Honors United States History
Mr. Yamron

Secondary Source Reading Assignment “Durant's Big Scam”

Directions: Read attached article “Durant’s Big Scam” and answer the questions below.

1. What two scandals are compared in the article?

2. The Crédit Mobilier scandal was linked to what government building project?

3. Who was Thomas Durant? Where did he think the real money was to be made?

4. What plan did Durant and his promoters come up with? How much money did they make from this plan? What happened to Union Pacific and its investors?

5. What was the idea behind the schemes at Crédit Mobilier and Enron?

6. What basic crime was committed in Crédit Mobilier and Enron?

7. Who were the big losers?

8. What role did Oakes Ames play in the Crédit Mobilier scandal? What punishment did Ames and others involved in the Crédit Mobilier scandal receive?
Durant's Big Scam

In this January 2003 essay, New Yorker financial columnist James Surowiecki investigates the Crédit Mobilier scandal behind the financing of the Union Pacific railroad, and compares it to the Enron scandal nearly a century and a half later.

As the 1990s came to an end, journalists and pundits began suggesting that we were living in a "new Gilded Age." At the time, the phrase conjured up the culture of the boom, replete with titans of industry, slick-talking hucksters, and the excesses of the nouveaux riche. What few suspected, though, was that the late nineties would prove to be a new Gilded Age in another, and more important, respect: the pervasiveness of business corruption and financial chicanery. Just as many of the great fortunes of the late nineteenth century were the product of accounting hocus-pocus, stock-market manipulation, and outright fraud, so too many of the supposed success stories of the late twentieth century were revealed to be little more than paper empires. From a certain angle, in fact, the two eras look almost eerily similar, especially when it comes to their quintessential scandals: the Crédit Mobilier scandal of the 1860s and the Enron scandal of the past few years.

An Attractive Deal

The Crédit Mobilier scam was born out of a simple reality: in the 1860s, the U.S. government wanted a transcontinental railroad more than investors did. While a railroad across the Rockies had a glorious air to it, the project also carried an enormous amount of risk, and risk is generally something investors prefer to avoid. As a result, when Congress chartered the two companies -- the Union Pacific and the Central Pacific -- that would build the transcontinental railroad toward each other, it had to make the deal as attractive as possible. (Hundreds of thousands of dollars in bribes, by all indications, also had something to do with the legislators' largesse.) By the time construction on the Union Pacific really got going (after an initial attempt quickly ground to a halt), the Union Pacific had been given huge land grants for each mile it completed, mineral rights on the land, and hefty subsidies for construction. The result was that what had previously looked a fool's errand suddenly became a seemingly sure thing.
Paying Themselves to Build It

Not sure enough for the men who controlled the Union Pacific, though. There was still the chance, after all, that, even with the subsidies and land grants, running the railroad might not be a profitable endeavor. In fact, Thomas Durant, who was vice-president of the U.P. in its early days, was convinced that all the real money to be made was in constructing the road, not operating it. So Durant and his fellow promoters they came up with a seemingly foolproof plan: instead of paying outside contractors to build the railroad, the U.P.'s biggest stockholders would just pay themselves. They took over an ephemeral construction company, the Crédit Mobilier of America, which just happened to win the contract to build 667 miles of Union Pacific railroad. The Crédit Mobilier charged the railroad tens of millions of dollars more than the actual cost of construction, all of which went right into the pockets of the men who were supposedly running the Union Pacific. By the time they were done, they'd cleared at least $23 million (and perhaps considerably more), and the U.P. was on the verge of bankruptcy. Everyone who had invested in the railroad but not the construction company found themselves with nearly worthless securities on their hands.

The Enron Scheme

A century and a half later, executives at the energy company Enron took a similar opportunity to enrich themselves. The schemes at Enron were far more complex than those at the Crédit Mobilier, but the idea was the same: funnel money from the company to outside businesses controlled by company executives. In Enron's case, these outside businesses were small partnerships that bore exotic names like Jedi, Chewco, and Raptor. The partnerships were created so Enron could offload risk and debt and hide losses, making its financial statements look better. The partnerships were supposed to be independent -- like the Crédit Mobilier -- but they were really just façades, with many of them actually run by Enron executives. The executives who set up and ran the partnerships -- like the company's C.F.O., Andy Fastow -- walked away with tens of millions of dollars, and in some cases earned 1,000% returns on their investments in the space of months. At the same time, as all these backroom deals were making the company look financially stronger than it actually was, the company's top brass was selling hundreds of millions of dollars in Enron stock. When the news of the company's dubious accounting and questionable finances broke, Enron's stock price went into a death spiral, dragging the company along with it. Within a few months, it was bankrupt, leaving the company's shareholders with nothing. The top executives, of course, all walked away with their fortunes intact.

Lining Their Own Pockets

The stories of the Crédit Mobilier and Enron are similar because both involve the same basic crime: self-dealing. Self-dealing is what economists call it when the people running companies look to line their own pockets instead of
those of the companies' owners, and it's a problem that capitalist economies have a hard time avoiding. That's because the people who own companies (the shareholders) are not the people who run companies (the managers), and supervising managers to make sure they're following the straight and narrow is not an easy task. The shareholders and bondholders of the Union Pacific trusted Thomas Durant and Oakes Ames (the congressman who eventually pushed Durant aside at the top of the railroad and the Crédit Mobilier) to do their best to make money for the railroad. But Durant and Ames were more interested in doing their best to make money for themselves, even at the expense of the U.P. In the same way, prosecutors charge, when Andy Fastow set up Enron's outside partnerships, he wasn't looking for the best deal for Enron shareholders. He was looking for the best deal for himself.

History Repeats Itself

The remarkable thing, of course, is that Enron happened despite the safeguards against corruption that have been put in place, in no small part because of scandals like the Crédit Mobilier. When Ames pulled off his scams, after all, America's capital markets were still relatively immature, shareholder rights were ill-defined, and there were no federal regulators. For that matter, Wall Street as we know it -- theoretically independent firms providing outside counsel to investors -- barely existed. So it's perhaps not too surprising that the swindle was so easy. In the case of Enron, though, none of these excuses apply. Instead, the system simply failed, as every check on executive misconduct -- accountants, Wall Street analysts, lawyers, regulators -- either turned a blind eye or actively participated in the schemes. In a sense, it was as if all the lessons that the scandals of the nineteenth century had taught us had to be learned all over again.

The Big Losers

The bitterest lessons, of course, were learned by the investors who lost billions as the value of Enron's stock disappeared almost overnight. One imagines that they felt much the same way the Union Pacific investors and government bondholders did when they realized that almost half of the company's capital had been pocketed by the Crédit Mobilier crowd. In both cases, greed overcame skepticism, and the necessary rule of caveat emptor was abandoned because of the promise of outsized profits. The flood of government money and free land that the Union Pacific was given was much the same played the same role as the seemingly infinite wealth that the 1990s stock-market bubble promised. As a general rule of financial history, fraud and scandal inevitably accompany financial manias, and what the New Economy was to the new Gilded Age the railroad was to the old.

Punishing the Perpetrators

There are, of course, important differences between the two stories. Although there was a lot of talk a year ago about Enron as a political scandal,
the reality is that its impact has been confined mainly to the business pages. Oakes Ames was a congressman who corrupted many of his colleagues by handing out shares in the Crédit Mobilier to forestall an investigation into the company. But Enron's efforts to use political influence to save itself failed. In the same vein, although Ames was censured by Congress, no one in the Crédit Mobilier case was ever prosecuted. In the case of Enron, the accounting firm Arthur Andersen has already been effectively put out of business after being convicted of obstruction of justice for its role in the scandal, Andy Fastow has been indicted on 78 counts of fraud, and an investigation into what the people at the top of the company knew is still continuing. We may not have made much progress in learning how to stop self-dealing, but perhaps we've gotten a little better at punishing it.

Scandals in Retrospect

There is, though, an even more important difference which reflects less well on our own time. Although the founders of the Union Pacific were undoubtedly crooks and self-dealers who played fast and loose with government money and pocketed millions, all their chicanery did not stop them from building a railroad across the country. Seven years after the U.P. was chartered, after all, the final spike in the U.P.'s road was laid. In fact, while scandals like the Crédit Mobilier were endemic during the Gilded Age (Mark Twain's novel of the same name is about little else), the railways that were built during that time transformed the U.S. economy. In Enron's case, once it went bankrupt, it became difficult to see what its founders and managers had really built. Enron was supposedly the new-model energy company, light on hard assets, able to trade everything from electricity to bandwidth, a corporation that owned little but its intellectual property. And so it has left almost no trace behind, nothing but empty trading floors and used Aeron chairs. A century after the Crédit Mobilier news broke, people were still riding trains on the U.P. line. A century from now, all that will be left of Enron will be a few lines in an old business history book.