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ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM. By *David Skeel*. Oxford and New York: Oxford University Press. 2005. Pp. vii, 250. $25.

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INTRODUCTION

Everyone loves a good scandal. Scandals sell papers.[1] They focus public attention and galvanize public opinion.[2] They also divert and entertain.[3]

The recent corporate scandals are no exception.[4] Coming, as they did, in the midst of an economic downturn, they focused public attention on

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1. *See generally* JAMES T. HAMILTON, ALL THE NEWS THAT'S FIT TO SELL (2004).

2. *See, e.g.*, Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1 (stating that corporate scandals "helped galvanize support" for the passage of the Sarbanes-Oxley Act); Michael Dresser & David Nitkin, *The Political Game*, BALT. SUN, Apr. 20, 2004, at 2B (quoting a lobbyist's statement that "it takes a scandal to really focus the public's attention").

The public is mobilized, in part, by the simple fact of media repetition. Constant repetition is said to give rise to the "availability heuristic" and "cascade effects." *See generally* Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999); Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059 (2000).

3. *See* Richard A. Posner, *Bad News*, N.Y. TIMES, July 31, 2005, § 7 (Book Review), at 1 ("[Consumers of news] find scandals, violence, crime, the foibles of celebrities and the antics of the powerful all mightily entertaining.").

4. A partial list of recent corporate scandals might include Enron, WorldCom, Tyco, Adelphia, Martha Stewart's alleged insider trading, and the conflicts of interest among Wall Street bankers and analysts. *See generally* Amy Borrus et al., *Corporate Probes: A Scorecard*, BUS. WK., June 10, 2002, at 42 (providing information on several scandals, divided by industry); Robert Frank et al., *Executives on Trial: Scandal Scorecard*, WALL ST. J., Oct. 3, 2003, at B1 (providing information on several executives under investigation).

corporate governance and galvanized public opinion in favor of reform.[5] They also did not fail to entertain.[6]

But perhaps most importantly, scandals are rhetorically useful. They provide politicians with ammunition to attack their opponents and assure commentators of a wealth of material over which to disagree. Here again, the recent corporate scandals did not disappoint. Democrats and Republicans in Congress sought to blame the mess on each other,[7] the President pledged to get tough,[8] and the New York State Attorney General built a gubernatorial campaign out of combating corporate evil-doers.[9] Articles on corporate reform appeared regularly in newspapers and law reviews,[10] and prominent legal academics testified in Washington.[11]

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5. *See generally* Ronald Alsop, *Reputations of Big Companies Tumble in Consumer Survey*, WALL. ST. J., Feb. 19, 2004, at B1 (reporting on results of a Harris Interactive/Reputation Institute poll that found seventy-five percent of respondents felt that the image of large corporations was either "not good" or "terrible"); Julie Rawe, *Heroes to Heels: Several Wall Street Champs of the '90s Have Fallen from Their Pedestals*, TIME, June 17, 2002, at 48 (outlining improprieties at Tyco, Enron, Global Crossing, and Adelphia and describing the way these activities contributed to an environment of scandal and distrust). On the coincidence of scandal with economic downturns in provoking reform, see Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849 (1997) (showing that for over 300 years, major changes in securities regulation have tended to follow market collapses).

6. Consider the birthday party, funded through the corporate treasury and captured on video, that former Tyco CEO Dennis Kozlowski threw for his wife on the island of Sardinia—a party featuring tacky costumes, R-rated ice sculptures, and a private performance by Jimmy Buffet. *See* Helen Peterson & Nancy Dillon, *Hot Party Tape May Spice Up Tyco Trial*, DAILY NEWS (N.Y.), Oct. 28, 2003, at 54 (describing party).

7. *See* Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 417–18 (2003) (describing "confirmation bias" that enabled conservatives to see a "triumph of capitalism" in the scandals while liberals see "stark limitations of capitalism").

8. *See* President George W. Bush, Remarks by the President on Corporate Responsibility at the Regent Wall Street Hotel (July 9, 2002), *available at* 2002 WL 1461845 (detailing President Bush's "10-point Accountability Plan for American Business").

9. *See, e.g.*, Kulbir Walha & Edward E. Filusch, *Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitious Spotlight Hound? A Case Study of Eliot Spitzer and Marsh & McLennan*, 18 GEO. J. LEGAL ETHICS 1111 (2005) (detailing Spitzer's investigation of the insurance industry and other high profile corporate crusades); *see also* Eliot Spitzer 2006, Making a Difference for You, http://www.spitzer2006.com (last visited Sept. 9, 2005) (gubernatorial campaign site).

10. *See, e.g.*, John Thain, Editorial, *Sarbanes-Oxley: Is the Price Too High*, WALL ST. J., May 27, 2004, at A20; Paul Volcker & Arthur Levitt, Jr., Editorial, *In Defense of Sarbanes-Oxley*, WALL ST. J., June 14, 2004, at A16. Meanwhile law reviews throughout the country hosted symposia on corporate governance. *See, e.g.*, Symposium, *Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron*, 35 CONN. L. REV. 915 (2003); Symposium, *Enron: Lessons and Implications*, 8 STAN. J.L. BUS. & FIN. 1 (2002); Symposium, *Lessons from Enron, How Did Corporate and Securities Law Fail?*, 48 VILL. L. REV. 989 (2003).

11. *See, e.g.*, *Accounting Reform and Investor Protection: Hearings on the Legislative History of the Sarbanes-Oxley Act of 2002: Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 948 (2003) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University School of Law); *The Fall of Enron: How Could It Have Happened?: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 376 (2002) (statement of Frank Partnoy, Professor of Law, University of San Diego School of Law); *id.* (statement of John H. Langbein, Sterling Professor of Law and Legal History, Yale Law School). This testimony is collected in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy B.

Now, several years later, it remains unclear what we ought to make of all of this. Is there a lasting lesson buried amid the noise, or did we simply give in to cognitive biases causing us to rely excessively on narrative as opposed to statistical data and to weight bad news over good?[12] What, if anything, can we learn from the corporate scandals that we did not know before? And how should they shape the thinking of corporate leaders and policymakers going forward? These are the questions that Professor David Skeel of the University of Pennsylvania Law School addresses in *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From* (hereinafter *Icarus in the Boardroom*).

Icarus in the Boardroom is a historical analysis of corporate calamity that takes us to the beginning of the industrial era to study the periodic episodes of scandal that have roiled American business and stirred the federal government to action.[13] It is an extremely colorful account, peppered with an array of cultural references and fascinating anecdotes.[14] Indeed, because it is a trade book, aimed at an audience beyond the narrow confines of academia, *Icarus in the Boardroom* gives Skeel considerable room to display his wit and talent for creating lively prose, yet it is an unmistakably serious work of legal scholarship. Starting with the emergence of the corporate form and moving through the rise of the large corporation, Skeel provides a nuanced, historical account of the problems of corporate governance and offers an innovative set of proposals to address them.

Rapoport & Bala G. Dharan eds., 2004). Academics' ultimate conclusions on the causes of the corporate scandals tended to derive from and confirm their preexisting research agendas. *See* Gregory Mitchell, *Case Studies, Counterfactuals, and Causal Explanations*, 152 U. PA. L. REV. 1517, 1563 (2004) ("[T]he legal scholar acting as thought experimenter is left to her own psychological devices in imagining supportive evidence and causal connections as needed to confirm her 'pet theory.' "); *accord* Prentice, *supra* note 7, at 419 (acknowledging his own use of the scandals to "support . . . my attempts in recent years to apply behavioral decision theory to legal issues") (footnote omitted).

12. *See* Roy F. Baumeister et al., *Bad Is Stronger Than Good*, 5 REV. GEN. PSYCHOL. 323, 323–24 (2001) ("In general, and apart from a few carefully crafted exceptions, negative information receives more processing and contributes more strongly to the final impression than does positive information."); G. Daniel Lassiter et al., *Illusory Causation: Why It Occurs*, 13 PSYCHOL. SCI. 299, 299 (2002) ("Illusory causation occurs when people ascribe unwarranted causality to a stimulus simply because it is more noticeable or salient than other available stimuli."); Sunstein, *supra* note 2 at 1065–67 (discussing the availability heuristic and cascade effects).

13. Skeel has used legal history in his previous scholarship. *See, e.g.*, DAVID A. SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001). For other scholarship analyzing the corporate scandals in historical context, see generally Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1423–30 (2002) (providing historical survey of accounting scandals); Gregory A. Mark, *The Legal History of Corporate Scandal: Some Observations on the Ancestry and Significance of the Enron Era*, 35 CONN. L. REV. 1073 (2003) (surveying American attitudes to business in times of scandal and success); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 78 (2003) (articulating a historical account of the "the boom-bubble-bust-regulate cycle").

14. Who knew, for example, that Ken Lay's father was a chicken-farmer-cum-Baptist-minister, pp. 144–45, or that Bernie Ebbers had been a college basketball star until his Achilles tendon was severed by a "local tough" wielding a broken bottle, p. 148. We are also playfully informed that Samuel Insull's prodigious energies were rumored to have resulted, at least in part, from a beautiful spouse who "didn't like sex" and refused to sleep with him. P. 83.

This Review describes Skeel's account of corporate scandal and evaluates his policy recommendations. It argues that although *Icarus in the Boardroom* provides a compelling history of corporate scandal, the book's focus on federal responses to scandal—from the enactment of the Interstate Commerce Act to the Sarbanes-Oxley Act—misses an important part of the story. As corporate law scholars have long pointed out, corporations exist within a network of constraints, based in part on law and in part on markets, norms, and other non-legal sanctions.[15] Because it omits any sustained discussion of the reaction of these other sources of constraint, focusing instead on the federal reaction, *Icarus in the Boardroom* is largely incomplete as a history of scandal and reaction. A comprehensive account requires a more thorough treatment of other corporate constraints, beginning—this Review argues—with state corporate law. State courts have long engaged the problem of productive versus destructive risk that motivates Skeel's analysis. Moreover, this Review argues, the flexibility and interpretive suppleness of state corporate law jurisprudence may be better suited to respond to the problems Skeel identifies than a central, typically federal, regulator.

Part I of this Review describes Skeel's account of corporate scandal, focusing on the central theme of excessive risk-taking. Part II examines Skeel's most original policy proposal—the creation of an investor insurance scheme to protect against excessive risk. Although the proposal takes up only a few pages of the book, it targets the books' core concern—the risk of corporate fraud. In evaluating the proposed investor insurance regime, this Review raises a set of objections based on cost and administrability and argues that an insurance regime would be duplicative of existing mechanisms that effectively spread the risk of financial fraud. Part III then discusses the broader environment of constraint and emphasizes the responsiveness of state courts to corporate crises. It argues that state judges have every incentive to respond to periods of scandal and that state law jurisprudence has evolved a set of highly flexible mechanisms for increasing or decreasing the legal oversight of corporate governance. *Icarus in the Boardroom*, in other words, emphasizes Icarus, but the perspective is Daedalean. This Review, by contrast, emphasizes the ability of existing institutions to respond to the problems Skeel identifies, resisting the impulse to tinker with the system and federalize ever-greater amounts of corporate governance.

I. A History of Business Scandal

The phrase "corporate scandal" has been applied to a variety of frauds and failures, most recently including accounting fraud at Enron and World-

15. *See, e.g.*, Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1642 (2001) (developing a theory of the firm based upon "nonlegally enforceable rules and standards"); Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 379 (1990) (pointing to the "nexus of constraints" in the intra-corporate relationship).

Com,[16] looting at Tyco and Adelphia,[17] and corruption among Wall Street investment banks.[18] Going back a bit, a list of major business scandals might also include the savings and loan crisis (pp. 132–34), the Erie Railroad scandal (pp. 33–36), and the tulip and South Sea bubbles (pp. 15–16). Although acknowledging the possible breadth of its central theme, the narrative of *Icarus in the Boardroom* focuses on four central characters: Jay Cooke, Samuel Insull, Ken Lay, and Bernie Ebbers.[19] What these men have in common is their form of failure. The rise and fall of each traces the pattern of what Skeel describes as "Icarus Effect" failures (p. 7).

An Icarus Effect failure is one in which three core causal factors contribute to a financial collapse. The three factors identified by Skeel are (A) "excessive or fraudulent" risk-taking; (B) competition, both between and within firms, and (C) the "increasing size and complexity" of business organizations (pp. 5–6). The relative importance of each of the three factors is given away by the decision to name the tendency and the book itself after Icarus, the figure from Greek mythology who flew too close to the sun on waxen wings. When the heat of the sun melted the wax, Icarus was sent plunging to his death because, as Skeel interprets the tale, he "thought less and less about risk, and more and more about the majesty of his powers" (pp. 4–5). Icarus Effect failures, in other words, are a result of risk-taking run amok. The fundamental flaw in corporate America, Skeel argues, is the encouragement and facilitation of excessive risk.

Ken Lay at Enron and Bernie Ebbers at WorldCom are modern exemplars of the Icarus Effect. Each emerged as a consummate risk-taker by surviving round after round of "probationary crucibles."[20] Here Skeel draws upon current scholarship in the field of industrial organization describing executive promotion as an ongoing tournament that rewards short-term success and discourages loyalty (pp. 170–72). The result of this structure, as

16. *See generally* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (analyzing the immediate and root causes of the accounting fraud at Enron and the company's resulting collapse); Simon Romero with Riva D. Atlas, *Worldcom's Collapse: The Overview*, N.Y. TIMES, July 23, 2002, at C1 (describing the fraud and collapse at Worldcom).

17. *See generally* Peter Grant & Christine Nuzum, *Adelphia Founder and One Son Are Found Guilty*, WALL ST. J., July 9, 2004, at A1 (reporting developments in criminal trials of Adelphia executives accused of corporate looting); Mark Maremont & Jerry Markon, *Leading the News: Former Tyco Executives Are Charged—New York Prosecutors Say Ex-CEO, Finance Officer Ran "Criminal Enterprise"*, WALL ST. J., Sept. 13, 2002, at A3 (describing allegations that former CEO and CFO stole more than $170 million from the company, engaged in illegal stock sales, and committed accounting fraud to cover up their activities).

18. *See generally* Ann Davis & Susanne Craig, *Analyze This: Research Is Fuzzier Than Ever*, WALL ST. J., Apr. 26, 2004, at C1 (describing and critiquing the outcome of investigations into investment analyst conflicts of interest); Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583 (2004) (analyzing the conflicting interests involved in the allocation of in-demand IPO shares).

19. There is also a chapter discussing the rise and fall of junk bond financier Michael Milken. *See infra* note 72 and accompanying text.

20. P. 171 (quoting ROBERT JACKALL, MORAL MAZES (1988)).

described by Professor Donald Langevoort, is that tournament survival traits "such as over-optimism, an inflated sense of self-efficacy and a deep capacity for ethical self-deception ... are disproportionately represented in executive suites."[21] Enron was a paradigmatic example of the corporate crucible. As described by Langevoort:

> Enron was filled with people who [were] optimistic, aggressive, and focused. The culture quickly identified itself as special and uniquely competent, believing that special skill rather than luck (or just being first) was responsible for the early victories. That self-definition then set a standard for how up-and-coming people acted out their roles: Enron was a place for winners. With this—and the stock market's positive feedback—the company's aspiration level rose.
>
> This aspiration level required a high level of risk-taking by the firm .... [T]he compensation and promotion structure at Enron ... harshly penalized the laggards at the firm, which, on average, tends to lead to herding behavior (risk aversion). To counteract this, the company had to magnify the reward structure considerably for those who ended up as stellar performers—a winner-take-all kind of tournament.[22]

The same survival traits that this Darwinian process selects in corporate managers—over-confidence and a taste for risk—can lead them into a spiral of bad decisions and ever-greater risks once their luck begins to fail.[23] Put this together with the cult of the charismatic CEO and a compensation structure rewarding consistent short-term success and you begin to get at the core of what Kenny and Bernie did. Theirs, Skeel argues, were Icarus Effect failures, caused by the incentives in modern corporations pushing managers to take ever-greater risks.

Ebbers's and Lay's forefathers in fraud were Jay Cooke and Samuel Insull. Skeel credits Cooke, a Philadelphia banker who rose to prominence in the early 1860s, with leading the United States into its first Icarus Effect scandal. Cooke was a bond salesman who pioneered a new distribution

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21. Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 288 (2004). Langevoort elaborates, noting that "the luckier risk-takers will outperform more risk-averse realists on average, and the positive feedback will enhance their sense of self-efficacy." *Id.* at 299. But overconfidence is not enough. Langevoort also identifies the essential trait of "ethical plasticity":

> The person who most likely strikes the right competitive balance in a high-stakes promotion tournament is the one who best conceals from others the inclination to defect when necessary—extremely difficult in a corporate setting where one is being closely observed by subordinates, peers and superiors—yet does so nimbly. People who best deceive others are usually those who have deceived themselves, for they can operate in a cognitively unconflicted way. The Machiavellian with the best survival prospects in the corporate tournament is especially adept at rationalization: convincing himself as well as others that what is self-serving is also right.

Id. at 303 (footnote omitted).

22. Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition:* Corporate Irresponsibility *and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 973–74 (2002).

23. *Id.* at 974 (summarizing this cycle by noting that "overconfidence commits them to a high-risk strategy; once committed to it, they are trapped").

technique by marketing issues to the small financial institutions and private investors then ignored by other bond houses, essentially inventing retail investment banking (pp. 29–31). Having perfected his methods in a series of highly successful placements of government bonds, Cooke began to underwrite and distribute railroad bonds. Unfortunately, following some initial success, Cooke "bit[] off more than he could chew" by agreeing to underwrite a massive bond issue for the Northern Pacific railroad (p. 36). He could not sell the issue, and when the railroad eventually failed, he could not repay his investors, unleashing a massive financial crisis known as the 1873 Panic (pp. 36–40). Like the collapse of Enron and WorldCom, this first Icarus Effect failure involved a businessman who, thanks to a string of successes, came to believe in his own infallibility and therefore undertook more and greater risks. When the risks unraveled, Cooke, like Lay and Ebbers after him, brought enough ruin to stir a political reaction and, ultimately, regulatory intervention.[24]

Samuel Insull became a "corporate superstar" approximately fifty years after Cooke's fall from grace. A survivor of several probationary crucibles, Insull first rose to prominence at Thomas Edison's General Electric before launching his own enormously successful utility company in Chicago, an organization that he eventually built, through acquisitions, into a vast industrial empire that "fed his already gargantuan ego" (p. 84). Acquisitions, however, would cause Insull's downfall. Racing to build an empire of cross-holdings to match his rivals and burdening his organization with vast amounts of debt in the process, Insull "was absolutely unable . . . to imagine the possibility of his own failure; he entirely lacked the sense of caution of those who doubt themselves."[25] When his creditors finally took over, they discovered that Insull, like Lay and Ebbers later, had used the corporate structure to obfuscate the actual financial position of the enterprise.[26] As with other scandals, Insull's collapse brought ruin to many but was a boon to politicians who sought to use the collapse and Insull himself to illustrate the dangers of unregulated business (pp. 89–90). Insull's failure fit perfectly into the rhetoric of the New Deal, and this is precisely how President Franklin Roosevelt used it, railing in a famous speech against "the Ishmael or Insull whose hand is against every man's," and treating Insull as one with the "reckless promoter" and the "unethical competitor."[27] The result of this

24. As described by Skeel, the 1873 Panic was used by the populist movements of the day to lobby for railroad rate regulation, leading eventually to the Interstate Commerce Act of 1887, in which Congress took the matter out of state hands and launched extensive federal regulatory oversight of the railroad industry. Pp. 48–49.

25. P. 87. The quotation is taken from the principle biography of Insull. FORREST MCDONALD, INSULL 19 (1962).

26. P. 88. Skeel makes an explicit parallel between the complex holding-company structure used by Insull to defraud his investors and the complex structure of derivatives SPE transactions used by Lay and his CFO Andrew Fastow, noting that the Enron strategy "had an awful lot in common with Samuel Insull's holding-company manipulations . . . ." P. 159.

27. P. 80 (quoting Franklin D. Roosevelt, *New Conditions Impose New Requirements upon Government and Those Who Conduct Government*, *in* THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 742, 755 (Samuel I. Rosenman ed., 1938)).

rhetoric, of course, was a vast increase in governmental regulation of business that nearly resulted in the complete federalization of corporate law.[28]

Skeel's central narrative is the problem of risk. The other Icaran factors—competition and complexity—pale in importance and are perhaps best seen as enabling factors.[29] In fact, Skeel's focus on "excessive or fraudulent risks" comes close to conflating risk-taking and fraud, which as Professor Jonathan Macey pointed out in an early review of the book, would be an obvious error—fraud, after all, involves dishonesty or lying while risk-taking, on its own, does not.[30] This objection, however, is not entirely fair. While it is true that Skeel never sets out a clear line of demarcation between "excessive" and acceptable risk, the stories he tells enable us to do so.

The failures Skeel focuses on—Cooke's, Insull's, Lay's, and Ebbers's—all arise from a unique set of economic and cognitive factors that push executives to take risks and, when the outcome is not what they had hoped, to conceal the results and then place even greater bets in hopes of recouping their prior losses. The Icaran executive is thus a specific type of risk-taker, a product of successive probationary crucibles, overconfident and overcommitted to growth. Although, as Macey has pointed out, risk and fraud are not points on a continuum, what is special about the Icaran executive is her tendency, resulting from a unique incentive structure and psychological make-up, to convert risk-taking into fraud. For this particular species of risk-taker, it makes sense to discuss risk-taking together with fraud since one so easily becomes the other. Moreover, addressing the problem through disclosure obligations alone, because it does not respond to the underlying psychological biases and economic incentives, would not seem to prevent the problem.[31] Skeel's inquiry, therefore, is into the heart of risk-taking. How can investors be protected against Icaran executives?

II. Insurance against Risk-Takers

Having put the problem of magnified risk-taking squarely before us, the final two chapters of *Icarus in the Boardroom* address solutions, first reviewing the spectrum of proposed reforms, then offering an innovative

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28. Comprehensive federalization of corporate law stalled, Skeel notes, because the federal incorporation statute was appended to an unpopular antitrust bill, p. 105, a political mistake that the SEC has regretted (and has been trying to correct) ever since. *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 80 (2005) (describing the longstanding ambition of the SEC to regulate corporate governance and noting that the SEC "from time to time, has exploited scandals in the public securities markets" to achieve the goal of regulating corporate governance).

29. Outsized risk-taking is enabled by a large and complex organization, but a large and complex organization will not produce scandal without a risk-taking executive at its head. The same is true of competition. Insull, for example, had competition from the Morgan conglomerates and was able to mask his financial situation thanks to the complexity of a pyramidal holding structure, but these things would be benign if not for the Icaran lust for more and greater risk.

30. Jonathan R. Macey, *A Risky Proposition*, WALL ST. J., Mar. 15, 2005, at D8.

31. This is Macey's suggestion. *See id.* ("The government's role is to make sure that entrepreneurs make the proper disclosures.").

proposal.[32] The problem of magnified risk-taking can be managed, Skeel suggests, through the establishment of a comprehensive investor insurance scheme. He then offers two complementary models of an investor insurance regime, both inspired by the deposit insurance program created under the New Deal (pp. 213–14). Although each is a form of insurance, to distinguish them, I will call the first "investor insurance" and the second "investor protection." Investor insurance is designed to protect investors from market-wide declines, and investor protection is designed to make whole the victims of any one corporate fraud. Each proposal is extremely interesting and, at the same time, deeply problematic.

Investor insurance would guarantee a minimum payout for an investment portfolio over a specified period of time. Skeel suggests, for example, a 3% payout on funds invested for at least five years (pp. 213–14). Following this example, if an investor has $100,000 under investment and over a five-year period the investor's return is less than $3,000, the government will top off the investor, up to $3,000. If the investor's return is over $3,000, the government pays nothing. Because the stock market "rarely suffer[s] multiple-year declines," the proposal, according to Skeel, would not be "a major cash drain on the Treasury" (p. 214).

The second insurance model, investor protection, would create a compensation fund into which all corporations could contribute. The fund would then be used to make whole any shareholders injured when a participating corporation's share price plummeted as a result of a financial restatement or "improper accounting or corporate fraud of the sort alleged in WorldCom and Enron" (p. 214). The investor compensation fund would be administered by a new federal agency, the Federal Investor Insurance Corporation ("FIIC"), that in addition to lording over the collective money pot, would "provide a lot more oversight" of corporations (p. 214). Both of Skeel's proposals are open to a variety of objections based on administrability and cost.

First, the dollar costs of investor insurance are likely to be higher than Skeel suggests. Following the example above, any time gains fall below three percent, investors could call upon the government to bail them out. This would get expensive, considering that approximately $13 trillion is under investment in U.S. equity markets. A flat five-year period could thus trigger a government obligation of $390 billion. Although such periods are, as Skeel notes, uncommon (pp. 213–14), they do happen and have, in fact,

32. In evaluating existing reforms, Skeel critiques the Sarbanes-Oxley Act as excessively narrow, p. 191, and reviews proposals, among other things, to regulate derivatives, p. 205, monitor executive compensation, pp. 205–06, re-regulate deregulated industries, p. 207, reform tax and accounting rules, p. 208, and require mandatory portfolio diversification for employee pension funds, p. 212. Several of these proposals have been debated in the literature. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (discussing executive compensation as a central corporate governance problem); FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS (2003) (discussing role of opaque derivatives transactions in the fall of Enron); *see also* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing and critiquing BEBCHUK & FRIED, *supra*); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005) (same).

happened several times since 1970. An extended bear market could thus trigger a massive outlay on the part of the ultimate guarantor—that is, U.S. taxpayers. In addition, this outlay raises distributional concerns. Should taxpayers, many of whom may not be wealthy enough to own substantial investment portfolios, be forced to bail out the wealthier investing class?[33] Even assuming that tax dollars tend to come from those wealthy enough to hold investment portfolios, should these dollars really be diverted from other projects targeted at lower income classes in order to benefit the investing class?

In addition to the dollar costs and distributional consequences of investor insurance, there is also the problem of moral hazard.[34] The guarantee that investors will always receive a three-percent return creates an incentive for them to take imprudent risks with their portfolios. Investors may add much riskier securities to their portfolios or increase their exposure to volatile securities through leverage on the basis of the government's promise to top them up to three-percent in case their strategy generates losses. These incentives will tend to lead to an increase in risky portfolios and a sharp rise in prices, especially for volatile securities, thereby increasing the probability of a crash and a government bailout.[35] Indeed, the deposit-insurance regime, the inspiration for Skeel's investor-insurance proposal, has been criticized for creating moral hazard problems that contributed to the savings and loan crisis of the mid-1980s.[36]

Similar objections arise in connection with the investor-protection regime outlined by Skeel. Investor protection is also a form of insurance, but this time the cost of the insurance is paid by corporations themselves through contributions to an investor-compensation fund administered by the FIIC. Of course, anything that is funded by a corporation is ultimately funded by its investors, and so it makes sense to ask whether investors

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33. To use the language of William Jennings Bryan, quoted by Skeel: should the "struggling masses" be forced to bail out "the idle holders of idle capital?" P. 211.

34. Moral hazard is created when the costs of a decisionmaker's actions are borne by others, often an insurer, causing the decisionmaker to take riskier actions than an even weighing of expected costs and expected benefits would produce. *See* TOM BAKER, INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS 4–8 (2003) (discussing moral hazard and adverse selection).

35. *See generally* CHARLES ADAMS ET AL., INT'L MONETARY FUND, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS, PROSPECTS, AND KEY POLICY ISSUES 70 (1998) (discussing economic models in which moral hazard leads to market collapse).

36. *See* Kenneth E. Scott, *Never Again: The S&L Bailout Bill*, 45 BUS. LAW. 1883, 1898 (1990) ("The magnitude of [the losses of the FDIC and FSLIC] was occasioned by a literal explosion of . . . moral hazard. Uniformly priced deposit insurance constitutes a subsidy to risk taking by thinly capitalized institutions and induces extreme risk taking by the owners of insolvent institutions."); *see also* Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1 (1987). In Professor Miller's words:

> The deposit insurance system is often said to create moral hazard on the part of depository institutions by giving them an incentive to take excessive risks with the knowledge that the costs of unsuccessful risk-taking will be borne by the deposit insurance funds, while the benefits will be captured by the banks. Thus, the existence of deposit insurance creates a tendency towards the very action that one wants to protect against.

Id. at 19.

would want to buy this form of anti-fraud insurance. Insurance, after all, is not free. Insurance premiums reflect not only a policy's risk—an actuarially determined probability of loss—but also a loading fee reflecting the insurer's costs.[37] This means that it always costs more to buy insurance than to bear a risk oneself and that individuals should buy insurance only against potential losses that are large enough substantially to diminish their quality of life.[38] Although investment losses may seem to present precisely this sort of risk, it is important to remember that the losses guaranteed under the investor-protection program are idiosyncratic and therefore capable of being spread costlessly (or nearly so) by holding a diversified portfolio.[39] As a result, it is not clear what, apart from loading fees, an investor gains from investor-protection insurance that she cannot already achieve through portfolio diversification.

The investor-protection proposal also seems to add little to the current investor-compensation regime, which is based on the interplay of securities law and directors' and officers' liability insurance ("D&O insurance"). Currently investors who are harmed by a financial restatement or an Enron- or WorldCom-style fraud can sue in a class action under Rule 10b-5 of the Securities Exchange Act.[40] Settlements of such claims are typically paid through a company's D&O insurance.[41] If the insurance market is reasonably efficient, different companies will pay different premiums for D&O insurance on the basis of their riskiness, and insurance companies will act as monitors of corporate governance.[42] But even if the insurance market does not work perfectly, the combination of securities law and D&O insurance effectively provides a compensation fund for investors harmed by a corporation's fraud or misrepresentations.

The major difference between the existing investor-compensation system and Skeel's proposal is the creation of the FIIC, a new alphabet-soup bureaucracy that, in addition to administering the compensation fund, would

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37. KARL H. BORCH, ECONOMICS OF INSURANCE 13–15, 163 (Kurt K. Aase & Agnar Sandmo eds., 1990) (describing the insurance premium as the sum of the expected claim payment under the insurance contract, the administrative expenses of the insurance company, and the reward to the insurer for bearing the risk, later referring to the difference between expected claims payments and the insurance premium as the "loading" of the contract).

38. *See* ROBERT I. MEHR & EMERSON CAMMACK, PRINCIPLES OF INSURANCE 35 (1976) ("Insurance for small losses which can be absorbed is uneconomical because the insurance premium includes not only the loss cost but also an expense margin.").

39. For this reason, mandatory portfolio diversification, another of Skeel's suggestions, pp. 212–13, may be an excellent idea, at least for pension and retirement plans.

40. *See* 17 C.F.R. § 240.10b-5 (2000); *see also* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003) (describing the multiplicity of situations in which there is a shareholder remedy under Rule 10b-5).

41. James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 512 (1997) ("[A]pproximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds.").

42. *See* Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' & Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147 (2006).

monitor the fund's corporate members. Is this a good thing? One might doubt, first of all, whether a government agency has the right incentives to act as a monitor of corporate governance, especially considering that institutional investors have largely failed to act as monitors of corporate governance in spite of the fact that they, unlike government bureaucrats, have their own capital at risk. Government oversight introduces additional layers of agency costs, including regulators' career incentives and the endemic problem of regulatory capture.[43] In short, instead of agents watching agents, we would have bureaucrats watching agents.[44] As flawed as this world is, it is hard to see how that would make it a better place.

These problems are not necessarily fatal to Skeel's proposals. For example, the worst distributional consequences of investor insurance might be solved by providing it only below a specified threshold of wealth. And it might be possible to avert the problem of moral hazard by limiting investment insurance to indexed portfolios. As currently proposed, however, there is scant detail on how the insurance regime should be crafted to avoid these problems. *Icarus in the Boardroom* offers a set of innovative proposals in skeletal form, just what a trade book should do, but it leaves us eagerly awaiting Skeel's future academic work to see how the investor-insurance proposals will be refined.

III. A NETWORK OF CONSTRAINT

As corporate law professors advise their students every semester, the regulation of risk-taking is itself a risky business because it threatens to stifle progress and innovation (good risk-taking) along with fraud and failure (bad risk-taking). Skeel is plainly sensitive to this dilemma. He advertises it, no doubt, to his own students and recites it obligingly in *Icarus in the Boardroom* (p. 196). Moreover, his proposals stop well short of stifling innovation—insurance and oversight, after all, are not the same as mandates and prohibitions. Nevertheless, the book's predominant focus on federal responses to governance failures renders it largely insensitive to the broader network of constraints operating upon corporate managers. This oversight renders the account as a whole somewhat misleading. After all, it is easy to support additional regulation when the subject of the regulation—here, corporate management—appears largely unconstrained. A closer examination of the broader network of constraints, however, reveals that corporate managers, far from being unconstrained, are held in check by a complex

43. On the capture of regulators by interest groups, see THE POLITICS OF REGULATION (James Q. Wilson ed., 1980); *see also* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263 (1982); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988).

44. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

regulatory environment. State corporate law courts, backstopped by a variety of market- and norm-based constraints, provide the first line of defense against Icarus Effect failures. This Part of the Review describes key aspects of that regulatory environment, ultimately arguing that existing state law institutions, rather than additional federal regulation, may hold more promising solutions to the problems Skeel identifies.

State corporate law, not federal securities law, is the primary source of authority for corporate-governance problems,[45] and state corporate law has long struggled with the problem of regulating risk.[46] The interplay of the business judgment rule with the traditional fiduciary duties of care and loyalty is explained largely by the twin goals of protecting managerial incentives to take risks while also discouraging fraud.[47] The business judgment rule offers total

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45. This is a function of the so-called "internal affairs" doctrine that delegates authority for regulating the internal affairs of corporations to states in the absence of specific Congressional enactments. *See* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 91 (1987) ("It . . . is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."). *But see* Thompson & Sale, *supra* note 40, at 861 (arguing that outside of the context of self-dealing and acquisitions, "corporate governance . . . has passed to federal law and in particular to shareholder litigation under Rule 10b-5").

46. *See In re* Walt Disney Co. Derivative Litig., Consol. C.A. No. 15452, 2005 Del. Ch. LEXIS 113, *6 (Del. Ch. Aug. 9, 2005) ("[T]he essence of business is risk—the application of informed belief to contingencies whose outcomes can sometimes be predicted, but never known."). Also consider Chancellor Allen's classic statement of the problem:

> Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modem public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence", "inattention", "waste", etc. could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimalist proceduralist standards of attention, they can face liability as a result of a business loss.

Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).

47. The duty of care requires that directors in control of the corporate enterprise exercise the same level of care that would be expected of an ordinarily prudent person in the conduct of her own affairs. Briggs v. Spaulding, 141 U.S. 132, 152 (1891); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963). The duty of loyalty, in its simplest formulation, is a proscription against director conflict of interest and self-dealing. *See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). The business judgment rule, in the words of one commentator:

> is simply that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment—even for judgments that appear to have been clear mistakes—unless certain exceptions apply.

ROBERT CHARLES CLARK, CORPORATE LAW § 3.4, at 123 (1986).

protection for mistakes[48] but no protection for self-dealing or fraud.[49] This structure is the result of an attempt to shield managers from liability for risks that do not turn out as hoped while holding them accountable for attempts to defraud the firm or its investors.

Because it is based on the application of these broad principles, state corporate law jurisprudence is highly fact-specific and extremely flexible.[50] The business judgment rule is a moving frontier.[51] Judges decide when and how it will apply, effectively raising and lowering the hurdle that determines the extent of their intervention in corporate governance.[52] Moreover, they are granted almost complete autonomy by a statutory structure that leaves the substance of corporate regulation to the judiciary.[53] The authority of the judiciary is further enhanced by a weak set of precedents and a very narrow scope of stare decisis, such that decisions occasionally seem to be largely ad hoc.[54] Finally, an array of rhetorical devices embedded within corporate law jurisprudence—from "good faith" to "enhanced scrutiny"—allow fiduciary duties to regulate either lightly or heavily depending upon the circumstances.[55]

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48. Plaintiffs bringing a challenge under the duty of care must allege facts that show the board's conduct is so careless as to constitute "gross negligence." *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

49. Plaintiffs bringing a challenge under the duty of loyalty do not bear the burden of establishing a *gross* conflict of interest—*any* material conflict will do. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

50. *See generally* Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar's* Price Discrimination in the Market for Corporate Law, 86 CORNELL L. REV. 1257, 1259 (2001) ("[M]uch of Delaware corporate law's indeterminacy and litigation intensiveness is an unavoidable consequence of the flexibility of the Delaware Model, which leaves room for economically useful innovation and creativity.").

51. Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005) (articulating a theory of corporate law jurisprudence based on the judiciary's response to the twin threats of corporate migration and federal preemption).

52. The question of judicial intervention in corporate decisionmaking has been described by former Chief Justice Veasey as the "defining tension" in corporate law and by former Chancellor Allen as "the tension that occupies its core." William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 894–95 (1997); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393 (1997).

53. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (2003) ("The beauty of the Delaware corporation law ... is that the framework is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis.") (Veasey, C.J., dissenting).

54. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000) (noting that the Delaware judiciary is less bound by principles of res judicata and stare decisis than other courts).

55. *See* Griffith, *supra* note 51; *see also* Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1 (2005).

The responsiveness and interpretive subtlety of state corporate law is best illustrated by a consideration of Delaware's takeover jurisprudence beginning in the watershed year of 1985.[56]

A. *Takeover Jurisprudence*

In the late 1970s and early 1980s, American corporations began to fall victim to hostile takeover bids. These were troubled economic times—with inflation, interest rates, and unemployment all high—and takeovers seemed to make matters worse.[57] The financiers who engineered the deals were popularly reviled—vilified as cannibalistic raiders, taking personal advantage of a weakened national economy and putting employees out of work[58]—while in academic quarters and in Washington, they were celebrated for enhancing the efficiency of corporate America.[59]

In the thick of this controversy, the Delaware Supreme Court handed down a highly significant set of fiduciary duty decisions that served, at least in the short term, to increase the scope of judicial intervention in corporate governance. In *Smith v. Van Gorkom*,[60] the court loosened the standard of gross negligence to permit it to second-guess a board's decision to approve a takeover. In *Unocal v. Mesa Petroleum*,[61] the court invented the standard of "intermediate scrutiny" to intervene in matters of takeover defense, setting limits on the ability of an incumbent board to resist an unwanted takeover offer. And in *Revlon v. MacAndrews & Forbes Holdings*,[62] the court created "*Revlon* duties" to restrict the ability of a target board to favor one buyer over another.

In each of these cases, Delaware courts responded to crisis by creating a means for greater judicial intervention. However, this increase in judicial intervention did not last.[63] The impact of each of the watershed decisions has been substantially reduced. *Van Gorkom* was immediately reversed by the

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56. *See* Chief Justice E. Norman Veasey, Speech Presented at the 4th Annual Mergers and Acquisitions Insight Information Co. (June 18, 2001), *reprinted in The Roles of the Delaware Courts in Merger and Acquisition Litigation*, 26 DEL. J. CORP. L. 849, 849 (2001) (describing the "watershed in Delaware corporate jurisprudence" in 1985).

57. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, 70–73 (2002) (describing the economic environment in the late 1970s and early 1980s as a time of rapidly increasing inflation and shocks in the world oil market resulting in action by the Federal Reserve Board to constrain inflation by increasing interest rates, leading to a recession, with unemployment reaching 10.7% in 1982).

58. *See, e.g.*, WALL STREET (Twentieth Century Fox 1987).

59. *See, e.g.*, Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314, 329–37 (John C. Coffee, Jr. et al. eds., 1988) (describing positive economic effects of bust-up takeovers).

60. 488 A.2d 858 (Del. 1985).

61. 493 A.2d 946 (Del. 1985).

62. 506 A.2d 173 (Del. 1985); *see also* Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585, 603 (Del. Ch. 1987) (describing "*Revlon* duties").

63. Griffith, *supra* note 51, at 62.

Delaware legislature.[64] *Unocal* was slowly eroded through lax application.[65] *Revlon* was narrowed.[66] Each of these changes reduced the scope of judicial intervention in board decisionmaking.

Delaware's retreat from its own doctrinal innovations can be explained by the incentives operating upon the judiciary. Just as Delaware is the nation's leading exporter of corporate law, Delaware judges are the leading authorities on corporate law.[67] Yet the authority of Delaware judges over corporate law matters is subject to two pervasive threats—corporate migration and federal preemption. If enough corporations leave Delaware to incorporate in other states—whether because Delaware is too friendly or too hostile to management[68]—then the authority of the Delaware judiciary will be reduced. Similarly, if the federal government enacts laws or regulations that move the substance of corporate law, in whole or in part, into the federal sphere, the authority of the Delaware judiciary over those matters is effectively preempted.[69] We can therefore expect the Delaware judiciary to design its jurisprudence to protect itself against these threats.

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64. DEL. CODE ANN. tit. 8, § 102(b)(7) (2004).

65. *See, e.g.*, Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995) (allowing boards to refuse offers that are not coercive but merely inadequate); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1990) (rejecting an interpretation of *Unocal* that would have required the court to judge and the board to choose the best deal); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350 (Del. 1985) (upholding poison pill under *Unocal* scrutiny); *accord* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001) (finding that, except for those cases involving *Revlon* duties, the vast majority of Chancery Court decisions and all Supreme Court decisions between 1985 and 2002 approved the board's defensive devices in spite of claiming to apply intermediate scrutiny).

66. *See generally* Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989) ("*Revlon* does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest."); Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1993) (holding that *Revlon* duties could also be triggered by a stock-for-stock deal that caused a target corporation to go from being diffusely held to having a controlling shareholder); *Paramount Commc'ns, Inc. v. Time*, 571 A.2d at 1150 (limiting *Revlon* duties to situations in which the board has "abandon[ed] its long-term strategy" and "seeks an alternative transaction ... involving the breakup of the company").

67. *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) ("The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law.").

68. The race-to-the-bottom thesis suggests that the management's dominant role in deciding where firms incorporate will lead to lax corporate law. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974) (describing "the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy"). The theoretical foundations of the race-to-the-bottom thesis, however, have been undermined by an argument that the race creates incentives for states to appeal to shareholders rather than harming them—that it is a race, in other words, to the top. *See generally* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporate Law*, 76 NW. U. L. REV. 913 (1982) (challenging the Cary thesis); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) (arguing that state competition results in a race to the top); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (same).

69. Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004) (discussing the effects of possible preemption on Delaware law); Mark J. Roe,

Delaware's takeover jurisprudence is an example of these incentives in action. Federal preemption was a significant threat to the Delaware judiciary in the early and mid-1980s, when pro-takeover forces were strong in Washington.[70] The judiciary therefore reacted—in *Van Gorkom*, *Unocal*, and *Revlon*—by increasing judicial scrutiny of board conduct and limiting the ability of management to resist takeover bids. At the same time, however, there was also a significant pro-management lobby that threatened to reincorporate elsewhere if Delaware law became too hostile. This lobby was successful in persuading the legislature to overturn *Van Gorkom* and later, when the threat of federal preemption had faded, in persuading the courts to moderate their takeover jurisprudence. Courts began to apply *Unocal* less aggressively and to narrow *Revlon* but, by retaining the principle of *intermediate* scrutiny, never to the point at which other states could steal incorporations by appealing to shareholders.[71]

The lesson of this episode is that it is impossible to understand how corporate constraints change in response to scandal by focusing on the federal regulator alone. Federal regulation is important, of course, but it is not the entire story. Equally important, but more nuanced, is the way in which the network of constraint as a whole adapts to corporate crises. State law, in particular, is highly flexible and able to act prospectively, changing in response to the mere possibility of federal regulation. Thus, although *Icarus in the Boardroom* addresses takeovers in a chapter portraying Michael Milken as an Icaran executive,[72] the discussion ultimately fails to comprehend the complexity of the regulatory response and, as Skeel acknowledges, does not quite fit with the central themes of the book (pp. 140–42). What is missing is a more nuanced description of the interconnectedness of the various sources of regulatory authority within the overall network of constraint and, with it, an account of the plasticity of corporate law jurisprudence.

B. *Icarus Effect Jurisprudence*

The narrative structure of *Icarus in the Boardroom* is corporate scandal followed by regulatory response. The principal regulatory focus is the federal government, which as others have noted, tends to impose its governance terms on corporations in a one-size-fits-all manner.[73] Yet each Icarus Effect

Delaware's Competition, 117 HARV. L. REV. 588 (2003) (describing the substance of Delaware law in light of the risk of federal preemption).

70. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2510 (2005) ("[I]n the mid-1980s,] powerful policymakers in the Administration favored takeovers.").

71. This process is described in greater detail in Griffith, *supra* note 51, at 63–68. Moreover, residual inefficiencies in state law may be resolved by private ordering. *See* Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002) (arguing that adaptations such as incentive compensation and independent boards mitigate the seemingly harsh anti-takeover effects of state law).

72. Pp. 125–32. However, Skeel's characterization of Delaware law during this period as "Hamlet-like" is both pithy and apt. P. 138.

73. *See, e.g.*, E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key*

failure described by Skeel—whether Cooke's, Insull's, Lay's, or Ebbers's—is closely tied to situation-specific factors, unique conditions within the organization or business environment pushing the executive to convert risk into fraud. The problem of the Icaran executive is therefore ill-suited to a federal regulatory solution. The Icarus Effect requires a more nuanced response, better suited to the responsiveness and interpretive subtlety of state corporate law.

Corporate law courts could respond to the Icarus Effect, as they responded to the takeover crisis, by increasing judicial scrutiny. The standard of judicial deference to boards, in other words, would be lowered when the board has reason to know it has promoted or hired an Icaran executive. How should boards know they are dealing with an Icarus Effect situation? In spite of being highly situation-specific, Icarus Effect failures have a number of common features. Professor William Beaver of Stanford Business School suggests that earnings management is most likely when a particular set of factors is present—specifically: (1) a company has experienced unusually high growth, (2) management attributes this growth to skill rather than luck, (3) management has made continued growth an integral part of corporate strategy, (4) management is arrogant or naïve about its prospects for sustaining such growth, and (5) management perceives the financial reporting and internal controls as a nuisance or subservient to entrepreneurial goals.[74] Similarly, Langevoort emphasizes that fraud is more likely when the CEO has won her position by making grand promises, thus triggering a "winner's curse" problem—that is, the inability, once hired, to fulfill her promises.[75] These same factors can be found in each of the paradigmatic Icarus Effect failures identified by Skeel. The Enron board, for example, should have been especially suspicious of the financial dealings and results reported by its managers given the hyper-competitive tournament atmosphere that prevailed within the firm.[76]

In designing a jurisprudential response to Icarus Effect risk, corporate law courts would thus hold directors to a higher standard of oversight when

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Developments, 153 U. PA. L. REV. 1399, 1412 (2005) (contrasting Delaware corporate law with federal regulation); *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (critiquing recent federal regulation of corporate governance).

74. William H. Beaver, *What Have We Learned From the Recent Corporate Scandals That We Did Not Already Know?*, 8 STAN. J.L. BUS. & FIN. 155, 163 (2002) (further noting that "based upon the information disseminated in the financial press, the [corporate scandals] appear to fit these conditions quite well").

75. Langevoort, *supra* note 21, at 305–06 (discussing the winner's curse problem in connection with CEO hiring and the tendency to hire not the most able but the most optimistic executive). In his words:

> If fraudulent reporting is triggered by a winner's curse problem, for example, then the intensity of the audit checks into managerial truthfulness (including the CEO's own candor) has to vary with the index of internal pressure. An internal reporting controls system that does not have a thermostat built into it to adjust when performance becomes overheated is a deficient system.

Id. at 316.

76. *See supra* note 22 and accompanying text.

they design an aggressive promotion tournament within the firm or, alternately, when they hire an executive who has risen through such a structure in another firm. When, by contrast, boards do not adopt a set of incentives likely to lead to an Icarus Effect failure, courts would exercise traditional deference in the reviewing board conduct. Furthermore, this shifting of standards would not necessarily be fatal to the board. A board could carry its burden by showing that it had screened for traits suggested by Beaver and Langevoort and, when it found them, exercised continuing scrutiny of management's conduct and reports.[77] The role of corporate law would thus be to ensure that the degree of board scrutiny was suited to the managerial incentive structure within the firm.[78] A board that does not tailor its level of scrutiny to the incentives that it has created has arguably failed to act in compliance with its fiduciary duties. State fiduciary duty law is sufficiently flexible to allow this intervention under several doctrinal rubrics, including the emerging jurisprudence of good faith.[79]

Would such an interpretation of fiduciary duty solve the problem of the Icarus Effect? It is worth remembering, at this point, that state corporate law overlays a background of market forces and norms that also serve to constrain the decisionmaking of corporate managers. Product, labor, and capital markets discipline managers for making foolish decisions during the life of a firm.[80] Similarly, markets have evolved mechanisms to detect and sanction fraud,[81] and the D&O insurance market may already screen companies on the basis of their susceptibility to Icarus Effect failures.[82] This system of constraints may deter managerial misbehavior without the involvement of any court. Should the judiciary become involved, however, we may be comforted by the fact that corporate law judges, pressured by the twin threats of corporate migration and federal preemption, have ample incentive to police

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77. *See supra* notes 74–76.

78. Corporate law courts often emphasize that they are not "super-directors." *E.g.*, Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) ("To rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation."); *In re* RJR Nabisco, Inc. S'holders Litig., Civ. A. No. 10389, 1989 WL 7036, at *22 n.13 (Del. Ch. Jan. 31, 1989) ("To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors."). In evaluating the level of scrutiny applied by the board, however, courts could avoid reviewing the quality of actual business decisions—the firm's risk-reward calculation—by focusing instead on whether the internal system of checks and balances was suited to the incentive structure within the firm.

79. *See In re* Walt Disney Co. Derivative Litig., Consol. C.A. No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005) (discussing possible interpretations of the corporate law doctrine of good faith); *see also* Griffith, *supra* note 51.

80. *See* Rock & Wachter, *supra* note 15, at 1643-44.

81. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1, 47–57 (2002) (describing the ability of the market to respond to fraud and wrongdoing).

82. See Griffith, *Uncovering a Gatekeeper*, *supra* note 42 (arguing that D&O insurers underwrite coverage on the basis of corporate governance risk).

the barrier efficiently.[83] Policing managerial misconduct efficiently may mean there is some residual risk of an Icarus Effect failure, but pushing for a complete solution returns us to the basic corporate law dilemma of regulating too much and stifling good and bad risks alike.

In other words, although there may be some gaps in the web of constraints, it is telling that Skeel had to go back over a century to find four good stories of failure. This is not to say that the corporate scandals are unimportant. Skeel's historical account successfully brings together insights from industrial organization and behavioral psychology to teach a lesson about the fundamental flaws in corporate America. Nevertheless, it is a lesson that is probably best directed at members of the judiciary in Wilmington rather than the politicians and regulators in Washington.

CONCLUSION

In sum, *Icarus in the Boardroom* provides an excellent historical analysis of four episodes of scandal that have roiled American business. It also provides a superb illustration of the political use to which such events have been put, including the populist reform efforts following Cooke's collapse and Roosevelt's use of Insull in the rhetoric of the New Deal, ultimately stirring the federal government to action. The thread unifying these episodes is the Icaran executive—the consummate risk-taker and overconfident survivor of successive probationary crucibles, for whom risk-taking tends easily to transform into fraud. According to Skeel's account, the Icaran executive is the personification of the fundamental flaws of corporate America. And it is a convincing story.

Still, the book's focus on the federal regulatory response is somewhat misleading because it overlooks the broader network of constraints operating upon corporate managers. It is possible, of course, that this broader network of constraints was not fully in place at the time of Cooke or Insull, but the fact that it is in place now might explain why after Enron and WorldCom, as Skeel notes, there were "far fewer calls for a complete rethinking of the policies of the past twenty years—such as the scope of deregulation—than one might have expected" (p. 210). That dog might not have barked because more Americans now than ever before are investors and, as investors, they recognize that extra regulation, in light of the existing framework of constraint, could easily have amounted to excessive regulation, threatening the efficiency of the capital market and the value of their own investment portfolios.

When executives appear unconstrained, it is tempting to design constraints for them. Hence the book's innovative but ultimately problematic suggestion that the federal government establish an investor-insurance regime and set up a new agency to administer it. In making this proposal,

83. *See supra* text accompanying notes 67–70. Moreover, the increase in judicial scrutiny of boards following the corporate scandals suggests that courts have indeed sought to police this barrier more effectively. *See* Griffith, *supra* note 51.

Skeel has assumed the role of Daedalus, the mythological father of Icarus, famed for his tinkering and inventions, who concocted the artifice that carried the boy aloft. With a better pair of wings, Icarus might not have crashed, and in his policy recommendations, Skeel proffers a better set of wings, a way of controlling the costs of excessive risk in American business. This Review has taken a different approach and, rather than contriving a new device to fix the problems that Skeel identifies, instead seeks to emphasize the subtle ways in which existing institutions might address them.