Introduction

This issue of *Business History Review* is devoted to financial crisis, business failure, and scandal. As readers of this journal know, white-collar fraud is not a new phenomenon. Public and private authorities have confronted the problem for a long time, looking for ways to deal with it that will not stifle economic growth.

Free-market economists hold that market discipline will take care of any problems that arise. Recently, economist Anna Schwartz told the *Wall Street Journal*, "Firms that make wrong decisions should fail. . . . You shouldn't rescue them. And once that's established as a principle, I think the market recognizes that it makes sense."[1] While there are logical, theoretical arguments supporting the free-market position, historical evidence suggests a more complicated reality, one subject to bubbles and financial crises that cannot be fixed by free-market ideology alone.[2] After the Great Depression, most economists came to believe that some degree of regulation was necessary, recognizing that the government must intervene when self-regulation by industries and private organizations does not suffice.[3] At the same time, they agree that regulation has costs of its own.[4]

Crises, failures, white-collar fraud, and the private and public attempts to deal with them are not a twenty-first century invention but are as old as capitalism itself. In the 1630s, for example, tulip speculation

[1] Anna Schwartz, "The Weekend Interview: Bernanke Is Fighting the Last War," *Wall Street Journal*, 18 Oct. 2008. See also Anna Schwartz, "Real and Pseudo-Financial Crises," in Forrest Capie and Geoffrey Wood, eds., *Financial Crises and the World Banking System*, (London, 1986), 11–31.

[2] See, for instance, Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes: A History of Financial Crises*, 5th ed. (New York, 2005). For theory, see Irving Fisher, "The Debt-Deflation Theory of Great Depressions," *Econometrica* 1 (1933):337–57; and Hyman Minsky, "A Theory of Systemic Fragility," in Edward I. Altman and Arnold W. Sametz, eds., *Financial Crises: Institutions and Markets in a Fragile Environment* (New York, 1977), 138–52.

[3] Regarding self-regulation, see A. W. Mullineux, *Business Cycles and Financial Crises* (Hemel Hempstead, U.K., 1990). See also Per H. Hansen, "Bank Regulation in Denmark from 1880 to World War II: Public Interests or Private Interests?" in *Business History* 43 (Jan. 2001): 43–68, for the relation between crises and regulation. For the relation of the Kreuger crash to SEC regulation in 1934, see D. Flesher and T. Flesher, "Ivar Kreuger's Contribution to U.S. Financial Reporting," *Accounting Review* 61, no. 3 (July 1986), 421–34.

[4] For two classic articles, see G. J. Stigler, "The Theory of Economic Regulation," in *Bell Journal of Economics and Management Science*.2 (1971): 3–21; and R. A. Posner, "Theories of Economic Regulation," in *Bell Journal of Economics and Management Science* 5, no. 2, (1974): 335–58.

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in Holland reached a fever pitch, before the market collapsed; the early eighteenth century witnessed the rise and fall of the Mississippi and South Sea bubbles. While some historians question whether the Dutch tulip mania fit the category of a bubble, Anna Goldgar, in a recent book on the subject, argues that, no matter how one defines the phenomenon, the speculative fever that erupted threw a "whole network of values into . . . doubt."[5] It could be argued that this is what bubbles do: they challenge mainstream ideas about values to widespread effect, even as economists continue to maintain their paradigmatic belief in rational behavior and fundamentals.[6] Through the nineteenth and twentieth centuries, booms and busts were regular occurrences. How do we explain this? And how do we explain the stability and high economic growth that took place during the 1950s and 1960s, a period of managed economies?[7]

Economic theory provides some explanations for failures. Raymond Vernon's product life-cycle theory, for example, holds that innovators in one country eventually lose out to nations whose producers can manufacture the same items at lower cost. Then there is Joseph Schumpeter's concept of "creative destruction," which maintains that crisis and failure are part of economic life, and may even be a precondition for economic growth and development.[8]

Add to these explanations the factors of corporate fraud and irrational investor behavior. Examples abound of the "extraordinary popular delusion and madness of the crowd."[9] In 1920, for example, Charles

[5] Kindleberger and Aliber, in *Manias, Panics and Crashes*, 115–16, maintain that it was a bubble, while Peter Garber, in *Famous First Bubbles: The Fundamentals of Early Manias* (Cambridge, U.K., 2000), and Earl A. Thompson, "The Tulipmania: Fact or Artifact," *Public Choice* 130, nos. 1–2 (2006): 99–114, argue that there was no bubble. In his article, Thompson claimed that regulatory changes led to the dramatic decline in the price of tulip bulbs, which constituted a rational response to the changes. A different, microhistorical, perspective, is taken by Anne Goldgar, in *Tulipmania: Money, Honor and Knowledge in the Dutch Golden Age* (Chicago, 2007), 18.

[6] See, for instance, Patricia Cohen, "Ivory Tower Unswayed by Crashing Economy," *New York Times*, 5 Mar. 2009; and, more generally, John Kenneth Galbraith, *Economics in Perspective: A Critical History* (Boston, 1987).

[7] The point could be made that the instability that followed was a direct cause of the managed economies, but, to my knowledge, such causality has not been demonstrated. Rather, it could be argued that the high and stable growth of this period was the result of a unique combination of a number of factors. See, for instance, Robert Reich, *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life* (New York, 2007), 15–49; and Barry Eichengreen, *The European Economy since 1945: Coordinated Capitalism and Beyond*, (Princeton, 2007).

[8] R. Vernon, "International Investment and International Trade in the Product Cycle," *Quarterly Journal of Economics* 2 (1966): 190–207; and Joseph A. Schumpeter, "The Process of Creative Destruction," in Schumpeter, *Capitalism, Socialism and Democracy* (New York, 1942), 81–86.

[9] For popular delusions, see the classic by Charles MacKay, *Extraordinary Popular Delusions and the Madness of Crowds* (New York, 1980; originally published in 1841). For the Charles Ponzi scheme, see Mitchell Zuckoff, *Ponzi's Scheme: The True Story of a Financial Legend* (New York, 2005).

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Ponzi devised his eponymous scheme, recently resurrected by Bernard Madoff and others. In 2001 and 2002, we saw the massive corporate failures of Enron, Parmalat, WorldCom, Royal Ahold, and Tyco. Thus, we must conclude that destruction is not always creative. Sometimes failures and crises are just what they seem to be: destructive of wealth and harmful to the real economy, creating nothing new, and leaving thousands of citizens in desperate straits. In a worst-case scenario, they undermine the legitimacy of capitalism and market economies.[10]

We can only hope to be able to learn how to deal with crises, fraud, and failure by discovering their underlying causes and grasping their impact on the economy and, more generally, on society. Unfortunately, history does not offer much ground for optimism about our ability to learn enough to enable us to avoid trouble in the future.[11] For this reason, it is important for business historians to examine scandals within their historical social, cultural, and economic contexts.

Scholars have noted that business crises and white-collar fraud tend to occur in clusters.[12] This raises the question of whether some business systems are more likely to succumb to crisis and fraud than others.[13] The tendency toward clustering suggests a correlation between the macroeconomic phenomena of bubbles, economic shocks, and disturbances and the behavior of managers and investors at the microeconomic level.

Thus, although failures and scandals occur amid busts and crises, not all banks fail in a financial crisis, and not all companies commit fraud, indicating that we cannot understand booms and busts, failure and fraud at the aggregate level alone. We must also study individual companies and banks in order to understand why some companies fail while others do not. Business historians are equipped to examine periodic crises at both the macro- and the microlevels, and to view them through the lens of particular, individual examples.

Financial bubbles are the result of many managerial and investor decisions. In order to understand how certain decisions can lead to a

[10] See, for instance, Roy C. Smith and Ingo Walter, "Four Years after Enron: Assessing the Financial-Market Regulatory Cleanup," *Independent Review* 11 (Summer 2006): 53–66.

[11] The disciplines of behavioral economics and behavioral finance are gaining ground. See, for instance, Dan Ariely, *Predictably Irrational: The Hidden Forces that Shape Our Decisions* (New York, 2008); and George A. Akerlof and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism* (Princeton, 2009).

[12] See Kindleberger and Aliber, *Manias, Panics and Crashes*, esp. ch. 9; and Stewart Hamilton and Alicia Micklethwait, *Greed and Corporate Failure: The Lessons from Recent Disasters* (New York, 2006).

[13] This topic is discussed by J. C. Coffee Jr. in "A Theory of Corporate Scandals: Why the USA and Europe Differ," *Oxford Review of Economic Policy* 21, no.2 (2005): 198–211. Coffee argues that the issue of different corporate governance systems is important. For business systems, see Richard Whitley, "Dominant Forms of Economic Organization in Market Economies," in *Organization Studies* 15, no. 2 (1994): 153–82.

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general crisis, we must embark on more detailed studies of how individual firms came to settle on their eventual courses of action.[14] Studies of failure at the firm level illuminate how the general business climate and the institutional framework influence managers' decisions, and demonstrate how external conditions interact with individual firms' internal controls and corporate governance. A "microperspective" reveals how the incentive structure, which is made up of formal and informal institutions and enforcement characteristics, actually influences decision-making at the organizational level.[15]

The sociologist Maurice Punch has argued that corporations have criminogenic features, which is to say that they provide the context, means, and opportunity for highly paid executives to commit fraud. He is not implying that fraud is always, or even usually, part of a master plan. Instead, it may begin with an error in incentive structure and continue down a slippery slope until the perpetrators arrive at a point of no return. A case in point is the 1994 Barings Bank failure, which occurred when the trader Nick Leeson propelled Barings into bankruptcy through his rogue trading. The Barings failure points to the need to analyze the corporate culture, internal controls, organizational structure, and incentive structures in detail, in order to figure out how one person could bring down a two-hundred-year-old investment bank. The Enron failure requires a similar level of scrutiny. However, Punch also argues that, in

[14] One such study, prepared from a behavioral finance perspective, is by L. Lai, "The Norwegian Banking Crisis: Managerial Escalation of Decline and Crisis," *Scandinavian Journal of Management* 10, no. 4 (1994): 397–408. For an instructive discussion of behavioral finance, see Verner de Bondt, "Bubble Psychology," in William C. Hunter, George G. Kaufman, and Michael Pomerleano, eds., *Asset Price Bubbles: The Implications for Monetary, Regulatory, and International Policies* (Cambridge, Mass., 2003), 205–16. There is also an enormous literature on individual firm failures, such as, for instance, on Enron: Kurt Eichenwald, *Conspiracy of Fools: A True Story* (New York, 2005); and on Long Term Capital Management: R. Lowenstein, *When Genius Failed: The Rise and Fall of Long Term Capital Management* (New York, 2001). Although many books on failure are of high quality, they have not been written by business historians. In the interwar period, the Kreuger scandal in 1932 was the most important, and the literature on that scandal is abundant and growing. See, for instance, R. Shaplen, *Ivar Kreuger: Genius and Swindler* (1960); and the excellent Harvard Business School case by Geoffrey Jones and Ingrid Vargas, "Ivar Kreuger and the Swedish Match Empire," Harvard Business School case 804-078.

[15] For the institutional framework, see Douglass C. North, "Institutions and the Performance of Economies Over Time," in Claude Menard and Mary M. Shirley, *Handbook of New Institutional Economics* (Dordrecht, 2005), 21–30. For some important recent work on the incentive structure and how it may lead to excessive risk taking, see Roy C. Smith and Walter Ingo, "Four Years After Enron: Assessing the Financial-Market Regulatory Cleanup," *Independent Review* 11 (Summer 2006): 53–66; Roy Smith, and Walter Ingo, *Governing the Modern Corporation: Capital Markets, Corporate Control, and Economic Performance* (Oxford, 2006), ch. 11, 270–92; and Chris McKenna, *The World's Newest Profession: Management Consulting in the Twentieth Century* (Cambridge, U.K., 2006), ch. 9, 216–44. For social and cultural perspectives on failure, see, for instance, Scott A. Sandage, *Born Losers: A History of Failure in America* (Cambridge, Mass., 2005); and Stephen Mihm, *A Nation of Counterfeiters: Capitalists, Con Men and the Making of the United States* (Cambridge, Mass., 2007).

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order to understand corporate fraud, we must look at how fraudulent behavior in an organization becomes accepted over time. This issue cannot be reduced to an economic principal-agent problem, despite the relevance of such an angle. The social construction of fraud as a legitimate pursuit, a way to achieve some higher goal, is an important avenue for further research.[16] Mark Granovetter has stated that while social networks and personal relations can create trust, trust may also be a starting point for defrauding a company.[17] Well-functioning boards, internal controls, and other standards of corporate governance are essential for safeguarding against such a danger.

The recent corporate disasters seem to lend at least some credibility to Punch's hypothesis and Granovetter's assertion, but questions still remain: Are frauds and scandals independent of the historical context? Are serious financial crises and clusters of corporate failure and fraud more likely to occur during periods that emphasize free markets and focus on shareholder value? Or are they more prevalent during periods of intense government intervention?[18] It may not be a coincidence that the second period of globalization, which started with the deregulation of the 1970s and culminated in the current decade—a period that some scholars characterize as one in which the world economy became "financialized"—is more fragile, presenting more exposure to fraud and excessive risk-taking than the "golden age" of economic growth, which lasted from 1950 to 1973.[19] (A cultural perspective on frauds and crises is also called for. Movies like *Wall Street*, *Other People's Money*, and *Barbarians at the Gate* demonstrate that crises and failures affect popular culture, but, surely, culture affects the economy as well.) In other words, are the Kreuger crash of 1932, the Enron scandal of 2001, and the financial crisis that started in 2007 products of two periods of financial capitalism marked by unrestrained market forces, cutthroat competition, and problematic incentive structures that led market participants to take on too much risk while leaving adequate controls behind? Comparative historical work can provide some of the answers.

[16] Maurice Punch, *Dirty Business: Exploring Corporate Misconduct. Analysis and Cases* (London, 1996); and James Gobert and Maurice Punch, "Because They Can: Motivations and Intent of White-Collars Criminals," in Henry N. Pontell and Gilbert Geis, eds., *International Handbook of White Collar and Corporate Crime* (New York, 2007), 99–122. For other studies on the Barings failure, see Hamilton and Micklethwait, *Greed and Corporate Failure*; and Helga Drummond, *The Dynamics of Organizational Collapse: The Case of Barings Bank* (New York, 2008).

[17] Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology* 91 (Nov. 1985): 481–510.

[18] This question is addressed directly by Naomi Lamoreaux in this issue.

[19] See, for instance, R. Dore, "Financialization of the Global Economy," in *Industrial and Corporate Change* 17, no. 6, (2008): 1097–112. See also, R. Wade, "Financial Regime Change?" *New Left Review* 53 (Sept.–Oct. 2008): 5–21.

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This issue of the journal brings together diverse examples of this overlooked aspect of business history. Naomi Lamoreaux discusses the difficulty of navigating between the Scylla of too little government intervention and the Charybdis of too much. She argues that when corporations are relieved of government-imposed restrictions, the corporate-governance problem of principal–agent issues is more likely to arise. In that situation, cases like the Enron collapse will occur. While more government intervention may not prevent fraudulent executives from robbing stakeholders, it may at least reduce the frequency and seriousness of such behavior. Lamoreaux concludes, however, that the costs of government intervention to economic growth may be large, an assessment that is likely to provoke a needed debate.

Lamoreaux's paper covers a period of more than three hundred years and spans a number of Western countries. Thomas Max Safley, in his article on a bankruptcy in early modern Germany in 1529, writes within a narrower scope, offering a fascinating account of how business failure, fraud, and its consequences were not fixed values but socially constructed terms that were constantly negotiated among the members of German society. Safley draws from Emile Durkheim to clarify that what constitutes bankruptcy and fraud (not to speak of scandal) is a discursive activity and to point out that deviant behavior is a "natural social activity that serves to communicate social identity, focus social opinion and reinforce social values." Thus, the distinction between acceptable and unacceptable business behavior is not a constant, but is shifting and subject to negotiation by a society's actors.[20]

Eric Hilt's in-depth analysis of the failure of Life and Fire Insurance of New York in 1826 makes Safley's point nicely. Hilt shows how defrauded investors and the courts struggled to make sense of what amounted to a gigantic Ponzi scheme carried out by the insiders of a company operating in a fragile institutional framework of regulation and corporate governance. The failure of Life and Fire Insurance of New York was clearly linked to a financial crisis, and is an example of entrepreneurs constantly pushing the limits on doing business until they veered into illegal, even criminal, behavior.

In their article on Alexander Hamilton's financial innovations in the early years of the republic, Richard Sylla, Robert E. Wright, and David J. Cowen discuss the relatively neglected financial crisis of 1792, showing the importance of leadership in crises. When no one is in

[20] Regarding this point, it is worth noting that organizational failure is a multidimensional concept. Failure is a social construction, and its meaning depends on one's perspective. See Helmut K. Anheier and Lynne Moulton, "Studying Organizational Failures," in Helmuth K. Anheier, ed., *When Things Go Wrong: Organizational Failures and Breakdowns* (London, 1999), 273–90.

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charge, the problem of the prisoner's dilemma emerges, making everyone worse off than they were before. The 1792 crisis would have brought Hamilton's "financial revolution" to a halt, had he not orchestrated the support of government funds for the infant financial system. Thus, by 1792, it had become clear that, in troubled times, markets cannot always rely on themselves.

Edward J. Balleisen approaches the same subject from a different angle. He documents in great detail the antifraud campaign that was carried out from the mid-1890s to the early 1930s by the National Association of Credit Men and the Better Business Bureaus. He shows how the two organizations tried to reduce small-scale fraud performed by marginal businesses, and he describes how they cooperated with the authorities to bring fraudsters to justice. Although these organizations served the public interest in many ways, their cooperation with big business meant that they overlooked corporate wrongdoing. The Roosevelt administration began to regulate the large companies during the 1930s, in effect substituting public regulation for private oversight when the latter system failed to do the job.

These papers combine studies of single firms with micro- and macro-level analyses of financial crises and institutional frameworks. Most business historians have shied away from the study of crisis, failure, and scandal, choosing to focus on business successes. Recognition of historians' tendency to avoid these subjects led Patrick Fridenson, in a presidential address to the Business History Conference, to call for more historical research on such matters.[21] This issue of the *Review* represents a response to his call. We hope that the papers will suggest directions for future research, a need made more urgent by the dire economic and financial circumstances in which we find ourselves today. Many important questions confront business organizations and lawmakers. How they interact to address these questions will set the future direction for the functioning of the markets. Thus, it is critical that we learn how businesses, private organizations, individuals, and governments interacted in the past, as their actions have shaped the institutional framework we have today.

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[21] See the presidential address by Patrick Fridenson to the 2004 annual meeting of the Business History Conference: Patrick Fridenson, "Business Failure and the Agenda of Business History," *Enterprise & Society* 5, no. 4 (2004): 562–82.

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