

The Levers Are Not Connected: Strategic Management in the Last Days

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The standard theory of strategic management holds that senior executives, acting under the broad governance of a board of directors, set directions and allocate resources to achieve company goals. Books detailing the last days of a number of large companies make it clear that this theory does not describe reality in some cases. In the last weeks or days of these companies, very vigorous actions by boards of directors, senior managers, and outside advisors failed to change the outcome in the direction desired by the companies involved. This paper examines some of these descriptions of end-stage efforts at four companies that went bankrupt or were purchased and ceased to exist as independent entities. Common themes are explored, and topics for further study to improve understanding of this phenomenon are identified.

INTRODUCTION

Most college business majors, whether in undergraduate or MBA programs, take a capstone course in business strategy during their last semester. Widely used textbooks in the field are quite similar in their theory development. Two basic views are combined to explain what strategy is and how it is developed and implemented. The industrial organization economics viewpoint, particularly as developed by Michael Porter, maintains that industry forces are dominant in determining the success or failure of a company's strategy. In this view, the individual firm is something of a black box, and most theoretic development is at the level of the industry, with some attention also given to macro-environmental forces such as demographic and regulatory concerns that affect multiple industries. The resource-based view of strategy concentrates on the individual company. This view sees a company as a bundle of resources, and concerns itself primarily with analysis and improvement of this resource bundle as it affects competition with other firms.

Both views of strategy maintain that senior executives make decisions, set plans, and allocate resources to attain company goals in competition with other companies offering similar goods and services to customers. For publicly owned companies, shareholders who own the stock are the ultimate source of authority. Because of their wide dispersion and lack of detailed knowledge of the company, shareholders elect a board of directors to represent them in overseeing the managers who run the company from day to day. The chief executive officer is chosen by the board of directors, and while many CEO's have employment contracts, they ultimately serve at the pleasure of the directors.

Other senior managers are employed, depending on the size of the company, to assist in setting the strategic direction of the company, modifying it as necessary, and allocating and overseeing the resources needed to execute the company's strategy. Once set, strategy is modified as events demand. One famous definition of strategy states that it is "a pattern in a stream of decisions" (Mintzberg 1978). Only the most

far-reaching and significant executive decisions are normally submitted to the board of directors for approval. Many other decisions made by senior executives alone or in consultation with each other are executed without further review by anyone. Thus, senior managers have a good deal of power to act on behalf of the firm and its owners, and are evaluated on the results of these actions.

A number of recent books describing specific companies and events involved in the financial crisis that began in 2007 describe the actions of executives and boards of directors in the last days and weeks before companies failed. Some books describing similar situations with earlier company failures also describe such actions in the period just before failure. Taken together, these books can be seen as extended case studies detailing events inside the failing companies in their last days or weeks.

TABLE 1
BOOKS USED AS SOURCES

Author	Title	Date	Principal Subject
Bookstaber, R.	A Demon of Our Own Design	2007	LTCM; hedge funds
Cohan, W.	House of Cards	2009	Bear Stearns
Eichenwald, K.	Conspiracy of Fools	2005	Enron
Kelly, K.	Street Fighters	2009	Bear Stearns
Lewis, M.	Panic	2009	Financial Crisis
Lowenstein, R.	When Genius Failed	2000	LTCM
McDonald, L.	A Colossal Failure of Common Sense	2009	Lehman Brothers
McLean, B. & Elkin, P.	The Smartest Guys in the Room	2003	Enron
Muolo, P. & Padilla, M.	Chain of Blame	2008	Financial Crisis
Partnoy, F.	F.I.A.S.C.O.	2009	Derivatives; Financial Crisis
Smith, R. & Emshwiller, J.	24 Days	2003	Enron
Sorkin, A.R.	Too Big To Fail	2009	Financial Crisis
Tett, G.	Fool's Gold	2009	Financial Crisis
Wessel, D.	In Fed We Trust	2009	Financial Crisis
Zandi, M.	Financial Shock	2009	Financial Crisis

While there are thousands of case studies available for strategy students, relatively few describe failing companies. Obviously, executives are not anxious to have researchers or reporters document just how they brought their companies to oblivion. The books referenced in this paper were mostly written by

reporters. News reporters have a different method and approach to documenting their stories. They often have extensive contacts within a company, and have followed the company's actions and results for extended periods of time. If they mostly cover one industry, they also have contacts among the company's competitors, and in some cases among industry analysts and regulators. The authors of these books are also careful to state their sources, and their policies for verifying quotes or what a participant is said to have been thinking. The typical business case used in strategy classes in business schools is written either by a professor or by students under a professor's guidance. Such authors do not have the same level of contacts in a company as do reporters who have followed the same company and industry for years. They also do not have the time to interview many individuals, often more than once, and to do extensive research on a single company.

This is an exploratory study, and the sample chosen is one of convenience. The variety of books published on the financial crisis that began in 2007 provided the stimulus for the study, and earlier books with similar themes on other companies in their last days were added. All of the companies described in the study were in the financial services industry in one sense or another. Table 2 lists these companies, their primary businesses, and the year of their terminal crisis.

TABLE 2
COMPANIES INVOLVED IN THE STUDY

Company Name	Type of Business	Year of Crisis
Long Term Capital Management	Hedge Fund	1998
Enron	Energy Trading Company	2001
Bear Stearns	Investment Bank	2008
Lehman Brothers	Investment Bank	2008

ACTIONS OF EXECUTIVE MANAGERS

As documented in the books used for this study, the actions of CEO's and their immediate subordinates in their companies' final days present a picture of intense activity. These senior executives were, with one exception, physically present in their offices almost around the clock for the last few days before company failure. Several of the books describe all-night sessions, with take-out food and coffee provided. Executives telephoned dozens of individuals representing potential buyers or investors in their firms, regulators, and government officials. They met personally with other senior executives, with their boards of directors (sometimes by phone), with groups of lower level managers, and with attorneys. They did very little reading of reports or other documents or data.

In the end, their actions did not change outcomes. It was as if they pushed and pulled all the levers at their command, but the levers were disconnected. Decisions that might have saved their firms were made by potential investors or buyers, by regulators, and by customers. The inability of executives to influence these decisions positively is striking. In each case the executives were unable to slow or stop the outflow of funds, or to generate a sufficient balancing inflow of funds. They knew what needed to be done, they exerted great efforts to accomplish the necessary tasks, but they failed. The fact that this same pattern was observed in a number of large firms raises the question of whether these senior executives performed badly or whether they were operating in an environment where their performance was irrelevant. To the degree that the latter proves to be the case, the standard theories of business strategy did not apply in this

special set of cases, and that fact raises some interesting questions. In the following sections we examine some of the particulars of each case as narrated in the books that form the basis of this study.

LONG TERM CAPITAL MANAGEMENT

Well before the financial crisis that began in 2007, the failure of a major hedge fund threatened the United States financial system, and spurred a bail-out by private banks brokered by the U.S. Federal Reserve Bank. The outcome was the temporary survival of Long Term Capital Management (LTCM) under new control, and its subsequent demise. The primary source for the information in this section is a book titled When Genius Failed: The Rise and Fall of Long-Term Capital Management (Lowenstein, 2000). Its author was a reporter and columnist for the Wall Street Journal for many years.

LTCM was a bond-trading firm, a private partnership employing fewer than two hundred people and managing money for only one hundred investors in the Fall of 1998, with assets in the billions of dollars (Lowenstein, 2000 p. xviii). Among the principal managers of the fund was John Meriwether, previously a senior executive at Salomon Brothers. In 1991 he had been forced to resign from Salomon Brothers after one of his subordinates was found to have made an illegal bid to the U.S. Treasury. He subsequently resolved a civil complaint filed by the SEC without admitting or denying guilt, but agreeing to a three-month suspension from the securities industry and a fifty thousand dollar fine (Lowenstein, 2000 p. 21). Other principals of the firm included academicians Robert Merton and Myron Scholes, who shared the 1997 Nobel Prize for Economics.

In the four years after the fund's inception, the value of a dollar invested from the start appreciated by approximately 400%. The fund made a very large number of investments, mostly in derivatives of various types. The investment policy of the fund was guided by complex mathematical models and relied on very high leverage. For much of the fund's life, its assets amounted to more than thirty times its capital. This means that every dollar invested in the fund by its customers was used to borrow roughly thirty dollars for investment purposes. The mathematics involved far exceed the scope of this paper, but the degree of leverage was unusual for even a hedge fund, and would have been prohibited by laws and regulations to a commercial bank.

When a number of economic events combined to produce losses for the fund starting in Spring 1998, the losses reduced the amount of capital available to the fund in a dramatic way because so much of the fund's total obligations were backed by debt. As the losses accelerated and the available amount of capital decreased rapidly, the possibility of bankruptcy became real and the most important strategic objective of the firm became the raising of additional capital. The partners, still confident in their mathematical models, were faced with a situation that none of the models had predicted. Their conclusion was that the situation causing their losses was a freak occurrence, an anomaly that would quickly revert to the norm which had produced the previous four years' profits. They were convinced that, if they could raise additional capital, they could wait out the anomalous conditions and return to their former profitable condition once the temporary problems had passed.

As losses rapidly increased and the prospect of bankruptcy became more likely, the senior partners contacted the few outside investors capable of providing the amount of funds immediately needed. While Warren Buffet and Goldman Sachs expressed some interest, no individual or firm finally shared the optimistic view of LTCM's management. The nature and size of their investments proved surprising to each potential investor who reviewed their books, and appeared to each of the potential investors not to be worth the risk of substantial capital. Other investment banks and hedge funds, with investment positions similar to those of LTCM but on a much smaller scale, began to sell in order to reduce or eliminate those positions. The management of LTCM was convinced that these banks and hedge funds were deliberately taking advantage of LTCM's weakened capital position. However, as Lowenstein notes,

...the simple fact is that by mid-September, the Wall Street banks were not principally worried about Long-Term Capital—they were worried about themselves. Given that every bank had many of the same trades as Long-Term, exiting from their positions was a matter of self-preservation.

Goldman in particular was steeped in losing trades and, with its stock offering just weeks away, was desperate to cut its losses (Lowenstein, p. 174).

By this point, as the end approached, LTCM's management knew what was needed (large infusions of capital) but did not share or understand the view of those who could invest such capital that their business model, and indeed their business, was a failure. They carefully monitored each day's financial results, contacted potential investors and presented their case, and conferred with each other very frequently. Bear Stearns, an investment bank, executed the voluminous trades that LTCM made each day. By contract, LTCM was required to keep a minimum balance of \$500 million at Bear Stearns to assure adequate liquidity for the massive dollar volumes traded each day. As LTCM's actual capital diminished rapidly the amount on deposit at Bear Stearns constituted a larger and larger portion of their total capital. If Bear Stearns were to stop trading on LTCM's behalf, bankruptcy would occur immediately.

One of the many challenges for top management was to maintain the balance needed for trading; another was to preserve the company's dwindling capital and apply it to the best strategic use. These two challenges obviously pulled in different directions, but management's ability to resolve the conflict was negated by their contractual obligation to Bear Stearns.

As it became clear to both competitors and regulators that LTCM was rapidly approaching bankruptcy, and that such an event would have serious consequences for the entire U.S. (and perhaps global) financial system, pressure increased for some outside action to prevent a sudden bankruptcy. At the invitation of the chairman of the New York Federal Reserve Bank, representatives from twenty of the largest financial institutions gathered in an emergency meeting at the New York Federal Reserve Bank. After several days of discussion, disagreement and bargaining, a consortium of banks provided a total of \$3.65 billion dollars in fresh capital to LTCM and effectively became its new owners. During all of the negotiations that preceded this agreement, LTCM's managers were passive. They were able to make minor changes to the agreement, but essentially gave up control of their company and saw their previously huge personal investments in LTCM reduced to almost nothing.

In early 2000, Long-Term Capital Management was liquidated. The consortium of banks that had provide the capital infusion was repaid. John Meriwether and some of the other partners subsequently started a new hedge fund, JWM Partners, which suffered heavy losses in the credit crisis of 2007-2009.

ENRON

At the end of 2000 Enron was the seventh largest company in the United States measured by revenue. It had been chosen as America's most innovative company by Fortune magazine for six consecutive years. In August 2000 Enron's stock traded at \$90 a share, and in August 2001, after the bursting of the technology stock bubble, it traded at \$42. On December 2, 2001 Enron filed for Chapter 11 bankruptcy.

The primary source of information for this section is 24 Days (Smith & Emshwiller), a book by two Wall Street Journal reporters. At the time of the events described, Rebecca Smith was the Wall Street Journal's national energy reporter, and John Emshwiller reported on white collar crime. Their list of sources inside and outside of Enron is extensive. Other sources of information on the events described are Conspiracy of Fools (Eichenwald, 2005) and The Smartest Guys in the Room (McLean & Elkind, 2004).

In 2001 Enron was a very large trading company, making trades and in some cases markets in such diverse products as gas and electricity, space on broadband networks, and insurance against bad weather. The principal senior managers were Ken Lay, its long-time CEO, Jeff Skilling, who served as President and briefly as CEO, and Andy Fastow, its Chief Financial Officer. Lay was convicted in Federal Court, but died before his appeal could be heard. Skilling and Fastow are currently in Federal prisons, serving lengthy sentences for Enron-related crimes.

For several years before its demise, Enron employed very complex accounting methods to hide its true financial status from investors and regulators. When questions were raised in the business press in the Fall of 2001 regarding Enron's financial status and reporting, its stock price began to fall rapidly. On August 14, 2001 Skilling announced his resignation as CEO, a position he had held for only a few months.

Although the announcement and subsequent interviews with both Skilling and Lay stated that the resignation was for purely personal reasons and had nothing to do with Enron's performance or prospects, it resulted in heightened scrutiny of Enron in the press, and heightened concern on the part of investors and regulators.

Throughout the Fall of 2001 the company made additional revelations about its financial condition, and its stock continued to fall dramatically in price. On October 16 the company announced its third-quarter earnings, reporting the largest loss in the company's history and including several obscure statements about its financial arrangements that became the source of further trouble as they were clarified over the next several days. On October 25 Fastow was removed as Chief Financial Officer, raising further questions about the company's management. On November 8, it was reported that Enron was in talks with its rival Dynegy about possible acquisition by that company. Those talks ended on November 28, and on December 2 Enron filed for bankruptcy.

During October and November, when the news for Enron was steadily worsening and the prospect of bankruptcy became real, Ken Lay was the only executive dealing with strategic issues on a daily basis. Jeff Skilling, until recently CEO and the individual with the most detailed knowledge of the company's many businesses, had resigned and was gone from the company. Andy Fastow, the Chief Financial Officer and the one who would normally take the lead in dealing with lenders and investors, was under increasing pressure due to conflicts of interest in his various roles, and was forced to resign in late October. The board of directors remained remarkably passive throughout the time of turmoil, and was widely criticized when post-bankruptcy analyses revealed more details about Enron's fall.

The two events most likely to bring on the bankruptcy of Enron were a reduction of its rating by the major credit agencies below investment grade, and its failure to maintain adequate liquidity to meet its large daily cash needs from trading. The investment rating was a matter of fact: once one or more of the rating agencies reduced its rating on Enron's debt below investment grade, that fact would be known to all and provisions in many of its contracts requiring additional capital would be triggered. The liquidity situation was one of both fact and perception. If Enron's many trading partners suspected that the company was approaching a liquidity crisis, they would stop trading for fear that when the actual crisis hit, they would be left unpaid.

Lay tried to reverse the company's increasing problems by giving positive speeches to the press, investors, and employees. However, as events repeatedly contradicted his positive projections, he lost credibility as a spokesperson. Lay was an economist by training, and a relatively hands-off CEO. When major questions were raised by the press and the SEC about Enron's peculiar accounting practices, he was not well equipped to address the issues, and did not have a member of senior management who could do so.

Lay attempted, in November, to arrange an acquisition by Dynegy, another Houston energy company. Once this prospect became serious, numerous members of Dynegy's management met with counterparts at Enron, and Dynegy attempted to review and understand Enron's financial positions by reviewing its books. This process was made much more difficult by Enron's opaque accounting practices, but Dynegy finally decided that the risk was too great and the reward too small. While this review was in process, Lay also attempted to use his position as a major Republican fund-raiser to obtain help from the Bush administration, but was unable to do so.

An infusion of capital, which was the final hope of the other companies discussed in this paper, did not make sense for Enron. The company had relatively few physical assets for a company its size. Because of its accounting practices it was somewhere between very difficult and impossible for Enron's management to determine how much capital it needed, and thus for possible investors to determine the relative risks and rewards of investing. Because it had been so difficult to ascertain how Enron attained its profits, potential investors did not feel that they could make reasonably accurate forecasts about the impact of a capital infusion, other than postponing bankruptcy.

At the end of November, when Dynegy decided after examining Enron's books that they did not want to buy the company even at a reduced price, the perception of liquidity disappeared. Even before this point, there really was nothing that Enron management could have done to reverse the slide toward

bankruptcy. Enron's trading business depended on trust, and once it became clear that the company's reporting had been false in various ways, trust disappeared. The resignation of Skilling and the removal of Fastow both hurt the company's chances of survival. Even had both remained, the facts were such that, once they became known to investors and customers, trust would have disappeared.

BEAR STEARNS

Bear Stearns was one of the five major investment banks that had survived many years of mergers and acquisitions within its industry. The company participated in a major way in many investment banking activities. Among these activities were the trading of both equities (stocks) and fixed-income investments (bonds). The information in this section is based principally on House of Cards by William Cohan, Street Fighters by Kate Kelly, In Fed We Trust by David Wessel, and Financial Shock by Mark Zandi. While bonds originally referred to simple loans of money by investors to corporations, by the onset of the financial crisis in 2007, much of Bear Stearns' portfolio of fixed rate investments consisted of various types of derivatives, including a substantial amount of mortgage-backed derivatives. In a situation reminiscent of the Long-Term Capital Management case described earlier in the paper, Bear Stearns strategy also included the use of large amounts of leverage so that its capital base represented less than four percent of its total assets.

Collateralized mortgage obligations, which Bear Stearns, along with many other companies, originated and sold to investors are a form of fixed income investment. Many individual mortgages (Bear Stearns was primarily involved in residential mortgages) are bundled together into a single debt obligation. They are often divided into layers, or tranches, with varying degrees of risk involved. Lenders sell the individual mortgages to a firm such as Bear Stearns, which then combines and recombines them into collateralized mortgage obligations (CMO's) that are subsequently sold to investors who may be individuals or institutions. As the volume of CMO's that Bear Stearns was selling increased, they also began originating residential mortgages through subsidiaries.

Bear Stearns also sold large numbers of credit default swaps, a form of insurance against default purchased by financial institutions as a means to reduce risk. Credit default swaps are also traded as financial instruments between financial institutions or other parties that do not have a direct involvement in the risk insured. These, and many other forms of investments, are collectively known as derivatives, because their value is derived from some other asset, value, event or condition. Investment banks were very large originators of and purchasers of derivatives, thus creating a complex web of obligations among themselves and other financial institutions.

Much of the borrowed money that Bear Stearns used to finance its daily activities was borrowed from other financial institutions on a daily basis on the so-called repo market. This market involves very short-term borrowings, often renewed or "rolled over" on a daily basis. Bear Stearns alone borrowed in excess of fifty billion dollars daily in this market. Normally there was no problem in renewing these loans, but in essence they did constitute short-term funding that was used for longer-term obligations.

One other feature of Bear Stearns basic strategy is important for understanding what happened in the final days. As Bear Stearns purchased or originated individual mortgages, they owned these mortgages for a period of time until a sufficient number of them were accumulated and the complicated legal process of establishing a trust and constructing the collateralized debt obligation could be completed. During this period, anything that negatively affected the value of these mortgages such as defaults, foreclosures, or prepayments had a negative effect on Bear Stearns, because the value of the mortgage pool that would be formed and sold was reduced.

In June and July of 2007 two of Bear Stearns' hedge funds lost most of their value. Bear Stearns invested corporate money in these funds in an attempt to repair the damage, but the funds lost almost all of their value. The managers of the two funds were fired, and in 2008 were arrested and charged with securities law violations. In late 2009 they were found not guilty of the charges by a jury in New York. The loss of value in these funds generated uncertainty among investors and customers of Bear Stearns, and from this point the company's financial difficulties increased.

On August 5, 2007 Warren Spector, co-president of Bear Stearns, was forced to resign. This decision was controversial within the firm. While a difficult executive in some ways, Spector was the most knowledgeable of the senior managers of the firm's complicated products and businesses, and was seen by many as a crucial and believable spokesperson to regulators and investors.

During the Fall of 2007 Bear Stearns' performance was dramatically worsening, which led to increased difficulty in obtaining credit. The residential mortgage crisis had become full-blown, and Bear Stearns was unable to sell some of its collateralized mortgage obligations, leaving the firm in possession of large numbers of mortgages that were steadily decreasing in value. Other large financial institutions that purchased, bundled and sold residential mortgages were in a similar situation, and the market for these instruments was essentially frozen. Since the instruments were not trading, it was impossible to assign accurate values to these assets, but it was clear that their value had decreased and continued to do so.

The firm was forced to pay out increasing sums of capital to meet its many and varied obligations under various contracts, but was unable to raise additional capital as its stock price plunged and its creditworthiness was called into question more and more. It became clear to management that any successful strategy for surviving the problems would include raising billions of dollars in additional capital. They felt that this would restore confidence in the firm, and allow it to work through its trading positions and contractual obligations.

Senior managers of Bear Stearns pursued a large number of possible investors, ranging from private equity firms such as Kohlberg, Kravis, Roberts and Fortress Investment Group to the sovereign wealth fund of Saudi Arabia and CITIC of China. None of these overtures resulted in an increase in capital. As large banks began to take multi-billion dollar write-downs on their assets, primarily those that were mortgage-related, Stan O'Neal, the CEO of Merrill Lynch retired under pressure on October 26. One week later Chuck Prince, the CEO of Citigroup resigned.

Jimmie Cayne, the long-time CEO of Bear Stearns, was a world-class bridge player. Several times a year he played in championship bridge tournaments that required full time and attention for a week or more. He was also noted for leaving work on Thursday afternoons and playing golf on Fridays. His manner was frequently described as dictatorial.

On November 1, the Wall Street Journal published a long article about Cayne, detailing his absences from the office to play bridge and golf. The article also accused Cayne of being a regular marijuana user, and cited a specific instance in 2004 at a bridge tournament in Memphis when he entered a men's room with a female companion to smoke pot (Cohan, p. 401). This article weakened Cayne's ability to serve as a credible spokesperson for Bear Stearns. As the situation continued to worsen, pressure arose from senior executives below Cayne for his removal. He spent the last week of November and the first two days of December playing bridge at a tournament in San Francisco. Finally, in early January, under intense pressure from key subordinates, Cayne announced his retirement as CEO, remaining Chairman of the Board.

During January and February of 2008 most major financial institutions, in the U.S. and overseas, were losing money. Lending in all categories fell dramatically, and the ability to value assets accurately continued to suffer. U.S. regulators were deeply concerned. The usual tools for modifying a reduction in lending, such as reducing interest rates by the Federal Reserve Bank, had already been tried but the situation continued to worsen. The vague doctrine of "too big to fail" had been discussed for years. It seemed to mean that some very large companies were so important to the economy as a whole that, barring any other solution, the federal government would bail them out and prevent their bankruptcy. No one was quite sure if this were true, or what companies might come under this doctrine. Because the United States government cannot spend money that has not been appropriated by Congress (in most circumstances) this doctrine might prove very difficult to implement.

On January 9 Alan Schwartz, the new CEO of Bear Stearns, said in an interview on CNBC that "the strategy has to be to grow our business profitably. We need to earn a good return on equity. We need to grow our book value and need to do that in businesses we can grow organically" (Cohan, p. 418). He

went on to say that only after such internal growth would a merger make sense. In spite of this statement, Bear Stearns continued to explore ways to obtain additional capital through large one-shot investments.

Finally, in mid-March, a critical point was reached and Bear Stearns executives realized that as their losses and consequent need for capital were increasing day by day, the ability to raise capital, or even to roll over its daily funding in the repo market was gone. As Cohen describes the forces at work,

Various constituencies that interacted with Bear Stearns during the normal course of business—hedge funds that would normally have been happy to leave their free credit balances at the firm; counterparties that would normally have been willing to have Bear Stearns on the other side of a trade or a derivative; providers of the firm's overnight financing, either in the repo market or in the commercial paper market; brokerage customers who rarely worried about a thing and were pleased to be clients of Bear Stearns—all more or less simultaneously lost confidence in the firm (Cohen p. 50).

As the company's failure became imminent the Federal government stepped in. With many individuals and several agencies involved, the Federal Reserve Bank persuaded JP Morgan Chase to purchase Bear Stearns for \$2 a share (later increased to \$10 a share). The government persuaded JP Morgan Chase to make this purchase and assume the debts of Bear Stearns. JP Morgan Chase assumed the risk on the first billion dollars of losses, with the government assuming the risk on the next \$30 billion. For the executives and stockholders of Bear Stearns, this was the end of their company and of almost all the value of their stockholdings. For the company's many creditors it was a government bailout.

The management of Bear Stearns made many strategic mistakes in the months leading up to the company's sale. They pursued an excessively risky strategy. They did not execute the strategy well. The CEO (Caynes) and the board of directors by any reasonable standard failed to perform their duties in anything approaching an adequate fashion. The management failed to recognize the urgency of the need for more capital, and to seriously pursue the sale or merger of the company while there was still time. Nonetheless, partly because of these mistakes and partly because of the larger financial crisis, as the end approached there was really nothing that top management could have done that would have materially changed the outcome.

LEHMAN BROTHERS

Lehman Brothers was another large investment bank with a history going back several generations. With some difference in emphasis, it performed the same basic banking functions as Bear Stearns. Like Long-Term Capital Management and Bear Stearns, Lehman financed most of its investments and trades by borrowing, and like Bear Stearns, it obtained a significant portion of its borrowed funds on a very short-term basis. Lehman also held in its portfolio of assets large amounts of mortgage-related instruments such as the collateralized mortgage obligations described in the previous section. The information in this section is based primarily on A Colossal Failure of Common Sense by Lawrence McDonald, Too Big To Fail by Andrew Ross Sorkin, and In Fed We Trust by David Wessel.

On April 1, 2008, just weeks after the failure of Bear Stearns, Lehman sold \$4 billion of preferred stock in order to provide the firm with additional capital. During the last week of May, exploratory talks were conducted with executives of the Korean Development Bank. The subject was the possible purchase by this bank of an ownership position in Lehman for \$5 billion. In mid-June Richard Fuld, Lehman's long-time CEO announced the demotions of both Joe Gregory, the firm's president and Erin Callan, the Chief Financial Officer. At the same time, senior management began serious discussion of spinning off or selling parts of the business, and also approached a number of financial institutions about investing additional capital in the firm.

On September 8 the U.S. government announced that it was taking over Fannie Mae and Freddie Mac, the two giant mortgage lenders, replacing their CEO's, and placing them into conservatorship. This was another form of government bailout, and seemed to confirm the "too big to fail" theory. The next day

Lehman announced that it had lost \$3.9 billion in the third quarter. It also announced its intention to sell fifty-five percent of its investment management division and to spin off approximately \$25-\$30 billion of its commercial real estate assets into a separate publicly traded company. They also announced a cut in the stock dividend from 68 cents a share to 5 cents a share. There were no buyers for the investment management division or for the proposed new company holding commercial real estate assets.

The following weekend the most senior government officials in the area of finance met and, after extensive discussions, decided not to provide a government bailout for Lehman. Barclay's Bank was giving serious consideration to buying all of Lehman except for its commercial real estate investments for a low price. During the same weekend, as government officials were deciding against a bailout, numerous bankers were reviewing the real estate assets and were dismayed by what they found. Lehman executives were reaching out by phone to the government officials in Washington, to other bankers, and to possible investors.

On September 14 the Federal Reserve Board directed Lehman Brothers to file immediately for bankruptcy. After some discussion, Lehman's board of directors agreed, and Lehman Brothers entered bankruptcy. The "too big to fail" theory was about to be tested, and as subsequent events proved, the theory made sense. The Lehman bankruptcy was immediately followed by much greater market volatility and turmoil. The remaining investment banks either agreed to be purchased (Merrill Lynch), or changed their legal status (J.P. Morgan, Goldman Sachs). Although Bear Stearns filed for Chapter 11 bankruptcy, which allows for reorganization, it ceased to exist as the company it had been.

Many of the external conditions that impacted Bear Stearns and made their business strategy both untenable and unchangeable also impacted Lehman. By general agreement, the recession that occurred due to financial losses related to mortgage defaults and the resulting credit freeze was the worst in the United States since the Great Depression of the 1930's. Such unusual circumstances might not be foreseen when a company does its strategic planning. However, as we will see in the next section, a common thread running through the failure of all four companies studied in this paper is that they took greater risks, both in their strategies and in the execution of these strategies, than did many other companies that survived.

LESSONS LEARNED AND FURTHER QUESTIONS

Although the four companies studied in this paper failed over a time period of a decade, and were engaged in somewhat different businesses, there are many common elements. All four companies had trading as their basic, or one of their basic, businesses. Long-Term Capital Management traded many of the same financial instruments as did Bear Stearns and Lehman. A few instruments, such as credit default swaps and collateralized mortgage obligations either did not exist or were not widely traded by any company at the time of LTCM's failure. Enron traded primarily instruments related to energy, although they invented or embraced a variety of other derivatives.

Each of the four companies was very heavily leveraged—their capital represented only a very small percentage of their assets. None of the four was subject to the minimum capital requirements imposed on commercial banks. From reading the books used as sources for this study, it is clear that each of the four companies' managements displayed an unusual degree of arrogance and disdain for both competitors and customers. Many anecdotes in these books support the fact that a culture of arrogance and self-centeredness permeated not only the management but also the employee ranks in these companies. Most of the books emphasize the human element as well as strategic and economic factors in analyzing these companies as they failed.

In each of the four companies the board of directors was passive and uninvolved as troubles mounted and the end approached. The set of laws known as Sarbanes-Oxley was passed in response to the failure of Enron. Among other things it mandates more independence and more active involvement by directors in overseeing management. This law did not produce more involved boards at either Bear Stearns or Lehman Brothers. Three of the four companies had a change in CEO or President during the time of crisis. At Enron, Skilling's stated reasons for leaving have been widely questioned, but it has never been

established what his motives were. At both Bear Stearns and Lehman the changes (Cayne as CEO at Bear Stearns and Gregory as President at Lehman) were forced by senior executives rather than by the boards of directors. These changes deprived the companies of key managers and spokespersons as troubles deepened.

In all four cases, the proximate cause of failure was lack of capital, and the principal contributing cause was lack of trust by customers and investors. Enron is somewhat different from the other three companies, in that deliberately opaque (and as was discovered later, illegal) accounting practices contributed considerably to the lack of trust. Enron also was pursuing a business model that was unsustainable in a number of ways. Once customers and investors began to see these issues, and Enron's revised financial reporting revealed something closer to the actual state of affairs than their previous reports, the progress toward company failure accelerated.

The other three companies all appeared to be adequately capitalized and to be producers of above average profits until the final downward spiral set in. The authors of the books used for this study make clear that until the very end, management at each of these three companies believed that they had a sound business model (strategy) and that an infusion of capital and a bit of time were all that was needed to return them to their former high profits. The fact that their investors, potential investors, and customers all saw things differently is remarkable.

It appears that the major strategic obstacle that each of these four companies was unable to overcome to prevent their demise was a lack of trust. The almost frantic activity of senior managers in the last days and weeks was basically directed at finding some individual or company with sufficient resources who trusted that management could and would use these resources wisely if invested. Facts (dismay at the actual financial condition of the company under close examination) and perceptions (there is no plausible way for this company to return to profitability; no one else trusts them so why should I) made the actions of the company executives irrelevant.

This study is exploratory in nature, and as such it raises a number of questions that would extend and fortify our analysis if they could be answered. Perhaps the most important and intriguing question is this: why did these particular companies fail while others in their peer groups did not? Why did other hedge funds succeed, and what did they do differently from LTCM? Why is Dynegy still a going concern while Enron is only a memory? Why is Goldman Sachs currently under scrutiny for excessive executive compensation while Bear Stearns and Lehman are historical footnotes?

Another question that would almost certainly prove illuminating if answered is why some companies that approached the brink of failure were able to succeed in their efforts to implement ongoing strategies? MGM Mirage reportedly came within a day of declaring bankruptcy, yet was able to restructure its debt and as this is written is celebrating the opening in Las Vegas of City Center, the largest privately-funded development in U.S. history. General Motors, with government assistance, entered and exited from Chapter 11 bankruptcy in less than two months. Comparative studies with these and other companies would greatly enhance our understanding of how strategy works in practice as corporate failure nears.

Another question that might shed valuable light on standard strategic theory is whether the issues that cause failure of large companies in the financial industry also affect other industries in similar ways. All four of the companies in this study were basically in the business of trading. Jeff Skilling, former CEO of Enron, was known to brag of his "asset-light" approach to business. It seems ironic that the only remnant of Enron with real value was a network of gas pipelines. The books used for this study uniformly suggest that the corporate cultures, the attitudes of senior management that percolate down to the ranks of employees, played a key role in the failure of the companies studied. This suggests that a study based on the economic conditions of an industry may be incomplete, or incorrect. Detailed studies of companies that succeed in difficult times and similar companies that fail might reveal, at least to some extent, the impact of quantitative versus non-quantitative measures in analyzing strategy, particularly for companies in crisis.

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