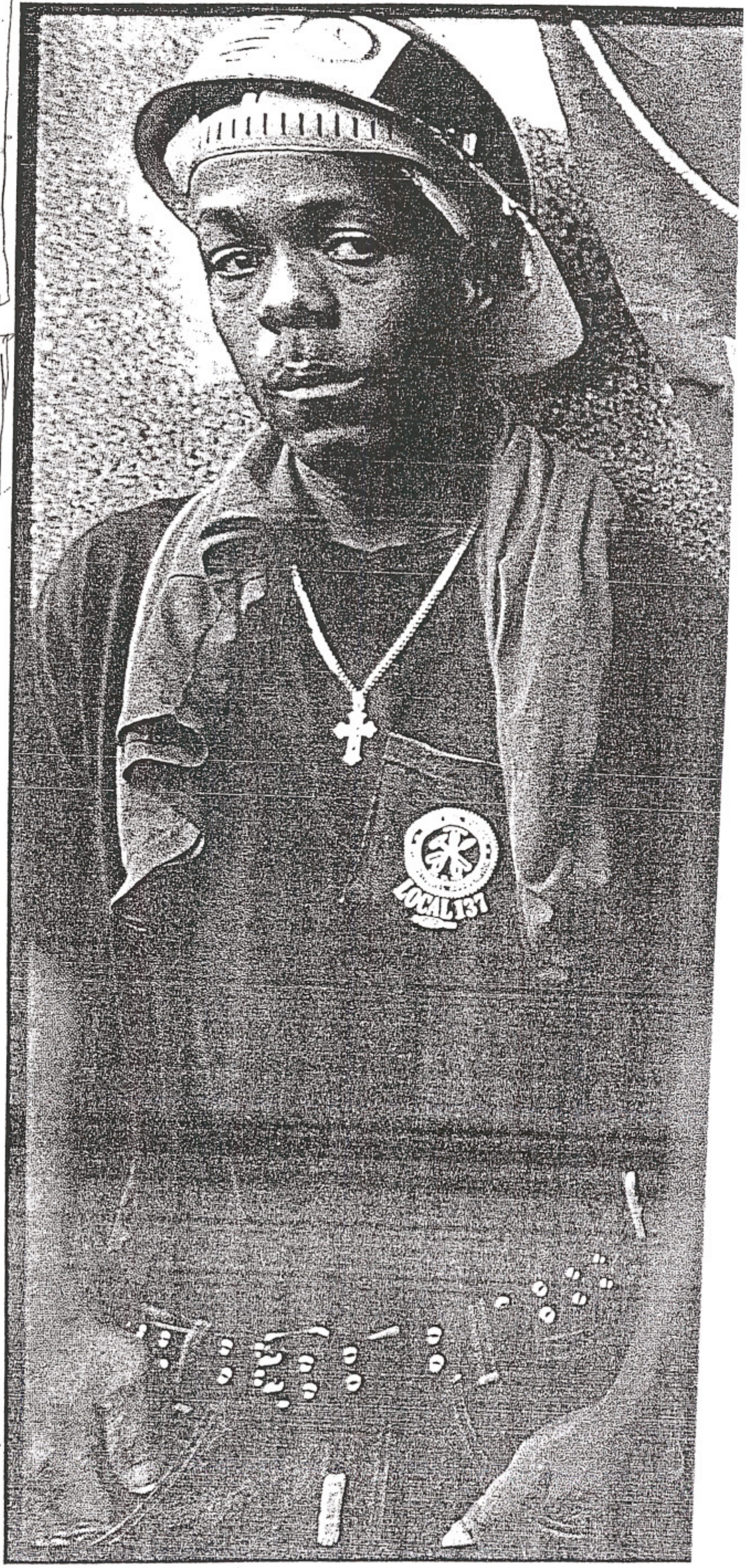
In 1997, David Yermack, an economist at N.Y.U.'s Stern School of Business, published an article in the *Journal of Finance* in which he noted that companies carefully time the dates on which they grant stock options to their chief executives. Typically, firms that have good earnings news to announce award the options just before they release their quarterly reports, so that the strike price is fixed before investors bid up the company's stock and the new options increase in value. Companies with bad earnings to report tend to delay the granting of options until after the earnings announcement, when the stock price will have already fallen, thereby reducing the strike price. This finding strongly implied that senior executives were using inside information for their own benefit, which might well be illegal, although no such case has ever been brought to court. "It looks a lot like insider trading," Yermack said recently.

Another example of managerial self-enrichment was the increasingly common—and perfectly legal—practice of companies purchasing their own shares from stockholders and then retiring them. According to George Fenn and Nellie Liang, two economists at the Federal Reserve Board, most stock buybacks are intended to increase the value of executive stock options by reducing the number of shares that a company has outstanding, making it possible to report increased earnings per share even if total earnings don't rise at all. This sort of financial engineering can boost a firm's stock price in the short run, but it can also do long-term damage. During the nineteen-nineties, I.B.M., Disney, and many other companies borrowed heavily, partly to finance buybacks. Consequently, corporate liabilities are now higher than ever, and companies like Disney are struggling under heavy debt loads.

At the same time, many firms exploited the lax accounting treatment of stock options to exaggerate their profitability. Sanford C. Bernstein, a New York brokerage firm, calculated that if all the companies in the S. & P. 500 index had expensed the stock options they issued between 1995 and 2000 their profits would have grown at an annual rate of only six per cent, rather than the nine per cent they reported.

As the Nasdaq headed for 5,000, even some leading advocates of the shareholder-value movement called for changes in the design of stock options. In early 1999, Alfred Rappaport, a consultant who wrote the management text "Creating Shareholder Value," published an article in the *Harvard Business Review* in which he pointed out, "Under current compensation schemes, senior managers are rewarded even when their companies underperform." The vertiginous rise in the Nasdaq and the Dow meant that nearly anybody who was lucky enough to be in charge of a public company stood to get very rich, however lacklustre his performance. Rappaport proposed indexing the strike price of executive stock options to the Dow or the Nasdaq. This way, he explained, the options would rise in value only if the stock outperformed the market, and chief executives would have to earn their fortunes.

Despite the eminent sense of this proposal, nobody in corporate America paid any heed to it. Under the nonsensical accounting rules covering options,



SEPTEMBER 11, 2002, 8:30 A.M. *Sheet-metal workers on Church Stree* the value of indexed options had to be deducted from earnings, whereas the value of ordinary options didn't. Businesses weren't willing to reduce their earnings by making the switch. Until very recently, only one firm in the country, Level 3 Communications, a computer-networking company, indexed its executive stock options to a broad market average.

Worse still, many companies repriced their senior executives' stock options at a lower level whenever the stock price fell. The chip company Advanced Micro Devices, for example, repriced the options of its founder, Jerry Sanders III, no fewer than six times, allowing him to make untold millions of dollars while his firm's stock performed modestly. The software company Oracle followed the same practice. In 2000, Larry Ellison, Oracle's already wealthy founder, made seven hundred million dollars by cashing in some low-priced options shortly before his firm's stock price collapsed.

It is hard to think of a better example of what is wrong with corporate America. When the firm's stock price does well, the people in charge make out like lottery winners. When the stock price plummets, they get another set of chances to win. The scheme, in its audacity, and its logic, is almost beautiful. Graef Crystal, an expert on executive pay, who wrote the book "In Search of Excess: The Overcompensation of American Executives," told me recently that if you combine a volatile stock with a willingness to reprice the stock options "then you have created a money machine, an antigravity device, which guarantees that the senior executives will get super-rich."

LIGHT GLASS STILL-LIFE

An empty tumbler
half filled with the troubled light
of a winter dawn,

the gray out of which
all the blood of darkness had
gradually drained:

it looks like itself
in just the same way that it
looks like other things

—but not like light, which
cannot look like anything
although (or because?)

likeness itself is
a part of the shadowing
light sheds on tumblers

at dawn, half filling
them with the stuff appearance
is also made from.

The tumbler, then (half
Like some *x* or *y*, half not),
Always seems to reign

The most insidious aspect of executive stock options is that—especially in tough times—they give senior managers a strong incentive to mislead investors about the true condition of their companies. Even before the current raft of financial scandals, more and more firms were resorting to accounting skullduggery, exaggerating their revenues and understating their costs.

Economists like Michael Jensen largely ignored this disturbing development, but inside the accounting world it was well known. Under the American system of corporate governance, which hasn't changed much since the nineteen-thirties, public companies provide an earnings update every quarter, and release a more detailed, audited report every twelve months. In preparing their financial results, firms rely on the Generally Accepted Accounting Principles, a lengthy set of rules that the S.E.C. and the big accounting firms agree upon. The rules are designed to provide a fair picture of how much money a company is making after subtracting its expenses from its revenues, but a determined management can interpret them in many different ways.

In 1993, Howard Schilit, a professor of accounting at American University, in Washington, D.C., published a book about the tricks that companies use to boost their earnings. Back then, most people who weren't C.P.A.s assumed that (outside Hollywood, anyway) accounting standards were clear and exacting, but Schilit had uncovered dozens of ways in which firms can manipulate their results. His book, "Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports," identified seven accounting dodges ranging from sleight of hand to outright fraud: (1) recording revenue too soon or of questionable quality; (2) recording bogus revenue; (3) boosting income with onetime gains; (4) shifting current expenses to a later or an earlier period; (5) failing to record liabilities or improperly reducing them; (6) shifting current revenue to a later period; (7) shifting future expenses to the current period as a special charge.

The following year, Schilit founded the Center for Financial Research & Analysis, a company that monitors corporate financial statements and issues warnings to its clientele of institutional investors. As the decade progressed, the number of warnings increased. "The accounting problems didn't suddenly happen in the last six months or twelve months," Schilit told me not long ago. "They were horrendous in the period

Over itself as
If it, too, were one of its
Own subjects, like the

Representations
With which the visible world
Is always being

Refilled, even as
The stuff of representing—
Authoritative

Black-and-white—itself
Yields definition to the
Gray of resemblance.

And all the while *like*
Keeps on coming as close to
Is as you can get

—Ever hope to get—
Philosopher, with all your
Whatever it is

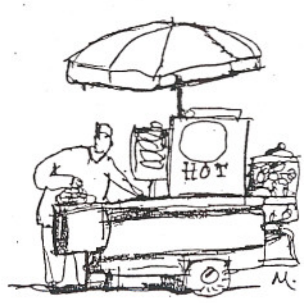
That would make this glass
Overflowing with glassness
A mere . . . An only . . .

—*John Hollander*

from 1997 onward." Schilit and his colleagues often received a hostile reaction when they publicly questioned a company's earnings. "People got very angry," Schilit recalled. "The amount of money that C.E.O.s were making from out-of-control option plans was astounding, but everybody who was around them was happy, because they were also getting rich. They didn't want somebody raising questions."

In September, 1994, Schilit issued a warning about C.U.C., a Connecticut-based direct-marketing company that sold memberships in discount clubs, such as Shoppers Advantage. Its earnings had been rising sharply—partly because the company had been treating some of its marketing costs as capital expenditures, which allowed it to make them appear much smaller. If a firm spends three hundred million dollars on a state-of-the-art factory, say, it can spread the cost over thirty years rather than immediately charging the full amount to its profit-and-loss account. But marketing expenditures, such as advertising and direct mailing, are not really long-lasting investments. In treating them as such, C.U.C. was using shenanigan No. 4. The firm had also taken a number of "restructuring charges," to cover the costs of closing factories, making payments to laid-off workers, and so on. Such charges are often used as a slush fund. Firms deliberately write off more money than they need, and then they use some of the leftover cash to boost future earnings—a case of shenanigan No. 7.

In early 1997, Schilit and his colleagues issued another report on C.U.C.



The warnings enraged Walter Forbes, C.U.C.'s chief financial officer, but investors didn't take much notice. Between September, 1996, and April, 1998, C.U.C.'s stock price doubled, as the firm merged with a big franchising company, H.F.S., and changed its name to Cendant. Forbes became chairman of the merged firm. Days after the stock price peaked, the company announced it had uncovered accounting irregularities that had inflated its earnings by more than a hundred million dollars, and the stock fell almost fifty per cent. In July, 1998, Forbes resigned. In June, 2000, three former employees in Cendant's accounting division pleaded guilty to fraud. Forbes and another former C.U.C. executive are awaiting trial on charges that they inflated earnings for almost a decade.

Cendant was a major financial scandal. Almost twenty billion dollars of shareholder value was wiped out, and the company ended up paying $2.8 billion to settle shareholder suits, but the story rarely made it out of the business section. Schilit told me, "When a bull market is raging, investors lose a lot of money on Cendant, and the advisers, the investment bankers, say, 'O.K., Joe. Fraud can happen. But you made a lot of money on the previous five deals I brought you.' Investors tend to grit their teeth and say, 'Yes, I got nailed on this one, but I did make money on the five other deals.' "

Around the time that the truth about Cendant emerged, an accounting scandal forced Al Dunlap to resign from Sunbeam, the appliance maker where he had been wielding his chainsaw, and ramping up the value of nearly four million stock options. Dunlap denied any wrongdoing, but in 2001 the S.E.C. charged him and four of his former colleagues with fraud, claiming that they had given a false impression of Sunbeam's business by inflating its "stock price and thus improving its value as an acquisition target." Sunbeam eventually filed for bankruptcy, and its stockholders—the most important people in the company, according to Dunlap—ended up with nothing.

The frauds at Cendant and Sunbeam were dwarfed by an even bigger accounting scandal, at Waste Management, the largest trash-hauling company

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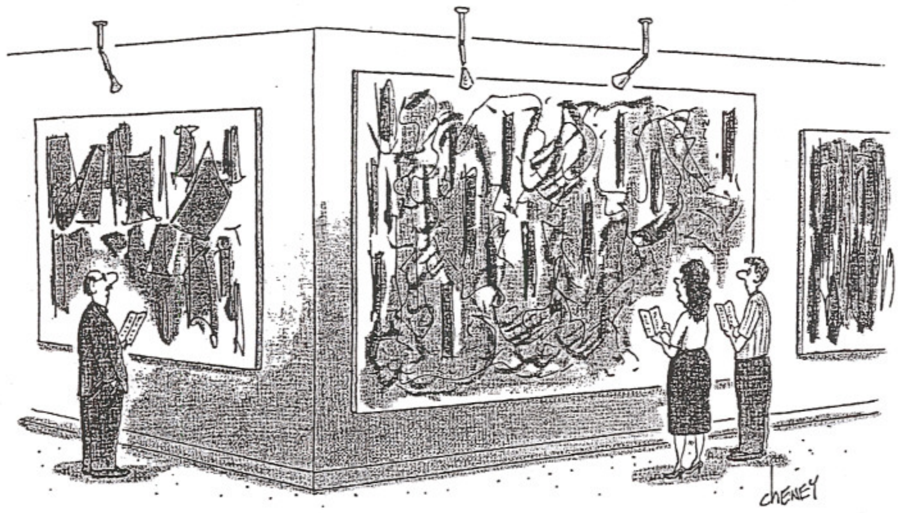

"It's good, but it doesn't say 'bipolar.'"

in the country. Schilit first warned investors about aggressive accounting in 1995, but the company's stock kept rising. In July, 1998, Waste Management merged with one of its biggest rivals, U.S.A. Waste Services, and the next spring its stock reached a record high. A few months later, the firm announced that it was reviewing its accounting records. The S.E.C. launched an investigation, which discovered that between 1992 and 1996 Waste Management had exaggerated its profits by $1.43 billion.

Cendant and Waste Management were both scrappy firms trying to crash their way into the financial establishment. Lucent Technologies, the former equipment-making division of A.T. & T., was the bluest of blue chips. Lucent went public in April, 1996; within three years its stock had risen eightfold, and it had become the most widely held stock in America. In 1998, Lucent generated about a billion dollars in net income. Investors were expecting the firm's rapid growth to continue over the next year, and the company was doing nothing to dispel the idea that it would. But in reality Lucent's sales were slowing, and its inventories were rising. The company included in its earnings gains from its corporate pension plan (shenanigan No. 3), started capitalizing software expenditures (shenanigan No. 4), and created new reserves related to acquisitions (shenanigan No. 7). In February and May of 1999, the Center for Financial Research & Analysis issued two warnings about Lucent's financial condition. "There wasn't one thing that leaped out at you," Howard Schilit recalled. "There was just a whole series of little tricks here and there."

As usual, investors didn't pay much attention. That November, Lucent's stock hit eighty dollars. On January 6, 2000, Schilit and his colleagues issued a third warning, detailing how Lucent had artificially boosted its earnings by reversing a previous restructuring charge. A week later, Lucent announced that it would miss Wall Street's earnings estimates for the last quarter of 1999, and its stock fell sharply. Two and half years later, it is trading below two dollars.

"What Lucent taught a lot of people, me included, was that this could happen anywhere," Schilit said. "These blue-chip companies were just as susceptible to accounting trickery as the small ones."

If investors had been paying more attention, they would have seen that Schilit wasn't the only one warning that something was wrong with the upbeat figures corporate America was releasing. Between the fourth quarter of 1996 and the fourth quarter of 2000, the firms in the S. & P. 500 reported that their earnings per share had increased from $38.73 to $54.78, with not a single down quarter. Even at the end of 2000, most big companies were predicting further rises in profits. But according to the Commerce Department, which measures the gross domestic product and its components, corporate profits peaked in 1997, at close to eight hundred billion dollars. Thereafter, they fell sharply, to just above seven hundred and twenty billion dollars in 1998. Profits didn't recover their 1997 level until 2000, whereupon they slumped again in 2001.

There are two possible ways to explain the glaring difference between the Commerce Department's numbers and corporate America's. The government calculates profits from corporate tax filings, which often contain lower estimates of earnings than the filings that firms present to Wall Street. (For some reason, firms feel no urge to exaggerate their profits to the I.R.S.) Moreover, the government gathers numbers from all types of enterprises, big and small, whereas the S. & P. 500 is composed of the largest corporations in the country. It is at least conceivable that the decline in profitability that the Commerce Department detected was concentrated among tax avoiders and small firms. But a far more convincing explanation is that the vast majority of major corporations were artificially inflating their profits. Instead of admitting that rising wages and intense competition were corroding their earnings, they were resorting to subterfuge.

The men heading these companies faced an unenviable dilemma. At the stock market's peak, many of them had options worth tens of millions of dollars. But this wealth was alarmingly evanescent: with a plunge in the company's stock price, their options would be rendered worthless. In these circumstances, it would have taken a brave man to tell the truth about what was happening to corporate earnings. Such corporate statesmen were in short supply. Far more common were senior executives, who, in Alan Greenspan's words, sought to "harvest" some of their stock-market gains before it was too late.

Even Michael Jensen, the great defender of big payouts for C.E.O.s, now concedes that the design of enormous stock-options packages had a disastrous effect on corporate ethics. If he had his way, Jensen told me recently, every standard executive stock option would be scrapped. Instead, managers would receive options with a strike price that went up every year. "I was a defender of the move toward stock options and more liberal rewards for C.E.O.s. But I'm now a critic of where we got to," Jensen said. "For a long time now, we've had a situation in which the stock prices of many firms have been too high," he explained. "That is to managers what heroin is to a drug addict." When stock prices are overvalued, managers get into an elaborate game with Wall Street to try and justify them. "But if they are too high you can't possibly justify them. So you keep struggling for ways to get the earnings up, to generate the reports that the market is expecting to see." Whenever a company does admit that its earnings aren't growing as rapidly as investors are expecting, its stock price gets crushed and its management gets pilloried. "Once you train managers by penalizing them for telling the truth and rewarding them for lying, then that kind of unethical behavior gets extended to all sorts of things," Jensen said.

Jensen's discovery that executive stock options can have perverse results is rather belated, but his analysis of the last few years is hard to fault. Stock options, instead of spurring corporate leaders to build businesses that would create wealth for decades to come, encouraged them to manage for the short term, tailoring their actions to the demands of Wall Street stock analysts; and, in all too many cases, the practice turned them into crooks. WorldCom, for example, the second-biggest long-distance phone company in the country, classed billions of dollars in routine expenditures, such as payments the firm made to other telephone companies for connecting calls, as capital investments, which made it look a lot more profitable than it really was. Global Crossing, a startup company that built a transatlantic communications network, swapped fibre-optic capacity with other telecommunications companies in order to create fake revenues. Dynegy, an energy-trading firm, recorded phantom trades to do the same thing. Xerox, Qwest, and Rite Aid are all accused of inflating their revenues.

None of these accounting shenanigans emerged until after the Nasdaq crashed, in April, 2000, but they were all similar to the ones Schilit had identified in the nineties. At Enron, the finagling was more complicated. The wrongdoing appears to have begun in earnest toward the end of 1997, when the credit-rating agencies (Moody's and Standard & Poor's) became increasingly concerned about the debt that Enron had taken on as it expanded from a gas-pipeline company into areas like energy trading and online commerce. If the credit-rating agencies had downgraded Enron's debt, its stock price would have fallen, which would have had a disastrous impact on the massive stock-option packages that virtually all the firm's senior executives owned. In order to forestall this eventuality, Andrew Fastow, Enron's chief financial officer, set up a series of investment partnerships, with names like Chewco and LJM1, which were used to reduce Enron's debt and disguise its losses on new ventures. An investigative committee appointed by Enron's board later concluded that "the transactions between Enron and the LJM partnerships resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense." Just as important, the partnerships helped to maintain Enron's stock price long enough for the firm's senior management to cash in hundreds of millions of dollars of stock options.

Jensen has been looking closely at Enron. In a recent working paper, he and another economist, Joseph Fuller, pointed out that "Enron was in many ways an extraordinary company. It boasted significant global assets, true achievements, dramatic innovations, and a promising long-run future." The firm's one big problem was its outsize stock-market valuation, which in August, 2001, reached almost seventy billion dollars. In order to justify this outlandish figure, Wall Street analysts were demanding higher earnings, and Enron's top executives were casting around for ways to meet these demands. "If Enron's management had confronted the analysts with courage and conviction and resisted their relentless focus on outsize earnings growth, the company could have avoided questionable actions taken to please the analysts and the markets," Jensen and Fuller conclude. "The result could well have been a lower-valued but stable and profitable company."

A corollary of this argument is that Kenneth Lay and his colleagues were not necessarily deceitful or venal people; nor were the heads at WorldCom, Dynegy, and Global Crossing: they were all

"Excuse me, Missy! Unilateralism has no place in this family."

victims of circumstance. "It is important to recognize that this doesn't come about as a result of crooks," Jensen insisted. "This comes about as a result of honest people being subjected to forces that they don't understand. The forces are very strong, and this evolves over a period of time. You end up with highly moral, honest people doing dishonest things. It wasn't as if the Mafia had taken over corporate America. We are too quick to say—and the media feed this—that if a bad thing happens it's because a bad person did it, and that person had evil intentions. It is much more likely that there were some bad systems in place."

What Jensen doesn't say, of course, is that he and other economists were at least partly responsible for the compensation systems that unleashed an orgy of self-enrichment. In retrospect, Jensen and his colleagues were hopelessly naïve in assuming that executive stock options wouldn't be abused. If the past thirty years have demonstrated anything, it is that the avarice of America's corporate leaders is practically unlimited, and so is their power to run companies in their own interest. "When I did my first study, in 1973, the average C.E.O. of a major company was making about forty-five times the average pay of the workers," Graef Crystal reminded me recently. "When I wrote my book, in 1991, the pay ratio was a hundred and forty. Now it's five hundred." Under the light-handed regulation of public companies that has been fashionable since the Reagan era, the onus has fallen on auditors, boards of directors, and outside stockholders to restrain the selfishness of senior executives, but none of these groups have proved up to the task.

Even before the Enron scandal, it was clear that many auditors were not doing their jobs properly. In the case of Waste Management, for example, Arthur Andersen complained about many of the bookkeeping ruses that the senior managers were using, but it approved the company's financial statements nonetheless. Had Andersen done otherwise, it would have risked losing a lucrative client. Between 1991 and 1997, Andersen billed Waste Management $7.5 million in audit fees and $11.8 million in fees for other services, such as work on tax and regulatory issues. Meanwhile, Andersen Consulting billed Waste Management six million dollars, $3.7 million of which was related to a strategic review designed to "increase shareholder value."

Boards of directors often end up as patsies for the senior managers they are supposed to be monitoring. As Graef Crystal has been pointing out for years, the typical American board is composed of ten friends of the chairman, a token woman, and a token representative of a minority group. All too often, chief executives largely determined their own compensation arrangements, and the board rubber-stamped them.

"I think there were some people who were greedy, and who felt nobody was watching and they could get away with anything," Carl McCall, the state comptroller of New York, said when I spoke to him last month. McCall recently served on a New York Stock Exchange panel that recommended a set of reforms for companies wanting to list themselves on the Exchange. After the reforms are adopted, every company on the N.Y.S.E. must have a majority of independent directors on its board, and three of the company's committees—the audit committee, the compensation committee, and the nominating and governance committee—must be made up solely of independent directors. (At the moment, members of the audit committee have to be independent, but companies are not even required to have compensation, nominating, or governance committees.)

These are worthwhile reforms, but, as Paul Volcker points out, "There's a limit on the supervisory, skeptical role that you can expect a board of directors to provide. In a successful company, the directors are going to have a collegial feeling. They have been appointed by the C.E.O. They are going to be heavily influenced by what he says. They are going to give him the benefit of the doubt." Moreover, a management team that is determined to act crookedly can often hide its fraud. At Enron, the outside directors included a former accounting professor and a former federal energy regulator, but neither of them was aware of the extent of what had been happening to the company until they read it in the newspapers.

Of course, senior executives are ultimately responsible to the owners of the company: the stockholders. But it

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was the weakness of the stockholders that justified the use of executive stock options to begin with, and little has changed in this regard. Most investors will simply sell their stock in a company if they see something they don't like. During the nineteen-nineties, there was another reason that investors were reluctant to police rapacious executives: most were too greedy themselves to question the startling earnings growth that supported the bull market. They gleefully accepted the optimistic line that Wall Street and corporate America fed to them, pausing only to inspect their monthly statements from Fidelity and Charles Schwab. It was only after the bubble burst that they were shocked to discover that many of the schemes they had been sold were illusory, and that some senior executives were dishonest.

What now? Early in the summer, Hank Paulson, the publicity-shy chairman and chief executive of the Goldman, Sachs Group, astonished many of Goldman's bankers when he appeared at the National Press Club, in Washington, and lambasted some of his fellow chief executives, the very people with whom his firm does business. Never in his lifetime, Paulson declared, had America's business leaders been held in less repute, and, he added, much of the scrutiny was deserved. When I caught up with Paulson a few weeks ago, he said that the media frenzy and political outcry about corporate malfeasance would last until the November congressional elections, but he expected a letup thereafter. "I really believe that there are more well-run companies in the United States than there are anywhere else in the world," Paulson said. "Clearly, the U.S. economy is not full of Enrons and WorldComs. But they did illuminate flaws in the system." Greed took over in a number of cases, Paulson added, but "much of what has happened can't be explained by something as simple as greed." Greed didn't create investors' desire for steady earnings increases, or the stock-market bubble, or the lax accounting rules. Now that some of these issues were finally being addressed, Paulson was encouraged. "I actually think we'll be out of this sooner than some people think. And I also think we'll emerge stronger for what we've been through."

The optimists could yet be proved correct as some of the reforms take hold. But there are also discouraging signs. Too many companies remain reluctant to offend investors by telling the truth about their finances; the government still hasn't forced companies to acknowledge the true cost of the stock options they issue; and neither recession nor scandal has halted the corporate practice of bestowing gigantic options packages on senior managers. In 2001, according to Pearl Meyer & Partners, more than half of America's top two hundred chief executives received mega-options, with an average value of more than fifty million dollars. Virtually all of them were granted with fixed strike prices. Indexed options, although increasingly popular in Britain and other parts of Europe, remain rare in the United States.

An effective compensation scheme rewards people for improving things that are under their control. If a cobbler mends more shoes, he deserves the extra payments he receives. If a slugger hits more home runs, he deserves a higher salary. If a manager reorganizes a firm and makes it operate more effectively, he, too, deserves more money, but stock options are a poor way to measure his contribution, because their value is beyond his control. Investors determine a firm's stock price, and they often do it for reasons that have more to do with crowd psychology than with a rational analysis of how the business is doing. The actions of a chief executive frequently bear only a distant relation to the behavior of his firm's stock. Even stock options that are indexed to broad market averages, such as the S. & P. 500, suffer from this weakness. If war breaks out in the Middle East, the chief executives of Exxon and Chevron will see their stock options soar in value because investors are bidding up the price of all oil stocks.

Managers ought to be paid for improving how their companies serve their customers, not for improving how investors rate their stock. "Everybody gets rewarded in a bull market—the good, the bad, and the ugly," Volcker pointed out to me. "Nobody gets rewarded in a down market. And it's not that everybody's a genius in a bull market and a dolt in a down market. They are the same people." After giving the matter much thought, Volcker has concluded that it is time to scrap stock options. "They are subject to abuse and temptation in a way that's almost irrefutable," he said. "And I think we ought to get rid of them."

Volcker is surely correct. And reforming executive pay should be part of a broader program to save capitalism from the capitalists. In the nineteen-thirties, Franklin D. Roosevelt recognized that the real threat to the system comes not from protesters on the streets but from the business leaders themselves, whose greed and self-dealing undermine the public consent on which they ultimately depend. There are at least two ways that C.E.O.s could be reined in. In Germany, most big firms have two boards: an operating board, which deals with the day-to-day running of the company, and a supervisory board, which oversees the actions of the senior managers. The chief executive doesn't even have a seat on the supervisory board. In Britain, the post of chairman and chief executive is often split, so the company has two powerful figures at the top, who can keep an eye on each other. Americans often presume that their system of corporate governance is the best in the world, but there are things to be learned from practices elsewhere. Above all, it is time to downsize the myth of the all-powerful C.E.O. Effective leadership is one aspect of corporate success, but it is by no means the only one. History, competition, and luck also play crucial roles. And most C.E.O.s are eminently replaceable.

In recent weeks, senior executives of WorldCom and Adelphia Communications have been paraded before the cameras in handcuffs. Paulson and Volcker both told me that they found these pictures unsavory. Maybe they were, but they sent a salutary message to other senior executives: public companies are social organizations with social responsibilities. Unless this message is heeded, the furor over Kenneth Lay and his fellow corporate scoundrels will gradually fade. And, once the economy and the stock market revive, the greed cycle will start up again. ♦