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american cronyism: how executive networks inflated the corporate bubble

"Shareholder value" was the sacred mantra of American business in the 1990s. But creating shareholder value can be a fickle undertaking and corporate executives often followed the lead of their colleagues. The result was a contagion of questionable business practices that resulted in the creation of a corporate bubble—and its implosion.

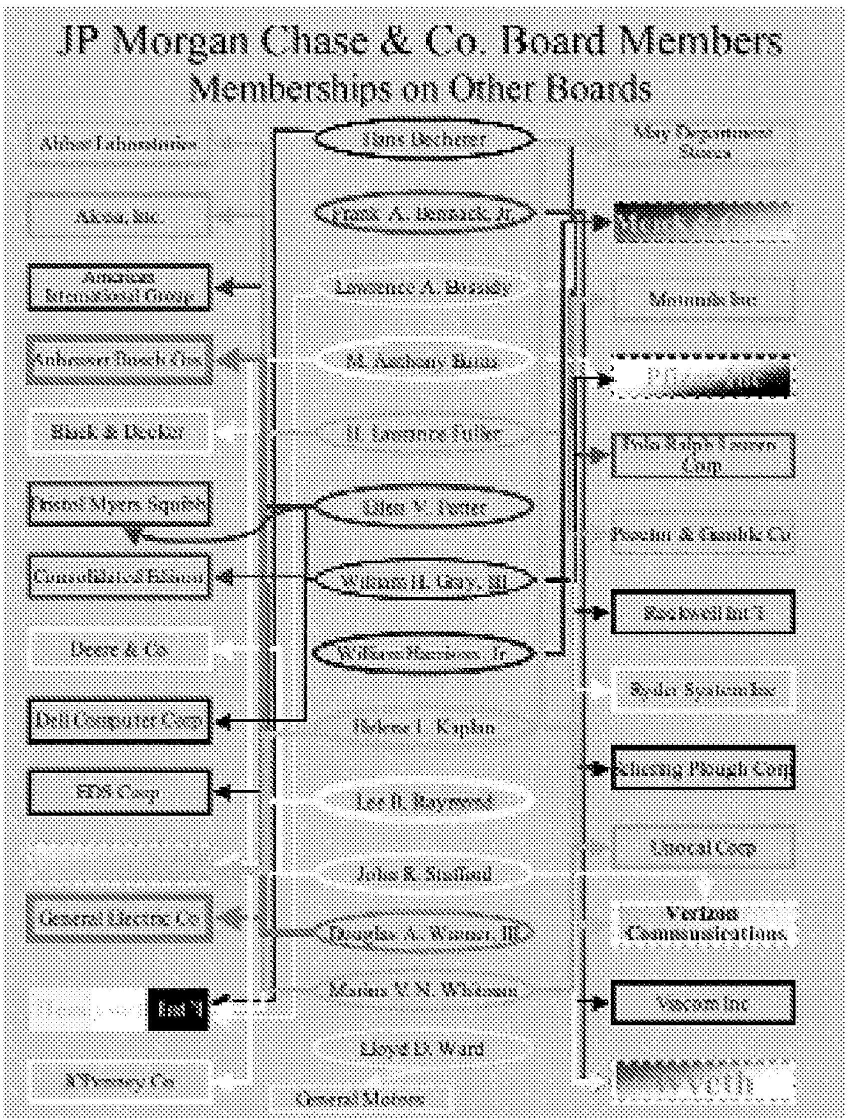

Image by Gerald F. Davis

Corporate affiliations of J.P. Morgan Chase & Co.'s Board of Directors, 1999. More than 80 percent of America's 1,000 largest corporations share at least one director with another large company.

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The business meltdown of the past three years has undermined faith in the way American corporations are run. For much of the 1990s, scholars and politicians promoted that system as the exemplar of how to organize an economy for growth and adaptability. According to this model, market institutions such as banks and investment firms channel funds to well-run companies and thereby quickly correct business errors. Less efficient economies, such as Japan's, suffered from "crony capitalism," which allowed businessmen's social connections to trump hard-nosed financial decisions.

American corporations are peculiar because ownership is typically dispersed—neither the company's managers nor anyone else owns dominant stakes. Nonetheless, according to this theory, corporate managers act in the corporation's best interest as long as they base decisions on the gauge of share price.

Now, we have witnessed several of the largest bankruptcies in American corporate history, the disappearance of one of the "Big Five" accounting firms, and a death spiral among numerous telecommunications businesses. While the White House has asserted that Enron and WorldCom officers were just isolated "bad apples," research suggests that the American corporate economy has evolved its own form of crony capitalism. Business leaders are connected by an expansive network that makes their companies receptive to ideas and practices promoted by analysts, consultants and influential companies. Corporate managers may be motivated by stock prices set on impersonal financial markets, but they pursue high prices in ways that are anything but impersonal. From who serves on boards of directors, to which bank underwrites new securities issues and how financial analysts rate them—personal connections were central to inflating the financial bubble and to its subsequent burst.

the american theory of corporate governance

American corporations stand out from businesses in most other large economies in their focus on creating value for shareholders, as defined by increasing share prices on the stock market. The faith in shareholder value follows from the well-established efficient markets hypothesis (EMH) in finance. The EMH states that financial markets are informationally efficient—the price of a company's shares provides the best estimate of that company's future profitability, given all publicly-available information. When new information about a company's future prospects becomes public, buyers and sellers respond and the share price adjusts quickly. The accuracy of the share price as an indicator of the company's future earnings is based on the fact that those who are better-informed than others stand to make money. If investors are certain that the market price is too low relative to the company's expected future profitability, they buy shares until the price matches the "true" value. Conversely, if convinced that a company's shares are overpriced, investors will sell. Many buyers and sellers making these calculations means that a company's share price at any given time is the "right" price—and thus an apt proxy for gauging how effectively a company is being managed.

Scholars in what is called the "law and economics" tradition developed from EMH a theory of how corporations are governed, relying heavily on the American experience. American corporations are peculiar because ownership is typically dispersed—neither the company's managers nor anyone else owns dominant stakes. Nonetheless, according to this theory, corporate managers act in the corporation's best interest as long as they base decisions on the gauge of share price.

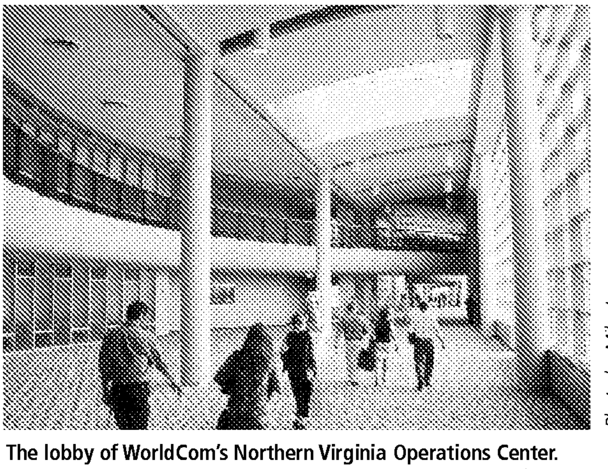


Photo by Mike Lee

The lobby of WorldCom's Northern Virginia Operations Center. When WorldCom declared bankruptcy July 21, 2002, with $107 billion in assets, it became the largest bankruptcy in U.S. history.

Indeed, the United States has evolved a set of legal and market-based devices that force company management to pursue shareholder value: a market for managers that pays corporate executives according to how much value they create, a market for corporate directors that rewards members of the board for establishing a reputation for integrity, and a market for cor-

Photo by Brett Coomer, United Methodist New Service

Enron headquarters in Houston, Texas, May, 2002. The collapses of Enron and WorldCom highlight the abuses associated with America's version of "crony capitalism."

porate control that allows outsiders who see a company that is underperforming to take over and oust its managers. Uniting all these markets is the share price prevailing on the stock market which provides an unbiased assessment of the corporation's value.

According to the theory of shareholder value, these markets are supported by other institutions which ensure that companies play by the rules. Accountants audit a company's financial statements for accuracy and are rewarded for their attentiveness, because the market value of an accounting firm's seal of approval depends on its reputation, which follows from the quality of its audits. Financial analysts working in brokerage firms are like private detectives, rigorously analyzing a corporation's record and future prospects to produce forecasts for clients who reward the analysts when they are accurate. And investment banks that finance stock offerings likewise must maintain their reputation for quality work if they want to receive repeat business. All these devices combine both to guide corporate executives toward shareholder value and to enhance public confidence in the corporate sector. So much for the theory.

the social meaning of shareholder value

As important as share prices are to managers, they provide a curious measure of value. They are based on expectations about the future constructed from present-day information. John Maynard Keynes famously compared playing the stock market to newspaper beauty contests in which the winner is the contestant who accurately picks the beauty chosen by the most other contestants. Thus, market value depends on what others think market value should be. We see this in other markets too, for example when home buyers avoid unusually-designed houses not because they dislike them per se, but because they fear that other buyers may dislike them.

Managing for shareholder value means monitoring how players in the market interpret news about the company. This does not mean that managers can focus on image to the exclusion of substance, or that deception goes unpunished. Investors have incentives to uncover falsehoods and can make money by betting against firms that lie. But many managers make decisions calculated to boost perceptions of their firm's value without considering its effects on the company's actual bottom line. For example, when a company buys back some of its own stock, it reduces the supply of shares and it also signals to investors that management believes its shares are under-priced. This move typically leads to increases in share price. Savvy corporate managers in the 1990s found that it was possible to increase value merely by announcing a buyback program without subsequently following through. Similarly, executive compensation plans explicitly touting their allegiance to shareholder value boost share prices more than the same plans described in more generic terms. And so-called pro forma earnings announcements, which gave more glowing impressions than accountant-certified earnings figures, became rampant in the late 1990s.

> There are many ways firms can and do manipulate analysts. To the extent that these efforts are successful—and to the extent that investors rely on analysts' advice—financial markets are vulnerable to the kind of booms and busts witnessed recently.

Efforts to mold perceptions did not just influence how managers presented corporate decisions, but also what actions they took in the first place. For example, firms that operated in more than one industry found that they were punished by the market—their shares lost value—for being "conglomerates," the corporate equivalent of unusually-designed houses, even if they were profitable in every industry. So, Ford spun off its highly profitable Associates First Capital unit with this announcement from its CEO: "We believe the market value of the Associates is neither fully nor consistently reflected in Ford's stock price. Because the market views Ford as an automotive company, it has not fully recognized or rewarded us for our diversification into non-automotive financial services businesses." It was not profitability that was at issue, but the market's evaluation of that profitability.

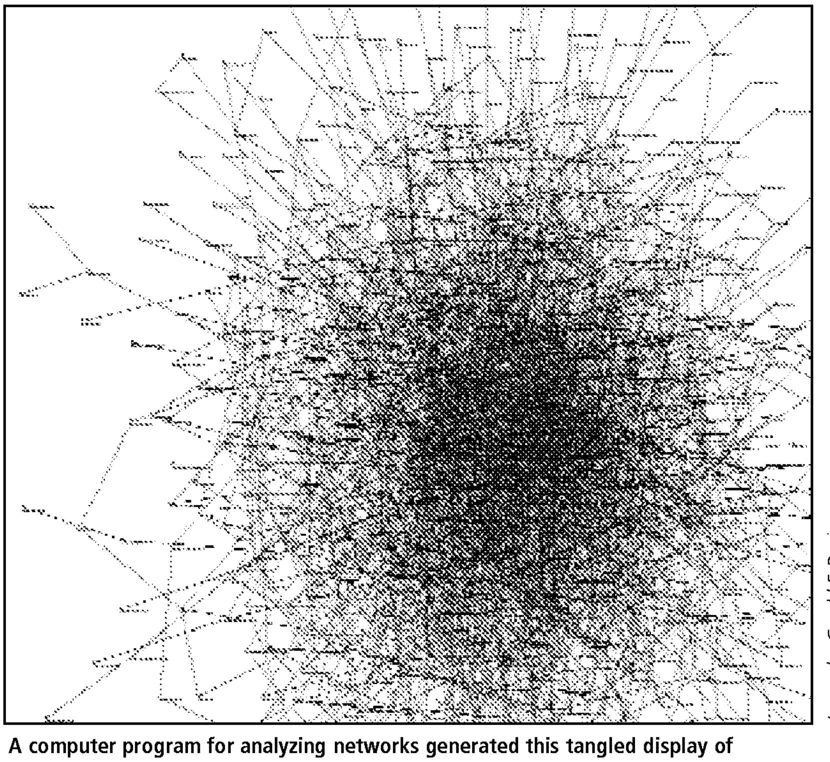


Image by Gerald F. Davis

A computer program for analyzing networks generated this tangled display of connections between board members of Fortune 1000 corporations.

One of the implications of EMH is uncertainty—future share price changes are a "random walk" that cannot be predicted based on prior price changes or on the company's fundamentals. In an situation such as this, social factors shape business judgments. Thus, studies find that financial analysts, whose job is to uncover information about corporations and render forecasts to their clients, often do little more than mimic the judgments of their peers. In deciding which companies are worth following, analysts commonly choose companies that other analysts have recently added. Analysts who follow the herd are also systematically over-optimistic about the prospects of the companies they follow. Corporate managers often play on this process, for instance, by requiring investment banks they do business with to have their analysts cover the firm.

Analysts also judge corporations by the company they keep. Thus, managers can boost the esteem in which their firm is held by who they choose as partners, underwriters, and who they sign contracts with. Directors are appointed to boards based in part on the contacts they bring with them. Analysts' admiration for companies goes up when well-connected directors are appointed. Biotech firm ImClone gained credibility with analysts and investors from the fact that Dr. John Mendelsohn—noted cancer researcher and president of Houston's M.D. Anderson Cancer Center—served on its board. But this big name did little to help the firm create profitable products. ImClone's CEO later pleaded guilty to insider trading charges after dumping his shares in the company as the FDA was about to announce that ImClone's only significant product, an anti-cancer drug, would not be approved.

There are many ways firms can and do manipulate analysts. To the extent that these efforts are successful—and to the extent that investors rely on analysts' advice—financial markets are vulnerable to the kind of booms and busts witnessed recently.

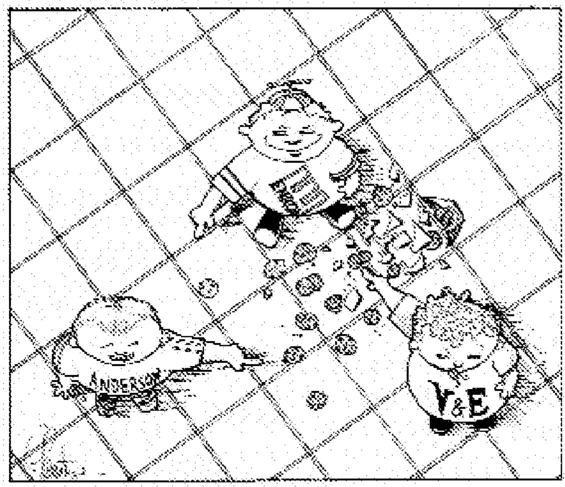
the pervasive role of social connections

A traditional tenet of shareholder value is that business is transacted through arms-length relationships that prevent personal ties from compromising the operations of the various markets that comprise the system. This presumption stands in stark contrast to the economic systems of most other industrialized nations. Outside the United States, social ties among members of the corporate elite are acknowledged to be widespread and influential. In France, the business elite is predominantly composed of graduates of two exclusive institutions, the Ecole National d'Administration (ENA) and the Ecole Polytechnique. Thus, a network of old school ties pervades the management of large French companies. Japanese *keiretsu* networks, dense social and ownership ties among member companies, the business sector, and government agencies, were by some accounts essential to that nation's robust postwar economic growth. South Korea created a similarly "networked" economic system as a path to rapid industrialization beginning in the 1960s. Chinese economic reformers—building on the successful models of Japan and Korea—encouraged the formation of business groups among companies as part of its program of industrial transformation beginning in the 1980s, and these networks have persisted and spread.

"Man's economy, as a rule, is submerged in his social relationships." Markets detached from social ties are highly artificial and rare, typically requiring exhaustive governmental efforts to sustain. The theory of American shareholder capitalism may describe a world of arms' length, financially-driven decision making, but the reality on the ground is quite different.

Elsewhere in the world, authorities view network ties among business elites as useful for promoting economic development, and thus to be tolerated or even encouraged. In shareholder capitalism, however, such "cronyism" is seen as a pathology that impedes the proper operation of markets. Social connections can interfere with pragmatic business decisions, which require objectivity and lack of bias. But as economic historian Karl Polanyi argues in *The Great Transformation*, "Man's economy, as a rule, is submerged in his social relationships." Markets detached from social ties are highly artificial and rare, typically requiring exhaustive governmental efforts to sustain. The theory of American shareholder capitalism may describe a world of arms' length, financially-driven decision making, but the reality on the ground is quite different.

Consider corporate boards of directors, where the highest-level business decisions are made. While the United States has no institution with the same gate-keeping power as the ENA in France, researchers have found extensive personal networks



Cartoon by Chris Panatier

among the American corporate elite. In particular, there is enormous overlap among corporate boards of directors. Shared directors—individuals serving on two or more boards—have been pervasive on American boards since the early part of the 20th century, when future Supreme Court Justice Louis Brandeis warned about the undue influence of J. P. Morgan and other New York bankers whose partners served on dozens of corporate boards. More than 80 percent of the 1000 largest U.S. corporations in 2001 shared at least one director with another large company, and on average any two of the corporations were connected by less than four degrees of separation.

Conseco—considered one of the worst-governed companies—was linked to Colgate Palmolive—one of the best—through this path: Conseco director David Harkins served on the Fisher Scientific board with Michael Dingman, who served on the Ford board with Robert Rubin, who served on the Citigroup board with Reuben Mark, CEO of Colgate Palmolive. A flu virus that infected the Enron board in January 2001 could have made its way to 650 of the Fortune 1000 companies by May through monthly board meetings.

The significance of the small "diameter" of this network was foreseen by C. Wright Mills almost 50 years ago in *The Power Elite*, where he argued that those in powerful positions often seem to know each other or to have acquaintances in common through shared affiliations, which in turn facilitates similar responses to shared problems. As a result, decisions on issues of corporate governance—and by extension shareholder value—were similar among companies due to their closely-connected boards of directors. Dozens of studies in recent years document that shared directors spread practices, information, and principles, which accounts for some of the surprising conformity among corporate managers in their approaches to corporate governance.

Photo courtesy of the Energy and Commerce Committee, U.S. House of Representatives

Congressional hearings by the Energy and Commerce Committee into the Enron collapse.

The adoption of takeover defenses, the creation of investor relations offices, and the development of compensation practices all spread from board to board through shared directors. For example, the controversial "poison pill" defense (fending off a hostile takeover of the company by increasing its cost—for example, by issuing new shares that would have to be redeemed by the new buyer) spread rapidly among large corporations in the mid-1980s when directors of companies that had adopted poison pill approaches touted them to the other boards on which they served. Similarly, companies created investor relations offices after learning about their benefits from directors serving on the boards of other companies that already had them. These networks also proved useful in influencing politicians. The legislatures of states where corporate leaders were closely connected to one another were more likely to adopt anti-takeover legislation protecting local companies than were lawmaking bodies in states with less intertwined corporate entities.

Moreover, to the extent that there is a "culture of the boardroom," it protects its own. Mills wrote of the power elite: "The question is not: are these honorable men? The question is: what are their codes of honor? The answer to that question is that they are the codes of their circles, of those to whose opinions they defer." When Dr. Mendelsohn of the M.D. Anderson Cancer Center came under fire for serving on the boards of two companies implicated in investor fraud—Enron and ImClone—his director colleagues came to his defense. Charles Miller, Chairman of the University of Texas Systems Board of Regents, which oversees the Center, had himself served on a dozen corporate and non-profit boards. As he put it: "We could all see, 'There but for the grace of God go I.'" The president of Rice University echoed: "All of us at one time or another have been up to our elbows in alligators."

connections outside the executive circle

If analysts and investors are like judges in Keynes's newspaper beauty contest, then corporate managers and boards are in a position analogous to the beauties themselves, adopting the fashions that their judges believe other judges will find appealing. In anticipating market reactions to their actions, some boards had help from the judges themselves. Jack Grubman, the former star telecommunications analyst at Salomon Smith Barney, attended board meetings to advise the directors of a half-dozen firms that he was responsible for analyzing, including WorldCom (subsequently the largest bankruptcy in U.S. history), Global Crossing (also bankrupt) and McLeodUSA (ditto). The intimate relationship between Grubman and the telecom sector he evaluated worked both ways. Salomon Smith Barney set aside shares of firms about to make an initial public offering (IPO) for the personal accounts of telecom executives such as Bernie Ebbers, acquisitive CEO of WorldCom. IPO shares typically shoot up in value on the first day of trading and generally provide an immediate payoff—what one investment banker called "free money." Ebbers, for instance, made $11 million from his IPO shares.

Ebbers' firm in turn sent tens of millions of dollars in fees to Salomon for investment banking services (although Salomon insisted there was no *quid pro quo*). Moreover, the value of a firm's IPO depends in part on its affiliations. During the late 1990s, announcing that a newly-public firm had a contract or alliance with WorldCom, for instance, generally enhanced its expected profitability and thus the value of its IPO shares. The incentives created through this web of connections among directors, executives, analysts, and investment bankers favored a Potemkin Village approach of building a false facade of value over the hard work of building real value.

Far from being a system characterized by impersonal, calculating relationships, the American corporate system is thick with social connections among the most important decision makers. Corporate directors and the executives they oversee, financial analysts, investment bankers, and state legislators responsible for creating corporate law, are tied together in a dense network that contrasts sharply with the theory of an anonymous market policed by independent analysts, auditors and legislators. This system is highly susceptible to "contagion" among managers. In the 1990s, the triumph of the ideology of shareholder value prompted the spread of practices thought to create shareholder value—or at least, of ones thought to generate higher share prices. In combination, these helped inflate the financial bubble that eventually, and inevitably, burst.

bottom line

In *The Great Transformation*, Karl Polanyi argued that Adam Smith's theory of how markets create wealth was really a theory of one particular nation—England—and that Smith did not even get that completely right. Self-regulating markets as Smith understood them were quite rare by historical standards and relatively recent even in England. Moreover, efforts to organize society around markets removed from their social contexts were bound to end badly, according to Polanyi—as they did in mid-Victorian England. During the 1970s and 1980s, scholars in the United States evolved a theory of economic institutions guided by the wisdom of impersonal financial markets and their ability to yield prices that provide an unbiased prediction of future value. Markets for managers, directors, financial analysts, accountants, and laws all combined to create a guidance system oriented toward shareholder value—at least in the American experience. Moreover, this system could be distilled and exported to other nations as a blueprint for economic vitality. In the words of Clinton's second Treasury Secretary, Larry Summers: "Financial markets don't just oil the wheels of economic growth—they *are* the wheels." Nations with the "right" set of economic institutions organized around financial markets could attract foreign investment to fuel local economic growth.

But the American theory proved difficult to duplicate internationally and misleading for the United States system itself. As in other nation's economies, the American corporate structure is influenced by crony capitalism. Social networks among key decision makers are rampant and influential, and although the operations of a financial market-oriented system are different in important ways from, say, South Korea, social ties are part of the warp and woof of economic activity even in "shareholder capitalism."

recommended resources

Davis, Gerald F., and Michael Useem. "Top Management, Company Directors, and Corporate Control." In *Handbook of Strategy and Management* edited by Andrew Pettigrew, Howard Thomas, and Richard Whittington. London: Sage, 2002. A critical introduction to the American theory of corporate governance and a review of research on the U.S. and other industrialized economies.

Davis, Gerald F., Mina Yoo, and Wayne E. Baker. "The Small World of the American Corporate Elite, 1982-2001." *Strategic Organization*, 2003. A description of the surprising stability and influence of the networks among U.S. boards of directors over the past 20 years.

Easterbrook, Frank H., and Daniel R. Fischel. *The Economic Structure of Corporate Law*. Cambridge, MA: Harvard University Press, 1991. An introduction to the law and economics of American corporate governance by influential legal theorists.

Rao, Hayagreeva, Henrich R. Greve, and Gerald F. Davis. "Fool's Gold: Social Proof in the Initiation and Abandonment of Coverage by Wall Street Analysts." *Administrative Science Quarterly* 46 (2001): 502-526. An examination of the social contagion processes among financial analysts that can promote financial bubbles.

Useem, Michael. *Investor Capitalism: How Money Managers are Changing the Face of Corporate America*. New York: Basic Books, 1996. Useem analyzes the rise of "shareholder capitalism" in the U.S. during the 1980s and 1990s and examines the increasing influence of institutional investors on how corporations were managed during the past decade.