PART I

Duplicity and the Evolution of American Capitalism

They look upon fraud as a greater crime than theft, and therefore seldom fail to punish it with death; for they allege, that care and vigilance, with a very common understanding, may preserve a man's goods from thieves, but honesty has no defence against superior cunning; and, since it is necessary that there should be a perpetual intercourse of buying and selling, and dealing upon credit, where fraud is permitted and connived at, or has no law to punish it, the honest dealer is always undone, and the knave gets the advantage. I remember, when I was once interceding with the emperor for a criminal who had wronged his master of a great sum of money, which he had received by order and ran away with; and happening to tell his majesty, by way of extenuation, that it was only a breach of trust, the emperor thought it monstrous in me to offer as a defence the greatest aggravation of the crime; and truly I had little to say in return, farther than the common answer, that different nations had different customs; for, I confess, I was heartily ashamed.

Jonathan Swift on the laws and customs of Lilliput,
Gulliver's Travels (1726)

Corruption, embezzlement, fraud, these are all characteristics which exist everywhere. It is regrettably the way human nature functions, whether we like it or not. What successful economies do is keep it to a minimum. No one has ever eliminated any of that stuff.

Alan Greenspan, interview on Amy Goodman's *Democracy Now!*,
Sept. 24, 2007

CHAPTER ONE

The Enduring Dilemmas of Antifraud Regulation

In the late fall of 1894, an up-and-coming Midwesterner gained a sharp lesson about the growing reach of the United States government. For eight years, this former railroad station manager had nurtured a succession of mail-order businesses in Chicago and then Minneapolis. Through experiments with national print advertising and wholesale catalogue distribution, he discovered an instinctive knack for mail-order marketing. Cultivating a folksy style, he combined alluring descriptions of goods, aggressive expansion, sharp discounts, and all manner of promotional hullabaloo. Within a few years, he gained endorsements from leading banks and public officials across the Midwest. Farm families responded so vigorously to his engaging sales pitches that his firm struggled to fill the orders that cascaded in with every day's post. By December 1894, this ambitious thirty-one-year-old employed over one hundred persons and had moved his main operations back to Chicago, to be closer to the manufacturers whose goods he required to meet his obligations. Then, just two weeks before Christmas, the United States Post Office threatened this mercantile impresario with the equivalent of a commercial death sentence. On December 11, the postmaster general issued a fraud order against his firm. The recipient of this administrative notice was Richard W. Sears, the creator of the "Dream Books" that came to rest on hundreds of thousands of kitchen tables across rural America, and the driving force behind Sears, Roebuck & Co. in its first two decades.

After the issuance of this order, anyone sending the firm correspondence would receive it back with a mark of public shame affixed, like the one in Figure 1.1. The same fate befell any mail sent out by an individual or firm under a fraud order. This administrative sanction represented a far greater commercial peril than civil lawsuits alleging deceptive business practices, or even criminal fraud proceedings, for it threatened to destroy consumer confidence. A fraud order proclaimed that the American state had adjudged a firm's business practices to be illegitimate. For most mail-order concerns, such a declaration augured crippling losses even if customers' trust somehow survived the rebuke, because it halted commercial correspondence. As we shall see (and as Sears, Roebuck's extraordinary growth in the decades after December 1894 would

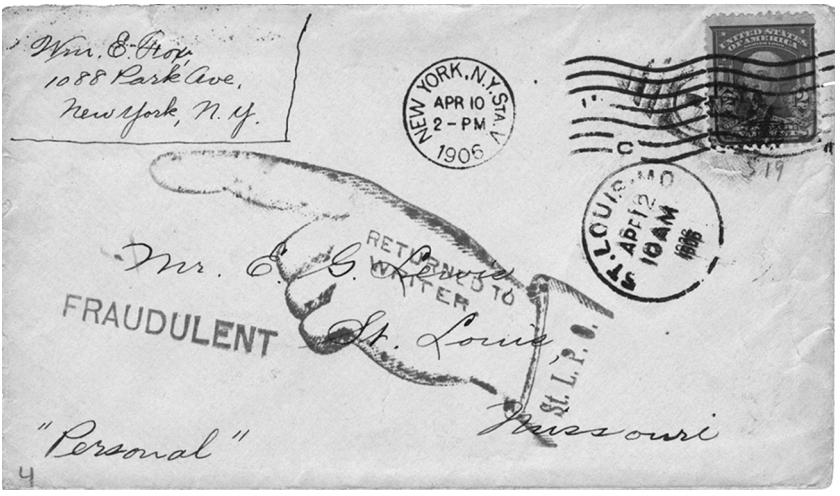

Figure 1.1: "FRAUDULENT" stamp on a 1906 letter returned to sender because of a postal fraud order. Reproduced with the permission of the Smithsonian National Postal Museum, Washington, DC.

suggest), Richard Sears found a way to make the fraud order go away. But his encounter with postal regulators reflected several interrelated problems that US businesses, policymakers, and citizens have confronted since the advent of modern capitalism—how should Americans define fraud, how much should they worry about it, and how should they structure institutional responses to it?

This book retraces how Americans wrestled with these questions for the better part of a century before Richard Sears's confrontation with the Post Office and for more than a hundred years after it. Throughout those two centuries, Americans of all socioeconomic groups had to navigate the challenges posed by lying promoters and cheating retailers. From generation to generation, the upward swings of the modern business cycle have encouraged investment scams and creative corporate accounting that press at legal and ethical bounds. After the bursting of economic bubbles, journalists, academics, and governmental officials dissect the preconditions for widespread malfeasance in the nation's commercial and financial firms. In periods of both boom and bust, some enterprises have tried to attract business through misleading or false claims.

Our own generation has confronted several acute episodes of commercial deceit. Millions of individuals have experienced identity theft. The internet has facilitated thousands of marketing scams. Few investors avoided losses from the accounting misrepresentations associated with a string of colossal corporate bankruptcies, such as those of Enron and WorldCom. During and after

the global financial meltdown of 2007–08, the business pages chronicled tales of prevarication and corruption at the heart of the American financial system. Deception became endemic within the chain of financing for the residential mortgage market. Manipulation became standard operating procedure in several markets, from the setting of benchmark interest and currency rates to commodities trading to the techniques of high-frequency stock trading.

Some economic deception is, of course, endemic to all modern capitalist societies. Throughout the world, business transactions depend on trust in far-flung counterparties across lengthening divides of space, beyond the social constraints of family, neighborhood, and religious community. The complexity of economic relations has created openings for those firms willing to take advantage of the enduring psychological vulnerabilities that behavioral economists have shown to be common to most investors and consumers. (Chapter Two of this book links the consistent psychological structure of economic deceit to these cognitive and emotional susceptibilities.) As a result, industrialized and industrializing societies on every continent have confronted the problem of how to handle financial and commercial misrepresentation.

Nonetheless, business fraud has occupied a large public footprint in the United States. Many of the world's most ambitious and expensive frauds have occurred in America; so too have some of the most far-reaching and innovative responses to financial and commercial deceit. From the American Revolution onward, the country's lionization of entrepreneurial freedom has given aid and comfort to the perpetrators of duplicitous business schemes. Enterprising risk-takers have enjoyed leeway from the arbiters of social norms, the makers of socioeconomic policy, and the practical operation of law, even when enthusiasm encouraged shading the truth or cutting legal corners.

The result has been latitude for processes of economic innovation in the United States, whether based on technological invention, new forms of organization, or the reimagination of the sorts of goods and services that might be offered for sale. But openness to innovation has always meant openness to creative deception. With every technological wonder, with every newfangled financial instrument or mode of organizing business ventures, with every beckoning new market, came bounteous prospects for dissemblers, operators, and downright swindlers. American popular culture, moreover, has retained a soft spot for charismatic grafters and oily-tongued salesmen, evincing admiration for their audacity, ingenuity, and capacity to land on their feet. Social commentators have often paired this appreciation with disapproval of the suckers who proved incapable of resisting pitches that were too good to be true.

And yet, the prevalence of economic deception has also always prompted anxieties about the dangers it posed to the health of American markets, about

the possibility that unchecked duplicity might unleash "self-destructive tendencies" in economic life.[1] These concerns have generated recurring antifraud campaigns within the American business community, the American state, and the quasi-public domains between the two. American elites, it turns out, have abhorred regulatory vacuums about business fraud, especially at moments in which its social and economic costs have prompted wider public anxieties about the legitimacy of capitalist institutions. Since the early twentieth century, such efforts have been amplified, and sometimes challenged, by antifraud initiatives with more popular roots.

The chapters that follow explore American ambivalence about economic deceit from the early nineteenth century to the present. Since the first years of the American Republic, fraud has posed enduring commercial, political, and legal conundrums. American business owners, investors, consumers, elected officials, jurists, public servants, lawyers, accountants, journalists, and social activists have all tried to resolve dilemmas about how to cope with the problems of commercial and financial diddling, and thus how to constitute key features of capitalist marketplaces. How much freedom should firms have in trying to lure investors to part with their savings, or entice consumers to purchase their goods or services? What sorts of redress should be available if businesses overstep prevailing boundaries, venturing too far away from expectations of candor in their assertions and promises? The perennial issue, whether through common-law adjudication, informal standard-setting, statutory reform, or administrative rule-making, has been how to differentiate illicit chicanery from enthusiastic puffery. Making this distinction has never been easy, either to set overarching policy or guide day-to-day administration and enforcement, as it raises contentious disputes about economic justice and the appropriate boundaries of commercial liberty.

Since the consolidation of independence during the War of 1812, the regulation of American business fraud has gone through four phases. After the two introductory chapters, the four remaining sections of this book grapple with each of these distinctive eras of policymaking and law. For each period, I explore prevailing views about the nature of fraud and the threats that it posed to the commonweal, the emergence of new modes of regulatory governance to cope with those threats, the impacts of those policies, and the critiques that they provoked, which shaped the historical transitions from one era of policymaking to the next.

Part II, "A Nineteenth-Century World of *Caveat Emptor*," explores the relationship between antifraud law and business culture from the early nineteenth century into the 1880s. Well after the Civil War, the practical law of business

fraud made it difficult to sustain many civil and criminal allegations of deceit. Reflecting a broader ethos of individualism and commercial permissiveness, this legal environment gave economic actors strong incentives to cast skeptical eyes on the firms and individuals with whom they conducted business. It also encouraged robust public discourse about prevalent misrepresentations and swindles, as journalists and editors found strong demand for coverage of business fraud and advice about how to avoid becoming a fraud victim.

Part III, "Professionalization, Moralism, and the Elite Assault on Deception," explores a series of legal and institutional challenges to *caveat emptor* that began in the mid-nineteenth century and accelerated in the Progressive era. Calls for greater regulatory paternalism came from many quarters—businessmen seeking to entrench their economic positions; professionals looking to solidify their social standing; social reformers and their political allies in both major parties, who argued that government had a duty to protect many social groups (the aged, the ill-educated and poor, recent immigrants, women, children) who were vulnerable to gross imposition; and individuals from all of these groups who, at some moments, viewed business fraud as a menace to economic and even social order. The resulting coalitions produced a cluster of antifraud initiatives targeting specific markets, such as commodities grading, the marketing of securities, mail-order retailing, and advertising, as well as growing organization of these efforts on a national basis.

Part IV, "The Call for Investor and Consumer Protection," examines the more ambitious and cohesive assaults on business fraud that policymakers fashioned during the New Deal and in the three decades following World War II. Triggered at first by the enormity of the Great Depression and the ensuing recalibration of government authority, these endeavors moved formal policy toward a stance of *caveat venditor*—let the seller beware—and relied more heavily on the national government. After 1960, a waxing consumer movement pushed elected officials to impose a yet wider array of disclosure requirements on businesses, and to expand the means by which disgruntled consumers and investors could seek redress through the legal system. Although this expanding web of antifraud regulation fell short of its architects' aspirations, these policies did circumscribe the scale and societal impact of business fraud.

Part V, "The Market Strikes Back," traces the partial resurgence of *caveat emptor* since the mid-1970s, as policymakers became convinced that economic growth required a much lighter regulatory touch. The resulting legal and bureaucratic shifts opened the door for a dramatic expansion in large-scale frauds, committed not just by marginal firms, but by some of the most important corporations in the global economy. It is possible that since the Global

Financial Crisis of 2008, antifraud regulation in the United States has entered a fifth phase, marked by revived skepticism about the reputational concerns of large corporations and renewed faith in the exercise of governmental power.

Throughout the book, I use fraud as a way to investigate the evolution of business-state relations and regulatory policy. Contemporary discussions of economic regulation often frame it in binary terms—there is "the market," on the one hand, and the state's "regulatory bureaucracy," on the other, with the latter constraining the former in the hopes of redressing some unfortunate by-product of market activity. But this framing mischaracterizes institutional realities. The efforts of nineteenth- and twentieth-century Americans to deal with the issue of economic misrepresentation show how markets and regulation have always been interconnected. Capitalist production, finance, and exchange depend on complex webs of regulatory policy. From the earliest phases of modern capitalism, regulation has defined property rights and guided contractual relationships by furnishing legal defaults. It has created modes of governance and stipulated social hierarchies for economic units—from the family farm and plantation to the sole proprietorship, partnership, corporation, and holding company, to the cooperative and the labor union. It has set standards for available products and services and demarcated the range of permissible business practices. Law and administrative regulation, in other words, have never stood apart from markets. Instead, they have always constituted them.[2]

In order to make sense of how prevailing antifraud policies have shaped American business, and how those policies have changed, in part because of pressures from business and other groups, it helps to think in terms of "regulatory ecology." At any point in time, that ecology includes many antifraud institutions. Many of these entities—legislatures, courts, regulatory agencies—operate inside government, whether at the local, state, or national level. But in the United States, a panoply of intermediary institutions have also helped to formulate and implement regulatory policy, including nongovernmental organizations (NGOs), industry trade associations, and the press. Self-regulatory organizations (SROs, in the parlance of management scholars and political scientists) have often served on the front lines of American efforts to promote truthful commercial speech and to identify and sanction those firms who stray from prevailing standards. The Better Business Bureaus stand out in this regard from their creation in the early twentieth century, and so receive extensive attention in this narrative.

In any given era, one must consider the missions, interests, capacities, and tensions that characterized all of these institutions, whether they resided inside, outside, or alongside the edges of "the state." One has to remain alert to the emergence of new institutions and the possibility that older ones may

shift focus, both because of novel pressures and eroding imperatives. And one has to trace the *interactions* among this evolving set of regulatory players. This last task calls for close attention to moments in which officials jockeyed for jurisdictional control and competed to shape policy goals, strategies, and tactics. But it also requires analysis of the periodic attempts to coordinate legal reforms, build enforcement networks, and move or respond to wider public sentiment.[3]

Attempts to police business fraud tell us much about the wider history of American business regulation. From colonial settlement onward, efforts to ensure candor in commercial speech have occupied a key element of the nation's regulatory architecture, at first through the medium of patronage-based inspection regimes for exported commodities. Since the mid-nineteenth century, antifraud initiatives have often emerged at the leading edge of regulatory innovation. During the postbellum decades, antideception campaigns prompted the states and the federal government to develop techniques of modern administrative governance, in contexts that ranged from fertilizer certification to mail fraud law enforcement. Each of the resulting antifraud bureaucracies received broad delegations of power from legislatures and depended on forms of technocratic expertise. The Progressive era, the New Deal, and the Great Society spawned numerous regulatory experiments aimed at curbing economic deceit. Almost every one of these initiatives produced not only powerful new administrative agencies within the state, but also new private and quasi-public institutions devoted to fighting business fraud. The long-term performance of these institutions speaks to the enduring role of economic interests in shaping regulatory policymaking and administration. But it also demonstrates the power of ideas to influence regulatory strategy, as well as the capacity of professionalism and public-spiritedness to guide decision-making.

In part because attempts to combat fraud spawned new forms of regulatory authority and novel enforcement tactics, the arena of fraud fighting also exposed a crucial tension in American legal culture concerning the requirements of due process. The most effective modes of enforcement involved techniques of moral suasion and swift mechanisms of regulatory redress—the "fraud order" that denied Richard Sears and his company access to the US mails, or a "cease and desist" order from the Federal Trade Commission, or a declaration by a local Better Business Bureau that a company's advertising was "Not in the Public Interest." The firms whose connections, networks, and behavior did not measure up to such scrutiny often took issue with the lack of procedural protections associated with antifraud regulation. Their complaints drew sympathetic responses from many legal elites committed to Constitu-

tional traditions of divided and accountable authority, and often culminated in the formalization of procedure. By slowing down antifraud enforcers, however, the turn to proceduralism muddied efforts to combat the prevaricators and outright cheats of the business world.

Business fraud has cut a wide enough swath through the American past that no volume with a two-century-long narrative arc could hope to be comprehensive, much less exhaustive. One key issue concerns the types of fraud under consideration, a second the evolving social and legal meanings of "fraud," a third the challenges of braiding dozens of particular stories of fraud and specific attempts to regulate it into an overarching analytical narrative. A few words are in order about each of these analytical choices.

My focus is on regulatory responses to fraud committed *by* business firms against external counterparties—suppliers, creditors, customers, and investors. Readers will find little discussion of fraud committed by consumers against businesses, as when forgers passed bad checks or policyholders cheated insurance companies, or about fraud committed by individuals against the government, whether through hiding income from the tax man or lying to gain access to public programs. I also sidestep the rich history of embezzlement committed by employees against their employers, whether public or private, as well as deceptions and gross impositions perpetrated by firms against their workers, such as the short-weighting of coal cars by nineteenth-century mining companies or the attempts of twenty-first-century retailing giants to avoid overtime payments to employees. Furthermore, I steer clear of most of the classic swindles directed at individuals by con artists, such as bunco steering (directing marks to a rigged game of chance) or the many types of advanced fee scams (promises of inheritances from long-lost relatives or other implausible tales that use the prospect of some unexpected windfall into making up-front payments).[4]

In terms of sociological theory, the book offers historical analysis of "organizational fraud"—fraud committed on behalf of firms against others—rather than "occupational fraud"—white-collar crime directed at businesses themselves by their employees. This distinction is far from airtight. The looting of firm assets by business managers, for example, has major collateral impacts on firm counterparties. Known among legal scholars as "control fraud," this form of managerial duplicity has been at the heart of significant episodes that do receive attention here.[5] I concentrate on organizational fraud because it exposes instructive historical conflicts within the business community. On the issue of fraud against businesses by consumers, or that of employees finding some new way to stick their hands into corporate tills, the business establishment has coalesced around the need for stern regulatory constraints and sub-

stantial investment in enforcement mechanisms. In the case of alleged deception perpetrated against workers, the business establishment has fought against legal reforms. By contrast, with organizational fraud, representatives of business have split into factions with clashing views about appropriate regulatory policies.

Several linguistic complications swirl about the phenomenon of business fraud. One can think of words such as "fraud" and "swindle" in either a colloquial or a technical sense. In the language of ordinary conversation and popular culture, to call a person or a business a "fraud" is, and has been for centuries, to make an accusation of ill-treatment or injustice, founded on deceit. A swindler pretends to be one thing, or to sell one thing, but is someone very different, or vends something of lesser or even no quality. In Noah Webster's 1817 *A Dictionary of the English Language*, "fraud" meant "deception or breach of trust with a view to impair the rights of another, a dishonest transaction"; to be "fraudulent" was to be "deceitful, trickish"; to "swindle" was to "cheat or defraud grossly or with deliberate artifice"; and a "swindler" was "one who lives by defrauding."[6] These meanings have retained their salience over the subsequent two centuries, joined by a slew of related Americanisms. Everyday language about business chicanery has often served as a rhetorical club. Disaffected consumers fulminated about encountering "a racket" as a way to bristle at an unsatisfactory purchase. Embattled business owners invoked the language of duplicity as a means of launching broadsides at nettlesome competitors. Alongside such elastic linguistic usages, however, one finds the much more circumscribed idioms and usages of law.

Fraud has an ancient pedigree in Anglo-American jurisprudence. Through centuries of cases at common law and equity, as well as countless legislative statutes, fraud acquired precise technical meanings. An allegation of "fraud" occurred in specific legal contests. It might be the basis for a civil suit that asked for damages: "so and so has defrauded me in commerce, and must therefore redress this wrong through monetary damages." It could constitute the defense of a litigant who sought to stymie enforcement of apparent contractual obligations: "I did sign that promissory note, but only because of illegal misrepresentations about the land that I purchased, and so I should not have to pay." It might be the substance of a criminal indictment: "Peter Funk is charged with one felony count of obtaining dry goods through false pretenses."

Each of these allegations required exacting standards of proof. To substantiate a claim of fraud, a litigant or prosecutor had to demonstrate several distinct propositions about economic behavior. At common law, and according to the requirements of many fraud ordinances and statutes, a showing of misrepresentation constituted a necessary element to such a case, but not a suffi-

cient one. The legal demonstration of fraud also required evidence that the falsehood concerned existing facts, rather than predictions about the future; that the party guilty of misrepresentation knew the claim was false and intended to mislead; that the other party in the transaction believed the false claim and then relied on it; and that the other party, further, had exercised appropriate diligence in assessing the false claim's plausibility. At each link of this logical chain lay pitfalls for those who sought to prove an allegation of economic deceit. Perhaps the teller of an economic tall tale believed his own pitch. Or maybe a seller's false statement was such a whopper that a judge and jury could not believe anyone with half a brain could be taken in by it. Or perchance the buyer did not avail himself of easy steps to check the seller's reputation or the veracity of his statements. As in so many other legal matters, standards concerning fraud created uncertainties that skilled lawyers could exploit.

From the early nineteenth century up to the present, popular ways of talking about economic duplicity have often diverged from technical concepts governing legal consideration of allegedly fraudulent behavior. At times, however, legal concepts have shaped the beliefs and norms of ordinary citizens. I try to remain alert to the crosscutting influences of popular and legal talk about fraud, as well as the moments when reformers attempted to mobilize more popular notions to reform legal standards and regulatory architecture.

Readers of this history are going to encounter many individual stories of business fraud, a wide array of measures to combat it through retrospective mechanisms of justice or prospective modes of regulation, and varied strategic responses to those attempts. Along the way, they will meet scores of dodgy businesses—both the worst fly-by-nighters and some pillars of the establishment—and a like number of officials in prosecutors' offices, government agencies, SROs, and consumer organizations. This approach runs the risk of eliciting frustration. Brief examinations of fraud incidents may prompt a desire for more extensive exploration of personal motivations and societal impacts. Almost every previous history of business fraud takes the opposite tack, burrowing into the details of a specific episode in one market, one community, one business, or the life of one ill-fated entrepreneur, teasing out the complex personalities of central figures in a confined narrative. That approach lends itself to compelling storytelling and clean plotlines.[7] But it obscures longer-term trends and institutional development. My hope is that readers will see how all the capsule stories build on each other, suggesting enduring patterns, pointing to pivotal inflection points, and evoking broader implications for contemporary policymaking.

For more than two hundred years, Americans have struggled with how to balance the impulse to foster entrepreneurial innovation against the felt need to attack the most damaging commercial and financial dissembling. No matter how state and nongovernmental institutions have set about corralling the perpetrators of business frauds, those figures have proved to be elusive quarries, both as objects of regulatory policymaking and subjects of regulatory discipline. No matter how insistent skeptics of heightened regulatory authority have been in arguing that antifraud regulations placed excessive burdens on legitimate firms, new coalitions have appeared to demand regulatory action. The resulting patterns of rule-making, public education, and regulatory enforcement offer decision-makers instructive guides about how to foster the social confidence on which complex modern economies depend.

We will soon dig into American battles against economic misrepresentation and the worst forms of swindling, from the age of P. T. Barnum, the peerless promoter of nineteenth-century humbug, to that of Bernard Madoff, the post-1990 hedge-fund wizard. Along the way, we will have the chance to explore fundamental transformations in the institutional bases of American capitalism. First, however, the mental frames of deceit in modern marketplaces bear some consideration. Economic actors, it turns out, at least some of the time have an "error-prone, suggestible, and fallible nature."[8] An appreciation for these cognitive vulnerabilities, and how some businesses have taken advantage of them through commercial truth-stretching and more blatant frauds, provides crucial context for the modern struggles to prevent such behaviors or blunt their corrosive impacts.