

Reexamining the Law-and-Economics Theory of Corporate Governance

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Are the markets enough to control fraud? This scholar takes on the widespread theoretical claims that there is no need for government protections against fraud.

LAW AND ECONOMICS SCHOLARS HAVE DRIVEN CORPORATE GOVERNANCE theory in recent years. The current theory's best-known proponents are Judge Frank H. Easterbrook and Daniel R. Fischel of the University of Chicago's Law School. Their classic text, *The Economic Structure of Corporate Law* (1991), advocates a paradigm shift, replacing Adolf Berle and Gardiner Means's (1932) emphasis on the separation between ownership and control in publicly traded corporations. Berle and Means, a law professor and an economist, focused on the opportunities for exploitation of the principals (shareholders) by the unfaithful agents (officers).

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Easterbrook and Fischel consider this view naive. They contend that if principals were routinely exploited, they would avoid equity investments in publicly traded companies. It follows that there must be market mechanisms that sufficiently constrain abusive behavior by agents to encourage investors to make massive equity investments in publicly traded companies. They argue that several different market mechanisms combine to act as an "invisible hand" aligning the interests of investors and officers and producing governance provisions that are "optimal for society" (Easterbrook and Fischel 1991, 4, 7).

Easterbrook and Fischel's work interests white-collar criminologists because it is one of the first efforts by economists to discuss what I have termed "control fraud"—fraud by controlling persons. In a corporation, this typically means the CEO. If the person controlling the firm is a criminal, he will use the firm as a weapon to defraud others. Easterbrook and Fischel acknowledge that fraudulent firms seek to "mimic" legitimate firms (1991, 280). However, Easterbrook and Fischel view control fraud as a trivial problem because the capital markets readily discern fraud and because legitimate firms have the incentive and the ability to distinguish themselves from the mimics (*ibid.*). The markets are so successful that "a rule against fraud is not an essential or even necessarily an important ingredient of securities markets" (1991, 283).

Fischel provides additional insights in two contexts. First, he served as a consultant to Lincoln Savings and CenTrust Savings before their failures. He prepared responses to critical examination reports by federal regulators. Second, he wrote *Payback* (1995), which criticizes the prosecution of Michael Milken and various CEOs of failed S&Ls in the 1980s and early 1990s.

The paradigm offers strong guidance about praxis. First, the federal government has no important role in preventing control fraud. Second, more regulation would be counterproductive.

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Third, prosecutions have been abusive and harmed the markets. Fourth, strict fiduciary duties (for example, restricting usurpation of corporate opportunity) and civil suits alleging breaches of fiduciary duty harm investors.

Collectively, these two books and Professor Fischel's lengthy responses to regulators offer a challenge to white-collar criminology, though they do not discuss the criminology literature. The 1980s' S&L debacle presents an excellent setting in which to evaluate the rival paradigms. The emerging facts in the ongoing crises are subject to more disputes but are still useful in evaluation.

The Criminology Paradigm: Control Fraud

White-collar criminologists look at the firm as a potential vehicle for fraud. It may be used as both a "sword" and a "shield" (Wheeler and Rothman 1982). As a sword, it is a means for taking money from others. In its capacity as a shield, the resources and apparent legitimacy of the firm provide a strong defense against sanctions. Control frauds defeat internal and external controls by doing the hiring and firing and determining reporting arrangements. Control frauds can optimize the firm for fraud, for example, by having it grow rapidly and invest in areas with lax accounting standards. Control frauds can use the entire resources of the firm to "harden" it as a shield. Control frauds agree that the best defense is a good offense, so they use their lawyers, experts, and legislators as a sword to intimidate regulators and reporters.

Fischel has challenged this view. Although he sees *traditional* S&L owners and the legislators they influenced as malign rent seekers, he argues that the most infamous S&L control fraud, Charles Keating, acted benignly when he influenced politicians. Fischel describes the (ultimately) successful regulatory intervention by the band of senators dubbed the "Keating Five" as "a model of how democracy is supposed to work" (1995, 212, 245).

I was one of the regulators subjected to this “model of democracy” and took the extensive notes of that meeting that led to the Senate ethics investigation. I was also at the key meeting with Speaker James Wright (D-TX) involving his efforts on behalf of the Texas control frauds, and I testified in his ethics investigation. The Texas control frauds influenced Wright to greatly delay and reduce the “recapitalization” of the Federal Savings and Loan Insurance Corporation (FSLIC). Keating used Senator Alan Cranston (D-CA) in the same manner. The control frauds added “forbearance” to the bill to gut the Federal Homeland Bank Board’s supervisory powers. Wright and Treasury Secretary James Baker reached a deal. The Reagan administration agreed not to reappoint Ed Gray as Bank Board chairman—Gray had “reregulated” the industry to fight the control frauds—and it agreed to support “forbearance.” Wright (nominally) supported the \$15 billion FSLIC recapitalization bill.

Keating’s political power was amazing. He induced a *majority* of the House to cosponsor a resolution calling on Gray not to go forward with reregulation. He convinced the administration to appoint two Bank Board members of his choosing, which would have given Keating control of the Bank Board. (Talk about “regulatory capture”!) One of the nominees, George Benston, ran into unrelated political problems and had to withdraw. The other nominee’s (Lee Henkel) first substantive act as a Bank Board member was to try to immunize Keating’s Lincoln Savings from sanction for its \$600 million violation of the rule. The Keating Five sought to do the same thing. That effort, which occurred shortly before Gray’s term ended, was unsuccessful with Gray, but, as I explained, he was not reappointed and could not sanction or close Lincoln Savings.

The intimidation was spectacularly successful with Gray’s successor, Danny Wall. Keating arranged a meeting with Senator John Glenn (D-OH) and Speaker Wright and an afternoon

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meeting with Bank Board Chairman Wall (which he set up through Senator Cranston). Faced with the combined pressure of the Keating Five and Speaker Wright, Wall immediately ordered a "peaceful resolution." He took the unprecedented act of removing the Federal Home Loan Bank of San Francisco's (FHLBSF) jurisdiction over Lincoln Savings. The FHLBSF had recommended that Lincoln Savings be closed. It grew to be the most costly S&L failure—\$3 billion. Our standard joke was that control frauds produced a *positive* return on investment in only one business line—political contributions.

The ability to secure extraordinary political power can be one of the most pernicious aspects of control frauds. In addition to the effect of economic losses, the abuses decrease public trust of elected officials and can lower the ethical standards of legislators. Curt Hébert, Jr., chairman of the Federal Energy Regulatory Commission, has testified that Kenneth Lay, who controlled Enron, repeated Keating's tactics—telling the chairman he could get him reappointed by the new administration if he were to change his policies. Enron influenced state legislators and regulators to deregulate approvals for wholesale energy sales through political contributions.

Control frauds "buy" regulators more directly. Keating unsuccessfully tried to hire Chairman Gray (offering to quadruple his salary) and the spouse of Lincoln Savings' top field regulator. Keating and the Texas control frauds' efforts to suborn state and federal regulators (including providing prostitutes to the Texas state S&L commissioner) worked. These extensive efforts to bamboozle, buy, or bully the regulators suggest that the control frauds disagree with Easterbrook and Fischel's view of the regulators as hopelessly behind the capital market in spotting frauds and failures.

Criminologists believe that control frauds are very difficult to detect and that markets rarely do so on a timely basis.

Easterbrook and Fischel use a partially dynamic model in which control frauds seek to mimic legitimate firms but are unsuccessful because honest firms distinguish themselves from the fraudulent by adopting signaling devices (e.g., hiring a first-tier audit firm). Criminologists posit a dynamic model in which control frauds mimic the signals the legitimate firms use to attempt to distinguish themselves from the fraudulent. Criminologists see the struggle as quasi-evolutionary and believe that the legal, political, and ethical environment may be critical to the relative success of the two groups. I predict that major control frauds will choose first-tier audit firms and, under current lax rules, will "shop" successfully for prestigious audit partners to provide "clean" opinions even for firms rendered deeply insolvent by fraud. Both the S&L debacle, in which *every* control fraud was able to obtain at least one clean opinion from a "Big Eight" auditor, and the ongoing scandals support this prediction.

Control fraud has two forms, opportunistic and reactive. Opportunists seek a setting in which to commit control fraud. Reactive control frauds respond to severe financial difficulties. Control-fraud theory posits that waves of control fraud occur in a particular industry when the legal, financial, and ethical environment simultaneously maximizes the opportunity for both forms of fraud. The mass insolvency of the S&L industry, the ease of entry to that industry, and its nearly optimal nature for control fraud produced the wave of S&L fraud of the 1980s. Currently, no single industry is so uniquely favorable for control fraud, so the control frauds have been spread more diffusely in the ongoing wave of fraud. Nevertheless, they appear to be concentrated in the high-tech sectors. When control frauds are concentrated, they are more likely to inflate "bubbles" and produce severe recessions. S&L control frauds were important contributors to the Texas real estate recession of the 1980s (Akerlof and Romer 1993; Black et al. 1995).

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White-collar criminologists overwhelmingly believe that public intervention is required to limit control frauds and that existing enforcement efforts against fraud are too weak. They favor stricter concepts of fiduciary duty, particularly of loyalty. In short, the two paradigms are polar opposites.

Testing the Law-and-Economics Paradigm

There are two primary means of evaluating the law-and-economics paradigm in the context of control fraud. Does it actually predict events? Is it logically consistent? I organize my evaluation by focusing on predictive utility and bringing in questions of logical consistency where relevant. Evaluating predictive success requires stating testable hypotheses. Fortunately, these hypotheses can be drawn both from Fischel's explicitly predictive application of the paradigm on behalf of Lincoln Savings and CenTrust Savings in 1987 and the Easterbrook and Fischel text (1991).

Predictive Efforts During the S&L Debacle

In 1986, federal S&L examiners severely criticized the operations, financial condition, and management of Lincoln Savings. Charles Keating, its de facto CEO and controlling shareholder, was a "captive" of Drexel Burnham Lambert. Drexel, not Keating, made all investment decisions on Lincoln's \$1 billion portfolio of Drexel-issued junk bonds. Drexel churned the account and dumped its losers on Lincoln and its fellow captives. Michael Milken, the de facto head of Drexel, had recruited Keating to the S&L industry, promising to make him a "merchant prince." Drexel funded Keating's entire purchase of the S&L. Fischel was a consultant to Milken, which led to his retention by Keating. Fischel concluded that "Lincoln is safe and hence poses no threat to the

FSLIC" (LEXECON 1987, 1). His view was premised on the efficient-markets hypothesis: "For publicly traded thrifts, stock market data provide far better estimates of a thrift's net worth than can be obtained from accounting data" (ibid., 11). And "We have developed a model that can be used to measure both the probability that a thrift will become insolvent and, more importantly, the expected cost that an institution imposes on the FSLIC" (ibid., 23).

By contrast, every "nontraditional" S&L failed, and this group provided all the most expensive failures.

The model provided three key predictions. First, Lincoln was extremely unlikely to fail. It had only a 0.31 percent chance of near-term insolvency (ibid., 25). Second, even in the extraordinarily unlikely event that Lincoln was to fail, it would impose little cost on the FSLIC. The "expected cost" of failure was less than one penny per \$1,000 of deposits (ibid., 28-29). Lincoln had roughly \$4 billion in deposits, so the expected cost was under \$400,000. By way of comparison, Lincoln's annual FSLIC insurance premium was roughly \$1 million. Third, the FSLIC's real concern should be "traditional" S&Ls that made few high credit-risk investments. Their expected cost of failure was *fifty times greater* than Lincoln's and eight times that of the nontraditional group (ibid., 28-29).

Despite its high market capitalization, Lincoln was insolvent when Fischel wrote his response to the examiners. Traditional S&Ls overwhelmingly proved successful. Even the failures among the group imposed only modest costs on the FSLIC. By contrast, *every* "nontraditional" S&L failed, and this group provided all the most expensive failures (National Commission on

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CenTrust was also a Drexel captive that owned a huge portfolio of Drexel-issued junk bonds. David Paul was its controlling owner-CEO. The examiners criticized CenTrust's overall operations and its junk bond portfolio, and Fischel was retained to rebut them. Fischel wrote that the examiners did not provide "any useful information about CenTrust's financial condition" (LEXECON 1988b, 1). He opined that the stock market capitalization provided the definitive judgment on the true value of the S&L and argued that Paul's control meant that his interests "coincide closely with those of the FSLIC" (ibid., 17). Indeed,

The bigger the share of stock held by any particular investor, the lower are agency problems between the firm and its shareholders. This is particularly true if the investor is an insider. Thus, Paul's investment is highly beneficial to both CenTrust *and* the FSLIC. (LEXECON 1988a, 8–9, emphasis in original)

Fischel's model was able to calculate the near-term risk of CenTrust's becoming insolvent as "less than a 0.0001 percent probability" (LEXECON 1988b, 24). That translates into less than one chance in a million.

The expected cost of CenTrust to FSLIC was less than "\$.00001 per \$1000 of deposits" (ibid.). It followed that the risk posed by CenTrust was "trivial" and that it was "very safe" (ibid.). Indeed, he concluded that CenTrust "is an extremely safe institution posing no threat to the FSLIC" (ibid., 50).

Any losses found by the examiners were irrelevant because they were taken into account by the market and were therefore "perfectly reflected in and subsumed by our overall measure of CenTrust's . . . risk" (ibid., 45, emphasis added). Note that this argument asserts that the model is not capable of falsification, which makes the model theology. The market is not simply reified; it is deified. Fischel was asserting a "perfect markets" hypothesis.

Fischel's predictions failed. CenTrust was a control fraud that imposed \$1.5–\$2 billion in costs on the taxpayers. CenTrust was insolvent at the time he wrote. His prediction that the ideal situation for the FSLIC was the CEO as controlling shareholder was also wrong. Keating and Paul were typical of the worst control frauds in combining ownership and control. As the National Commission on Financial Institution Reform, Recovery, and Enforcement (NCFIRRE) found, "The failed institution typically had experienced a change of control and was tightly held, dominated by an individual with substantial conflicts of interests" (1993, 4).

Other Easterbrook and Fischel Predictions Relevant to Control Fraud

First, Easterbrook and Fischel argue that markets will spot fraud with relative ease (1991, 20–21). As Fischel's experience demonstrates, this was not true in the S&L debacle. The current crisis demonstrates that the markets have imputed vastly overstated market capitalizations to deeply insolvent firms.

Second, they assume both that a controlling shareholder-CEO cannot prosper if the firm fails and that purchases of control guarantee honesty. "Control sales have built-in guarantees of the buyer's good intentions. . . . One who buys a controlling block of shares cannot hurt the corporation without hurting himself too. Substantial investment acts as a bond for honest conduct" (Easterbrook and Fischel 1991, 133).

As I noted, this proposition was tested during the debacle, and the opposite proved to be true. The ability of the current crop of control frauds to convert a substantial amount of the failing firm's assets to the personal benefit of the CEO is infamous.

This inability to understand how the controlling persons can profit from the failure of the firm has led other economists astray.

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It is sometimes reported that the underworld becomes involved in legitimate businesses by foreclosing on them when they are unable to pay off debts to usurers. These businesses sometimes go bankrupt. This is not surprising, for the advantage of owning a business which was forced to borrow at 200 percent interest from a loan shark is not immediately obvious. (Rubin 1978, 161)

The tone of Rubin's article is that the poor fools in the mob are too dumb to realize that it is irrational to "foreclose" on a firm

Lincoln Savings was insolvent by over \$100 million, and CenTrust was insolvent by over \$400 million (both on a market-value basis) when they were acquired.

that is a net *liability*. But the mob does not "foreclose" on a usurious loan. Usurious loans are void and unenforceable. The types of scams Rubin describes are known as "bust-outs," and they are profitable for the mob. The bankrupt owner of the firm, for example, a bar, does what the mob tells him. The mob defrauds his creditors. The bar buys liquor on credit. The mob resells the liquor in bulk and pockets the proceeds. The next stage is often insurance fraud. The bar is overinsured and burned down. The insurance proceeds are looted by the mob. Then the mob walks away.

Rubin's logic is half-correct. Voluntarily taking on a net liability is irrational *unless* the purpose is to gain a vehicle for control fraud. The majority of the control frauds who entered the S&L industry in 1981-83 acquired seriously insolvent S&Ls *without requesting or receiving FSLIC assistance*. Lincoln Savings was insolvent by over \$100 million, and CenTrust was insolvent by over \$400 million (both on a market-value basis) when they were acquired. George Akerlof and Paul Romer (1993) provided the first formal economic model of when the wealth-optimizing strategy for the controlling owner-CEO was to loot

the firm. Unsurprisingly, it was when the firm had little, or negative, capital.

Easterbrook and Fischel argue that the sole owner-CEO is superior because he picks a board of directors whose preferences are "identical" to his own (1991, 70, 73). Writers about the S&L debacle are universal in condemning the lack of independence and control exerted by the boards of directors. Control frauds select "yes-men" as employees and board members (Black 2000, 74-75).

Third, Easterbrook and Fischel posit that fraud will be "one shot." This idea flows from two earlier propositions: markets easily spot fraud, and then they exclude frauds because other market participants will not deal with them. Both assumptions are erroneous. Even when individuals are exposed as fraudulent, they are often able to commit new abuses. A CEO's bad reputation is a signaling device that aids the formation of abusive groups. Keating signed an SEC consent decree based on insider abuse of a financial institution before he entered the S&L industry. Herman Beebe was the CEO of an insurance company despite his felony conviction. He funded the entry of many of the Texas control frauds. Beebe's S&L and bank network involved scores of control frauds. They formed the "daisy chains" that swapped bad loans to hide real losses and to manufacture fictional profits. A number of Beebe's brigade had been leaders in the "Texas Rent-a-Bank" scandal of the 1970s. Beebe and his ilk were serial control frauds. Some of them exercised control of S&Ls through "straw men." Two infamous S&L control frauds escaped conviction and entered new lines of business in which they were convicted of new frauds.

Fourth, Easterbrook and Fischel predict that the markets promptly will spot the most sophisticated control frauds—those that try to mimic honest firms. The markets do so because legitimate firms can always successfully distinguish themselves from control frauds.

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High-quality firms must take additional steps to convince investors of their quality. One traditional step is [to hire an outside auditor]. The accountant who certifies the books of many firms has a reputational interest—and thus a possible loss—much larger than the gains to be made from slipshod or false certification of a particular firm. Similarly, firms may sell their securities through investment bankers who inspect the firm's prospects, and put their money on the line in making representations to customers. The larger the auditor or investment banker relative to the size of an issuer, the more effective these methods of verification are. . . .

[T]he more stock managers hold, the more willing other investors will be to believe the firm's statements. Another action open to the firm is to issue debt, which (a) forces the managers to pay out the profits, and (b) if there are no profits, forces the firm into bankruptcy. (Easterbrook and Fischel 1991, 282)

I have explained that S&L control frauds were *routinely* able to get clean opinions from "Big Eight" auditors, and the current control frauds were routinely able to get them from the "Big Five" (which is why we are left with the "Big Four"). The top firms, including Arthur Andersen, were suborned in the current crisis despite having paid *hundreds of millions of dollars* in damages arising from their aid to S&L control frauds. Easterbrook and Fischel have assumed away "agency" issues. The audit *firm's* interest in its reputation may be paramount, but the firms pressure their partners to bring in clients. Control frauds are adept at conning and suborning people, and they "shop" for the weakest link. One weak audit partner can provide scores of clean opinions for various control frauds. This creates a Gresham's Law-style dynamic in which bad auditing can drive good auditing out of circulation.

S&L control frauds sold securities through prestigious investment banking firms. The current crop of control frauds had investment banking firms fighting for their business.

Control frauds exploit the naive belief that a controlling owner will not loot "his" firm. Stock ownership *increases* the CEO's incentive to engage in reactive control fraud because

fraud creates fictional income and increases stock prices.

S&L control frauds were infinitely leveraged (that is, they were insolvent at all times). The current crop of control frauds was also addicted to debt. Easterbrook and Fischel assume that the manager of a debt-ridden firm has only two alternatives: pay out the profits or place the firm in bankruptcy if there are no profits. But they have implicitly assumed the conclusion they wish to prove—that the manager of a highly leveraged firm will not be a control fraud. Control frauds know that there are other alternatives. They create record, albeit fictional, “profits,” and they cause the firm to *grow rapidly*. Creditors are happy to provide credit to highly profitable firms. Outstanding debt is refinanced or replaced by new lenders. Control frauds increase outstanding debt *because* they are defrauding the creditors as well as the shareholders and because a ponzi scheme must grow or die.

Fifth, Easterbrook and Fischel predict that regulators will be deeply inferior to markets in valuing firms: “Defects that undercut the performance of capital markets are an order of magnitude smaller than the difficulties besetting regulators” (1991, 20). They assert that this is true even during a bubble. “Although market prices do not match true value, nothing comes closer. However short of information professional investors may be, however much they fall under the sway of trends and bubbles, everyone *else’s* information and incentives are worse” (1991, 191, emphasis in original).

Recall that Fischel asserted that this was true in the context of S&Ls considered by the regulators to be control frauds, i.e., Lincoln Savings and CenTrust. He concluded that the regulators provided no useful information on the S&Ls’ true financial condition because his market model “perfectly” captured that condition. The regulators’ judgment, however, proved far superior.

Easterbrook and Fischel advance a false dichotomy. Regulators take advantage of the market judgment and the auditor’s

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findings and then *add* their own findings and judgment to the mix. Where there are distinctive patterns, for example, S&L control frauds, the regulators often discern the probable failures years in advance. (Unfortunately, the ability to discern is not the same as the ability to prove.) There are situations in which regulators have superior information and expertise and far fewer biases. The (upwardly) biased nature of investment-banking-firm stock analysts is now widely recognized. No private analyst is going to speculate publicly that a firm is following a pattern associated with past control frauds—the libel suits would ruin his employer. No major control fraud was successfully exposed by an analyst. There were occasional negative reports, but none caused the markets to effectively deny funds to a control fraud. Overwhelmingly, it is the regulators who shut down the control frauds even though, unlike market investors, the regulators are constrained by the due-process clause and cannot simply close a firm they “have a bad feeling about.”

If “professional [equity] investors” are “an order of magnitude” superior to the regulators even during a bubble, then they should be the ones who discern the control frauds first and cause the stock to crash by dumping their positions en masse. Their task is made far easier by the insiders. Control frauds typically sell stock prior to the collapse. Professional investors are supposed to realize that this is warning sign. Yes, stock values usually fall when the insiders sell. No, absent SEC action or the announcement of a restatement, they do not plummet in a manner that indicates that the professionals have spotted the control fraud and have sold their entire positions. Easterbrook and Fischel argue that the price of securities is determined by the actions of the professionals, not the general investing public (1991, 18). Where are the scores of major control frauds closed by collapsed share prices prior to the SEC’s taking action or new managers’ restating earnings? No S&L control fraud was ham-

mered into submission by professional equity investors prior to the regulators' taking action against the S&L.

Possible Reasons for Predictive Failure That Would Not Invalidate the Paradigm

Easterbrook and Fischel do not discuss Fischel's effort to apply their theory prospectively in the S&L debacle. Therefore, they do not present any potential defense of the theory in light of its predictive failures. Fischel, in his book *Payback* (1995), does not disclose his predictions about CenTrust and Lincoln Savings. He acknowledges that David Paul and Charles Keating were frauds, but claims the enormous losses were unrelated to fraud. He asserts that CenTrust was rendered insolvent by Milken's guilty plea to a string of felonies and the 1989 passage of the Financial Institution Reform, Recovery, and Enforcement Act (FIRREA), which he claims "wrecked the high-yield bond market" (Fischel 1995, 270). Similarly, Fischel asserts that Lincoln Savings was rendered insolvent by an unrelated recession in Arizona real estate values (1995, 218). An extended discussion of these assertions is beyond the scope of this paper, but Akerlof and Romer (1993), NCFIRRE (1993), and Black (1993a, 1993b) argue that the control frauds were important contributors to, not the victims of, the real estate and junk bond bubbles.

Moreover, federal examiners warned Keating in 1986 that he was helping to produce a ruinous glut of real estate. I wrote in early 1985 in a Bank Board memorandum that he was embarked on a disastrous course. Federal examiners warned both Keating and Paul in 1986 that their junk bond portfolios were badly diversified, were of extremely poor quality, and were being churned by Milken. There were large losses in both junk bond portfolios by late 1987. Keating and Paul responded by increasing these defects. If professional investors are an order of magnitude supe-

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rrior to regulators, then Lincoln Savings and CenTrust should have been reduced to penny stocks no later than year-end 1984.

Praxis from the Law-and-Economics Perspective

Easterbrook and Fischel's most important recommendation is that officers be encouraged by stock options to hold a substantial portion of their assets in the firm's stock. This proposal aligns the interests of the agents and principals.

Easterbrook and Fischel see no reason to worry about the efficacy of the SEC or potential agency problems at the top audit firms. They find fiduciary duties too restrictive. They are very skeptical that there is any useful role for lawsuits asserting breach of the fiduciary duty of care. They believe that too *few* usurpations of corporate opportunities are approved. They think insiders could take these opportunities for themselves, compensate the firm, and maximize overall wealth. They criticize other scholars who see usurpations as abusive and propose to restrict them (1991, 115, 140–42).

Praxis from the Control-Fraud Perspective

White-collar criminologists see total domination of a firm by an individual as maximizing the risk of control fraud. Stock options can be desirable, if they are tied to long-term performance. However, control-fraud theory predicts that abusive firms will not make such a tie. That belief is borne out by both the S&L debacle and the ongoing crisis.

Control-fraud theory sees the regulator as vital. A weak agency, such as the Bank Board in the early 1980s and the SEC since its grossly inadequate resources and its inadequate salaries pushed turnover to 30 percent, is incapable of detecting control fraud on a timely basis. Strong antifraud supervision helps both custom-

ers/investors and legitimate firms. Antifraud supervision increases market efficiency by reducing "lemon's market" problems.

White-collar criminologists believe that fiduciary duties are critical and need reinforcing. Criminologists know that all forms of crime are limited most effectively by social/ethical standards that are internalized by the individual. Fiduciary duties are the vital standards in the corporate governance context. Control frauds will not compensate firms for usurping corporate opportunities. Further, criminologists recognize the danger that the CEO will come to see the firm as "his" firm. This mind-set is dangerous, as the recent scandals have made clear. The next step for too many CEOs is to see the assets of the firm as "his." Strong fiduciary duties of loyalty reinforce the proper message that the firm's assets are not the officers' assets and help increase the chance that when the junior officer eventually becomes CEO, he will not view the firm as his own private piggy bank.

Conclusions

The dominant law-and-economics paradigm for the aspects of corporate governance relevant to control fraud predict behavior and suggest policy recommendations that are polar opposites to the predictions and reforms advanced by criminologists. The law-and-economics predictions have proved to be erroneous, and the policies they recommend have left us exposed to the current wave of control frauds. The conventional economic wisdom about the S&L debacle has proved that hindsight can be 20:200. We cannot afford a repeat of this galloping myopia.

For Further Reading

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