BEAR STEARNS AND LEHMAN BROTHERS: "TOO BIG TO FAIL'S" IMPACT

Natalie Warrington*

Abstract

The 2008 financial crisis led to controversial government bailouts of institutions that were deemed "too big to fail" (TBTF). Critics propose that systemic risk and TBTF were the main causes of the financial collapse of Bear Stearns and Lehman Brothers—two of the institutions that were at the center of the bailout controversy. These bailouts have been criticized as creating moral hazard which, for financial institutions, means that decision makers, counterparties, creditors, and shareholders will take fewer precautions and take on more risk since the government will bail them out. However, whether various market participants in fact take fewer precautions and incur more risk because of the possibility of a bailout is not proven; other factors exist which may dictate the decisions of a TBTF firm.

This Article goes beyond the mere supposed direct causal link between bailouts and moral hazard, to examine the other possibilities which increase risk in a TBTF firm. Such factors include the effect of the executive compensation and the Investment Bank Business Model. This Article also considers the general nature of the asset manager relationship as promoting moral hazard insofar as the risk of personal loss is by nature minimal—there is no "skin in the game." This Article examines these factors in light of the actions of Bear Stearns and Lehman Brothers before their respective meltdowns, and in view of the firms' actions which were seemingly influenced by other factors rather than the possibility of a bailout. In view of these factors and the actions taken by such TBTF institutions, this Article suggests that a firm's TBTF status and the possibility of a bailout may not actually effectuate the excessive risks that give way to failure. At most, the moral hazard encountered as a result of these considerations likely carries only minimal influence over decision makers when compared to the myriad of other factors they face.

* J.D., 2014, University of Richmond School of Law; B.A., 2010, College of Charleston. The author sincerely thanks Professor William O. Fisher for his guidance and encouragement in writing this Article. His knowledge and commentary were invaluable to its development.

I. Introduction

Responses to the recent government intervention in the financial services industry during the 2007-2008 financial crisis indicate that government bailouts are controversial. Fervent opinions from legislators, industry leaders, and taxpayers fall on both sides of the line.

Proponents rationalize bailouts on the theory that some institutions are simply "too big to fail" ("TBTF"). They maintain that certain financial institutions are so significant that their failure could cause the entire financial system to collapse—a concept known as "systemic risk."[1] Therefore, proponents argue that the government must bail out TBTF institutions on the verge of failure in order to protect the entire financial system.[2]

Despite the recognized impact TBTF institutions have on the financial system, opponents argue against government bailouts, in part, because they create moral hazard.[3] Moral hazard is "the tendency of an insured to relax his efforts to prevent the occurrence of the risk that he has insured against,"[4] because if an actor does not have to deal with the consequences of his actions, he will not be as hard-pressed to avoid them.[5] "In the context of bank failures, moral hazard refers to the risk that shareholders, managers, or creditors of large financial institutions will take fewer precautions when they think the government will protect them."[6] "It refers to the danger that market participants take excessive risks, if they believe someone will bail them out if things go wrong."[7] "What moral hazard means is that, if you cushion the consequences of bad behavior, then you encourage that bad behavior. The lesson of moral hazard is that less is more."[8]

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1. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198 (2008) (discussing systemic risk). Schwarcz discusses that:

> A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences-sometimes referred to as a domino effect. These consequences could include (a chain of) financial institution and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both.

Id.

2. Alison M. Hashmall, Note, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-Bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 829 (2010).
3. *Id.* at 830.
4. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 135 (8th ed. 2010).
5. *See* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 239-41 (1996). Moral hazard "refers to the tendency for insurance against loss to reduce incentives to prevent or minimize the cost of loss." *Id.* at 239. Further, Baker discusses the fundamental proposition of moral hazard that people choose to act rationally. *Id.* at 241.
6. Hashmall, *supra* note 2, at 841.
7. John Authers, *The Short View: Moral Hazard*, FIN. TIMES (July 23, 2012, 5:37 PM), http://www.ft.com/intl/cms/s/1/b8e45cde-3938-11dc-ab48-0000779fd2ac.html#axzz3DgoNThm5; *see also* Frank Ahrens, *'Moral Hazard': Why Risk Is Good*, WASH. POST (Mar. 19, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/03/18/AR2008031802873.html (explaining the concept of moral hazard with respect to Bear Stearns).
8. Baker, *supra* note 5, at 238 (citing James K. Glassman, *Drop Budget Fight, Shift to Welfare*, ST. LOUIS POST-DISPATCH, Feb. 11, 1996, at B3).

As strong as the TBTF and moral hazard argument is theoretically, its actual impact is uncertain. How does a firm's TBTF status actually impact the various market participants? Is moral hazard incident to TBTF a real concern? There is no definitive answer. Whether any of the financial market players actually rely on a potential bailout and in turn take more risks and increase a firm's chances of failing is an open question.

This Article examines the facts and circumstances surrounding the near-collapse of Bear Stearns ("Bear") and the bankruptcy of Lehman Brothers ("Lehman"), two TBTF firms, and the actions taken by their executives, creditors, counterparties, and shareholders. On the basis of these facts, this Article suggests that where there is only the potential for a bailout, the reason a firm ultimately fails may have little, if anything, to do with its TBTF status. Four points support this suggestion. First, the presence of risk-inciting factors unrelated to TBTF at both Bear and Lehman diminishes whatever actual impact TBTF has on executive risk-taking. Second, market participants reacted to Bear and Lehman's situations by taking actions to protect their interests, as though there were no chance of a government bailout. Third, executives at Bear and Lehman did not stand idly by and wait for a bailout as their firms began to fail; instead, they took affirmative action to reduce their chances of failing. Fourth, Bear's shareholders were forced to take a loss despite the government's intervention. TBTF will unlikely impact an investor's decision to buy, sell, or hold in such a lose-lose situation. In sum, the reasons Bear unraveled and Lehman failed may have had little, if anything, to do with their respective firm's TBTF status.

II. Executive Risk-Taking

One of the primary concerns with government bailouts is the impact a firm's TBTF status has on the decision makers at those firms. Opponents argue that executives at TBTF firms see the potential for a bailout as a fallback, enabling them to take risks that they otherwise would not take.[9] These risks in turn make the firms more likely to fail, and thus increase the need for bailouts. Although there is little evidence to directly refute this proposition, there are a variety of other factors unrelated to TBTF that may motivate executive risk-taking, and the presence of these factors at the very least serves to weaken whatever actual impact TBTF has on executive risk-taking. In other words, if firms are more likely to fail, it is not necessarily due to the "excessive" risks associated with TBTF. In light of these other circumstances, TBTF may only slightly impact executive risk-taking, if it does so at all. With respect to Bear and Lehman, the structure of executive compensation,[10]

9. Jim Puzzanhera, *Several Banks Considered Too Big to Fail Are Even Bigger*, L.A. TIMES (Sept. 17, 2013), http://articles.latimes.com/2013/sep/17/business/la-fi-too-big-to-fail-20130917/2 (stating that one of the main problems with TBTF is "big bank executives take excessive risks").

10. *See generally* Lucian A. Bebchuk, Alma Cohen, & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257 (2010).

the investment banking business model,[11] and the asset-manager relationship all singularly, and collectively, had the potential to motivate the executives to take more risks and increase the chance of firm failure.[12]

A. Structure of Executive Compensation

The method by which executives at Bear and Lehman were compensated may have actually incentivized them to take more risks. An analysis of the compensation structures at both firms "indicates that the design of the firms' performance-based compensation did not produce a tight alignment of executives' interests with long-term shareholder value."[13] Rather perversely, "executives' payoffs provided them with excessive risk-taking incentives" through the structure of their bonus compensation, and their ability to cash out on shares and options.[14]

1. Bonus Compensation

The executive bonus compensation plan at both Bear and Lehman may have served as an incentive to take greater risks, because the bonus compensation structure at each firm "provide[d] executives with incentives to seek improvements in short-term earnings figures at the cost of maintaining an excessively high risk of large losses down the road."[15] During the years preceding the financial crisis, Bear and Lehman executives were provided with large bonuses based on current high earnings and stock price.[16] The executives "did not have to return any of those bonuses when the earnings subsequently evaporated and turned into massive losses."[17] Their ability to retain these substantial earnings may have encouraged them to take more risks with a focus on short-term results and a disregard for future losses.

11. Report of Anton R. Valukas, Examiner, *In re* Lehman Bros. Holdings Inc., No. 08-13555, at 76 (Bankr. S.D.N.Y. Mar. 11, 2010), *available at* http://online.wsj.com/public/resources/documents/lehmanvol8.pdf [hereinafter Examiner's Report]; *see also* FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT 292-308 (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [hereinafter FCIC REPORT].

12. Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 188 (2009) (referring to this dilemma as having "no skin in the game").

13. Bebchuk, Cohen, & Spamann, *supra* note 10, at 274.

14. *Id.* at 274-75.

15. *Id.* at 274.

16. *Id.* at 266-67. In 2006, the Bear Stearns' compensation committee awarded bonuses on the basis of present-day figures including "'record' earnings per share, net income, net revenues, large increases in book value per share, and the fact that '[t]he market price of the Common Stock increased by approximately 37%' during the fiscal year." *Id.* Lehman's compensation committee similarly awarded their bonuses based on "'record' net revenues, pretax income, net income, and earnings per share, as well as '[a]n increase in the Firm's stock price of 17% during fiscal 2006, and 123% over the last five years.'" *Id.*

17. *Id.* at 274.

2. Cashing Out on Shares and Options

Executives at Bear and Lehman might have also been incentivized to assume more risk because of their ability to cash out on large amounts of shares and options. By "cashing out of large amounts of shares and options" with regularity "throughout the period" prior to the financial crisis, executives had "incentives to place significant weight on the effect of their decisions on short-term stock prices."[18] "Such a design again gives executives an incentive to seek improved short-term results, which can lift short-term prices or prevent short-term price declines, even when doing so has the potential for adverse effects on long-term value."[19]

In effect, the structure of Bear and Lehman's bonus compensation plans, as well as the executives' abilities to cash out on large amounts of stock and options, gave them the opportunity to increase their own personal payoffs by taking on more company risk. That being the case, the executives may have taken advantage of these opportunities, inevitably increasing the companies' risks and the chances of firm failure, notwithstanding any executive's reliance on a potential government bailout.

B. Investment Bank Business Model

The investment bank business model at the time of the financial crisis may have contributed to executive risk-taking at Bear and Lehman. In the context of the financial crisis, "all of the major investment banks that existed at the time followed some variation of a high-risk, high-leverage model."[20] Accordingly, executives at Bear and Lehman took more risks because their business models required it. To that end, they employed strategies that demanded higher risks,[21] as well as responded to the competition by taking increased risks.[22]

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18. *Id.* From 2000-2008, Lehman's CEO received $461 million in net cash proceeds for his Lehman shares, and Bear's CEO received $289 million in net cash proceeds for his Bear shares. *Id.* at 268. Altogether, Lehman's top executive team sold the shares each owned in Lehman for a combined total of $850 million in net cash proceeds, and Bear's executive team sold the shares each owned in Bear for a combined sum of more than $1.1 billion. *Id.*

19. *Id.* Interestingly, Bear Stearns and Lehman did place restrictions on stocks and options. They "limited how quickly executives were able to unload equity awards, allowing such unloading to take place only five years after the making of the award." *Id.* at 269. Still, despite these efforts, "the members of the top teams were all long-serving executives who became free each year to unload the equity incentives awarded to them five years earlier." *Id.* Additionally encouraging risks, Lehman executives were "granted stock options that could be exercised as soon as the stock price crossed certain thresholds, which it usually did within a year of the option grant." *Id.*

20. Examiner's Report, *supra* note 11, at 3; *see also* FCIC REPORT, *supra* note 11.

21. As it happens, Lehman implemented an aggressive "high-risk strategy after the onset of the subprime residential mortgage crisis in late 2006." Examiner's Report, *supra* note 11, at 43. In part it did so because Lehman previously "benefited from a similar 'countercyclical growth strategy.'" High-risk strategies appear not to have been exceptional, but rather normal in the industry. *Id.* at 45.

22. The Bankruptcy Examiner for Lehman explained that "Lehman needed to take more risk in order to compete." *Id.* at 76.

Bear and Lehman executives were not the only executives that were taking these types of risks—most investment banks were taking similar risks on account of their business models.[23] In finding "insufficient evidence to support a claim that any Lehman officer breached the fiduciary duty of care in connection with managing the risks associated with the more aggressive business strategy Lehman adopted in 2006,"[24] the bankruptcy examiner considered that "[i]n many respects, Lehman's transactions were no different from those conducted by other market participants, and were, in some respects, less aggressive than those of their competitors."[25]

The investment bank business model required high amounts of risk, and executives at Bear and Lehman assumed risk in correspondence with the model.[26] As a result, this increased the likelihood of failing irrespective of the prospect of a government bailout.

C. Asset Manager Relationship

The asset manager relationship may also have contributed to executive risk-taking at Bear and Lehman.[27] Executives at Bear and Lehman were essentially in charge of managing other people's money. Okamoto discusses the nature of the asset manager relationship and how it creates moral hazard:

> Asset managers who profit from the gains earned using other people's money face a moral hazard. Since they do not bear the full cost of a loss of capital and since higher returns are correlated with higher risk, an asset manager has the incentive to take additional risk in order to earn additional returns. This is a form of agency cost inherent in the asset manager relationship.[28]

An asset manager at Bear or Lehman may have been willing to assume higher amounts of risk because of the lucrativeness of his personal return and the lack of burden of suffering any potential loss. Any burden resulting from a loss would fall on the client and/or company.

Professor Okomato discusses a solution to this problem: a system that measures "skin in the game." "The math here is straightforward. 'Skin in the game' is inversely proportionate to moral hazard. If you too have something to lose, I'm

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23. Commenting on the financial crisis, Timothy Geithner, the head of the Federal Reserve Bank of New York at this time, did not attribute blame to any specific institution. "The crisis exposed a range of weaknesses in risk management practices within financial institutions in the United States and throughout the world." WILLIAM D. COHAN, HOUSE OF CARDS 9-10 (2009).

24. Examiner's Report, *supra* note 11, at 166.

25. *Id.* at 170.

26. The Bankruptcy Examiner for Lehman appropriately noted, "[i]t is no coincidence that no major investment bank still exists with that model." *Id.* at 4.

27. Okamoto, *supra* note 12, at 183.

28. *Id.* at 204-05.

> In every failed institution, we find an asset manager of some kind who was using other people's money to make a bet that he could earn more with it than he had promised to pay back. In every case, while there were certainly consequences for failing to pay the promised return, the potential reward for betting harder and harder was a siren's song to take more risk, certainly more than one would have taken if they were betting their own money.

Id. at 188.

going to feel better about the risks you are asking me to take."[29] Accordingly, investors and firms often insist that managers place personal equity at stake so as to create "skin in the game" and counteract the effects of moral hazard.[30] Equity compensation typically seeks this end, however, as Okomato observes, "any efforts like these to balance the incentives depend on the relative size of the weights we add to the equation. If the rewards of increased risk-taking greatly outweigh the costs, the inherent moral hazard of the asset manager relationship will prevail."[31] Given that executives at Bear and Lehman were able to harvest large amounts of cash from bonus compensation and by cashing out on shares and options, they might not have had adequate "skin in the game" to thwart the effects of moral hazard.[32] Accordingly, the lack of personal consequences inherent in the asset manager relationship may increase executive risk-taking and the potential for firm failure, even more so than the prospect of a bailout.

In sum, the presence of these other risk-inciting factors at Bear and Lehman at the very least weakens the impact each firm's TBTF status had on executive risk-taking. The structure of executive compensation, the investment banking business model, and the asset-manager relationship each individually, and collectively, potentially incentivized executive risk-taking and increased the firm's chances of failing. The risks that caused Bear's fire sale and Lehman's bankruptcy could have more to do with such considerations and less to do with TBTF and the prospect of a government bailout.

III. Market Participants' Response

In the context of the financial market, the moral hazard argument is multifaceted. Those who oppose bailouts argue that a firm's TBTF status affects the decisions of market participants in addition to those at TBTF firms. Arguably, the market participants, including a TBTF's firm's clients, creditors, and counterparties, take fewer precautions to protect their interests in trading and dealing with TBTF firms, thus promoting risky behavior and relaxing market discipline.[33] As discussed by William C. Dudley, the President and Chief Executive Officer of the Federal Reserve Bank of New York:

> The market's belief that a firm is more likely to be rescued in the event of distress than other firms weakens the degree of market discipline exerted by capital providers and counterparties. This reduces the firm's cost of funds and incents the

29. Karl S. Okamoto, *Skin in the Game*, LEGAL TIMES, Sept. 29, 2008, http://www.law.com/jsp/nlj/legaltimes/PubArticleLT.jsp?id=1202424731791&slreturn=20131026173148.
30. *Id.*
31. Okamoto, *supra* note 12, at 207.
32. *See* Bebchuk, Cohen, & Spamann, *supra* note 10, at 266-70, 278-81, Tables 1, 2, 3, & 4.
33. "Shareholders, managers, or creditors of a financial institution are said to impose market discipline on an institution by monitoring its risks and restraining it from engaging in the overly risky behavior that can create systemic risk." Hashmall, *supra* note 2, at 840.

> firm to take more risk than would be the case if there were no prospect of rescue and funding costs were higher.[34]

The actions taken by Bear and Lehman's counterparties and creditors appear to contradict this position. When the market began to show signs of distress, clients, creditors, and counterparties reacted accordingly. "From approximately August 2007 to the beginning of 2008 . . . fixed income repo lenders began shortening the duration of their loans and asking all borrowers to post higher quality collateral to support those loans."[35] "[B]y late 2007 many lenders, both traditional and non-traditional, were showing a diminished willingness to enter into such facilities."[36] Paul Friedman, former Chief Operating Officer of Fixed Income at Bear Stearns explained that "[d]uring the week of March 10, 2008, Bear Stearns suffered from a run on the bank that resulted . . . from an unwarranted loss of confidence in the firm by certain of its customers, lenders and counterparties."[37] To shield themselves from loss, "prime brokerage clients withdrew their cash and unencumbered securities at a rapid and increasing rate; repo market lenders declined to roll over or renew repo loans, even when the loans were supported by high-quality collateral such as agency securities; and counterparties to non-simultaneous settlements of foreign exchange trades refused to pay until Bear Stearns paid first."[38]

Those dealing with Lehman acted similarly.[39] "[I]n reaction to rumors of Lehman Brothers' upcoming demise, hedge funds and other Lehman Brothers clients [moved] their business to other broker-dealers, and thus [withdrew] their collateral from Lehman Brothers."[40] "By September 12 . . . some of the largest investors [had] pulled back entirely, refusing to provide Lehman with the overnight

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34. William C. Dudley, President & CEO, Fed. Reserve Bank of N.Y., Remarks at the Clearing House's Second Annual Business Meeting and Conference (Nov. 15, 2012) (transcript available at http://www.newyorkfed.org/newsevents/speeches/2012/dud121115.html); *see also* FED. RESERVE BANK OF RICHMOND, OUR PERSPECTIVE: TOO BIG TO FAIL (last updated June 9, 2014), http://www.richmondfed.org/research/our_perspective/toobigtofail/index.cfm (explaining that "investors who have made loans to support activities assumed to be guaranteed face less incentive to assess the risks and related costs associated with extending funds to those firms or markets. This is the so-called 'moral hazard' problem of the financial safety net: expectation of government support weakens the private sectors' ability and willingness to limit risk").

35. Paul Friedman, Former Chief Operating Officer of Fixed Income, Bear Stearns, The Shadow Banking System: Hearing Before the Fin. Crisis Inquiry Comm'n 3 (May 5, 2010) (transcript available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0505-Friedman.pdf) [hereinafter Friedman Statement].

36. *Id.*

37. *Id.* at 2.

38. *Id.*

39. *See* Randall Smith & Aaron Lucchetti, *With Street Watching, 'Repo' Trading Is Light*, WALL ST. J. (Mar. 18, 2008), http://online.wsj.com/articles/SB120580762984844257. The market participants' reactions to Bear when it began to fail give a stronger indication of TBTF's impact because the political backlash from Bears' deal made any Lehman bailout all the more improbable. *Id.*

40. ADAM COPELAND, ANTOINE MARTIN, & MICHAEL WALKER, FED. RESERVE BANK OF N.Y., STAFF REPORT, THE TRI-PARTY REPO MARKET BEFORE THE 2010 REFORMS 28 (2010); *see also* Susanne Craig, Jeffrey McCracken, Aaron Lucchetti, & Kate Kelly, *The Weekend That Wall Street Died*, WALL ST. J. (Dec. 29, 2008), http://online.wsj.com/news/articles/SB123051066413538349; Serena Ng, Gregory Zuckerman, & Aaron Lucchetti, *Voicing Support, Clients Still Move To Pare Back Risks*, WALL ST. J. (Sept. 11, 2008), http://online.wsj.com/news/articles/SB122109337487221719.

financing it desperately needed to keep operating."[41] "Lehman's total tri-party book fell from $150 billion funded by over 60 investors on September 8, 2008, to $95 billion funded by around 40 investors on September 12, the Friday before LBHI filed for bankruptcy."[42]

Bear and Lehman's clients, creditors, and counterparties limited their risk of loss despite the potential for a bailout. Bear's prime brokerage clients withdrew their funds; its repo market lenders declined to roll over or renew the repo loans; and its counterparties insisted that Bear pay first. Similarly, Lehman's clients pulled their funds; and its lenders refused financing. As each firm respectively began to unwind, their clients, creditors, and counterparties took action to limit risk and to protect their interests. They effectively imposed market discipline regardless of the firm's TBTF status or the potential for a bailout.

IV. Self-Preservation Strategies

For bailout opponents, moral hazard means that TBTF executives take fewer precautions to prevent their firms from failing because they think that should anything happen, the government will bail them out. Bear and Lehman executives implemented a multitude of strategies to save their firms. Their tremendous efforts as well as the lack of alternative courses of action undermine this proposition. Notably, Bear executives took action to reduce the firm's reliance on unsecured financing[43] and to curb the market rumors that precipitated its fire sale.[44] Similarly, Lehman executives took action to manage and reduce risk,[45] to implement SpinCo,[46] and to find a strategic partner.[47]

A. Bear: Reduced Reliance on Unsecured Financing

Wary of a crisis, Bear executives took steps to strengthen its liquidity position.[48] To do this, they implemented a strategy to reduce their reliance on short-term unsecured funding sources and to increase their use of secured financing.[49] They "believed that secured funding was more reliable and that financing against

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41. Barry Zubrow, Chief Risk Officer, JPMorgan Chase & Co., Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm'n 8 (Sept. 1, 2010) (transcript available at http://fcicstatic.law.stanford.edu/cdn_media/fcic-testimony/2010-0901-Zubrow.pdf) [hereinafter Zubrow Statement].

42. COPELAND, MARTIN, & WALKER, *supra* note 40, at 56, figs. 20 & 21.

43. Samuel Molinaro, former Chief Operating Officer & CFO, Bear Stearns, The Shadow Banking System: Hearing Before the Fin. Crisis Inquiry Comm'n 1 (May 5, 2010) (transcript available at http://fcicstatic.law.stanford.edu/cdn_media/fcic-testimony/2010-0505-Molinaro.pdf) [hereinafter Molinaro Statement].

44. COHAN, *supra* note 23, at 12.

45. Examiner's Report, *supra* note 11, at 633.

46. *Id.* at 640.

47. *Id.* at 662.

48. Molinaro, *supra* note 43.

49. Alan D. Schwartz, Former President & CEO, Bear Stearns, The Shadow Banking System: Hearing before the Fin. Crisis Inquiry Comm'n 1 (May 5, 2010) (transcript available at http://fcic.law.stanford.edu/hearings/testimony/the-shadow-banking-system) [hereinafter Schwartz Statement].

liquid, high quality collateral would enable Bear Stearns to finance itself even in a challenging economic environment."[50] To implement this strategy, the executives:

> increased the use of secured repo funding; . . . introduced substantially greater amounts of longer-term secured funding into the repo and bank loan portions of [Bear's] secured funding mix; reduced reliance on short term unsecured funding sources, thereby lessening both exposure to rollover risk[51] and dependence on backstop lines of credit; and . . . expanded the size and scope of the Company's liquidity pool, which consisted of cash and cash equivalents held at, or available to, the parent company for deployment as needed.[52]

B. Bear: Promoted Market Confidence

Market confidence was critical for an investment bank survival during the financial crisis.[53] Preceding the crisis, investment banks relied heavily on short-term repo markets to fund their daily business. If their counterparties on these trades lost confidence in the bank and refused to roll over this daily funding, the bank would not be able to fund itself to operate. When rumors began to circulate the market that Bear was in trouble, Bear executives jumped to stop them.[54] On Monday, March 10, 2008, Bear released a statement "denying 'market rumors regarding the firm's liquidity' and adding that 'there is absolutely no truth to the rumors of liquidity problems that circulated . . . the market.' The release quoted Schwartz: 'Bear Stearns' balance sheet, liquidity and capital remain strong."[55] On Tuesday, March 11, 2008, Bear's Chief Financial Officer Samuel Molinaro appeared on CNBC to reassure investors, "There is no liquidity crisis. No margin calls. It's nonsense."[56]

On Wednesday, March 12, 2008, Bear's Chief Executive Officer Alan Schwartz appeared live on CNBC so that he could reiterate and elaborate the

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50. *Id.*

51. Rollover risk is "the possibility that the firm's lenders would not renew short-term unsecured funding lines." Friedman Statement, *supra* note 35 at 2.

52. Molinaro Statement, *supra* note 43, at 2. Friedman discussed during his statement:

> Bear Stearns implemented this strategy in late 2006 and 2007, and succeeded in reducing its short-term unsecured financing from $25.8 billion at the end of fiscal 2006 to $11.6 billion at the end of fiscal 2007, and specifically reduced its commercial paper borrowing from $20.7 billion to $3.9 billion. That funding was replaced by secured funding, principally repo borrowing.

Friedman Statement, *supra* note 35, at 2.

53. "[A]ll of the major investment banks . . . required the confidence of counterparties to sustain." Examiner's Report, *supra* note 11, at 3-4. "Lehman funded itself through the short-term repo markets and had to borrow tens or hundreds of billions of dollars in those markets each day from counterparties to be able to open for business." *Id.* If confidence were lost and its repo counterparties refused to roll over its daily funding, Lehman would not be able to fund itself and to operate. The other investment banks followed similar practices. *Id.*

54. "Since Wall Street is a confidence game as much as anything, for counterparties on routine trades to start asking pointed questions about things as fundamental as cash and liquidity is not likely to be good for business." COHAN, *supra* note 23, at 12 (emphasizing the importance of reputation).

55. *Id.* at 18.

56. Roddy Boyd, *The Last Days of Bear Stearns*, FORTUNE MAG., http://archive.fortune.com/2008/03/28/magazines/fortune/boyd_bear.fortune/index.htm (last updated Mar. 31, 2008, 1:59 PM) (internal quotes omitted).

message: "We don't see any pressure on our liquidity, let alone a liquidity crisis."[57] On Thursday, March 13, 2008, Alan Schwartz even pleaded with a well-respected prime brokerage client to vouch for Bear on CNBC.[58] In the end, the executive's attempts to invalidate the rumors proved futile, and the market responded accordingly.[59]

C. Lehman: Reduced and Managed Risk

Lehman executives implemented a substantial risk management system. Lehman's Global Risk Management Group ("GRMG") oversaw the system, in addition to risk managers embedded in the various business lines, and the Finance Department. In 2008 GRMG included around 450 professionals, and was regarded as one of the best in the industry.[60]

In addition, Lehman executives attempted to reduce risk by strengthening its liquidity position.[61] "[I]n 2008, Lehman reduced its total exposure to less liquid assets by almost 50%, from approximately $126 billion to $69 billion. [It] further strengthened [its] capital and liquidity positions by raising $10 billion of new equity."[62] Lehman's Chief Executive Officer Richard Fuld "directed that Lehman reduce its balance sheet in areas in which Lehman was vulnerable. In March 2008, Fuld appointed Bart McDade to be 'balance sheet czar' and instructed him to sell off assets and take other actions necessary to reduce the size of Lehman's balance sheet."[63]

D. Lehman: Attempted to Implement SpinCo

Eager to prevent failure, Lehman executives got creative and came up with the idea of "SpinCo." "The SpinCo idea was a variation on a good bank/bad bank structure."[64] Essentially, SpinCo was an off-balance-sheet entity that would transfer the ownership of the toxic mortgage securities Lehman held to Lehman's shareholders. SpinCo would "spin" those securities to Lehman's shareholders and

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57. *Id.*; *see also* COHAN, *supra* note 23, at 34.

58. Boyd, *supra* note 56; *see also* COHAN, *supra* note 23, at 49 (reviewing Bear executives' efforts to quash rumors of a liquidity crisis).

59. Boyd, *supra* note 56.

60. Examiner's Report, *supra* note 11, at 1-2. Lehman executives' efforts to manage risk are a particularly strong indication that they might have been taking the necessary precautions to avoid failure because it made these efforts even before the financial crisis.

61. *Id.* at 632.

62. Richard S. Fuld, Jr., Former Chairman & CEO, Lehman Brothers, Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis: Hearing before the Fin. Crisis Inquiry Comm'n 3 (Sept. 1, 2010) (transcript available at http://fcicstatic.law.stanford.edu/cdn_media/fcic-testimony/2010-0901-Fuld.pdf) [hereinafter Fuld Statement]. Notably however, "Lehman's balance sheet did not decline until the end of the second quarter of 2008, after Bear Stearns had already nearly collapsed." Examiner's Report, *supra* note 11, at 161.

63. Examiner's Report, *supra* note 11, at 634-35.

64. *Id.* at 640.

consequently off Lehman's balance sheet.[65] The primary purpose of SpinCo was "to relieve Lehman's balance sheet of its 'outside' commercial real estate exposure that had become a source of increasing market concern and pressure."[66] By transferring those securities to SpinCo, executives hoped the firm would "avoid the necessity of having to continue marking down those assets as the market continued to deteriorate."[67] This would allow Lehman to "avoid a 'fire sale for the vultures' that would have locked in its paper losses."[68] "[O]nce Lehman had purged its balance sheet of 'toxic' commercial real estate assets, it hoped that the post-spin 'clean' or 'core' Lehman (a.k.a. "CleanCo") could achieve returns on equity in the low teens, twelve times net leverage, and maintain an A rating."[69]

Unfortunately (and not surprisingly), SpinCo was doomed. Lehman executives had difficulty executing it due to issues with its capital structure, its ability to find willing investors, SEC accounting rules, and intensifying devaluations.[70] Although it was able to traverse its way past some of these roadblocks, the strategy ultimately failed to save Lehman.[71]

E. Lehman: Sought a Strategic Partnership

Lehman executives zealously tried to form a strategic partnership to save their firm. They reached out to a number of different parties, and some of them repeatedly. Lehman contacted Warren Buffett and his company, Berkshire Hathaway, a number of times, but Buffett proved too hesitant to make an investment in Lehman.[72] Lehman executives discussed the possibility of an investment with Korea Development Bank ("KDB"), but could not come to an agreement before KDB decided to terminate negotiations on account of the deteriorating global financial position.[73] They contacted MetLife, but were unsuccessful with them in large part "because MetLife already had substantial exposure to commercial real estate and could not take on Lehman's commercial real estate positions as well."[74] "In early August 2008, Lehman [executives] considered Investment Corporation of Dubai ("ICD") as a potential investor for up to $250 million in SpinCo junior, or mezzanine, debt,"[75] but ICD ceased contact with

65. *Id.* at 642; *see also* Yalman Onaran, *Lehman May Shift $32 Billion of Mortgage Assets to 'Bad Bank'*, BLOOMBERG (Sept. 4, 2008, 3:15 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQjsXBJ4uN1Y.

66. Examiner's Report, *supra* note 11, at 640-41.

67. *Id.* at 641.

68. *Id.*

69. *Id.* at 642.

70. *Id.*

71. Remarkably, despite Lehman's failure to implement SpinCo, Barclays was able to "launch[] its own SpinCo-like entity, selling $12.3 billion of high-risk credit assets to Protium Finance, a newly formed partnership run by former Barclays employees." *Id.* at 662.

72. *Id.* at 664.

73. *Id.* at 679.

74. *Id.* at 687, 691.

75. *Id.*

Lehman when Lehman's stock began to radically decline.[76] "In mid-July 2008, Lehman [executives] began talks with [Bank of America] regarding a potential merger between Lehman and [Bank of America's] investment banking division, under which Lehman would own approximately two-thirds of the resulting company."[77] Bank of America eventually determined that a merger with Merrill Lynch would be more advantageous.[78] In a last ditch effort, Lehman executives tried to strike a deal with the European bank Barclays. Although the parties were successful in coming to an agreement, the United Kingdom's securities regulator refused to waive the shareholder approval requirement that they needed in order to consummate the deal.[79]

Executives at both Bear and Lehman went to great lengths to try and save their firms. The many strategies that both firms employed to reduce their chances of failing indicates that the executives were not relying on a bailout. They appear to have done everything in their power to try and even prevent the need for a bailout. If the executives were relying on a bailout, it is unlikely that they would try as hard as they did to find another solution.

V. Effect on Investors

Bailout opponents argue that moral hazard affects shareholders in addition to the parties already discussed. Theoretically, a potential bailout incites investors to invest or to remain invested in a firm despite its likelihood of failure.[80] Realistically however, an investor would be foolish to maintain his investment in a failing firm. The resulting scenario is a lose-lose situation. Without a bailout, the investor has the potential to lose everything. Even with a bailout, the investor would still incur a tremendous loss and there would likely be little potential shareholder value remaining. The case of Bear, who essentially received a government bailout, demonstrates this.[81]

After the government intervened, Bear's shareholders received next to nothing compared to their original investment. As a result of the initial deal, shareholders were offered just two dollars per share. Just "fourteen months earlier [it] had been trading at $172.69 a share."[82] The deal primarily sought to protect creditors, not shareholders, and the government insisted on a low share price. The government was not trying to save shareholders' investments—it was trying to prevent systemic risk. Eventually Bear was able to find some leverage upon which to renegotiate and was able to raise the share price offered to its shareholders, but

76. *Id.* at 693.
77. *Id.* at 694.
78. *Id.* at 701.
79. *Id.* at 703.
80. Hashmall, *supra* note 2.
81. Cohan, *supra* note 23, at 116.
82. *Id.*

shareholders still took a major hit.[83] Consequentially the potential for a bailout most likely does not affect investors as opponents may imply.

Notwithstanding a bailout's realistic effect on a shareholder's investment, the problem inherent with moral hazard would likely not even apply to shareholders. Opponents argue that moral hazard increases a firm's chances of failing because of the limited precautions taken to prevent such failure. As previously discussed, executives and counterparties may increase a firm's chances of failing by taking excessive risks in running the firm or conducting business with the firm. An investor or shareholder, however, is limited in the actions he or she can take. An investor can only either buy, sell, or hold his or her shares. Such decisions do not make a firm more or less likely to fail. Those decisions do not promote the excessive risks within the company that cause the need for a bailout. That being the case, the worry over moral hazard as applied to shareholders appears misplaced. A shareholder can only take precautions to save his or her personal investment, and those have no impact on whether the firm is run in a way that increases its chances of failing.

VI. Conclusion

The impact of TBTF and moral hazard is still unclear. Whether any of the financial market players actually rely on a potential bailout and in turn take more risks and increase a firm's chances of failing is an open question. This Article demonstrates that the possibility of a government bailout may have little, if anything, to do with why a TBTF firm ultimately fails. The fact that a firm is considered TBTF may not necessarily impact the decisions of its executives, creditors, counterparties, or shareholders.

Looking at the near-collapse of Bear and the bankruptcy of Lehman, it appears that the reasons Bear required government intervention and Lehman failed may have had little, if anything, to do with their respective firm's TBTF status. First, there were other motivations promoting executives to take more risks at both Bear and Lehman and thus increase their respective chances of failing. Second, market discipline did not fail as a result of moral hazard. It continued to influence the actors and to restrain risk. Third, Bear and Lehman executives vigorously strategized ways to save their firms. They did not stand idly by and wait for a bailout. Fourth, both Bear and Lehman shareholders sustained immense losses despite the fact that one received government intervention.

The situations of both Bear and Lehman suggest that each firm's TBTF status may have had little, if anything, to do with its need for a bailout. In turn, executives, creditors, counterparties, and shareholders might make decisions and choose to take the risks regardless of the potential for a government bailout. Consequently, the emphasis opponents place on the effects of moral hazard and TBTF may be unwarranted.

83. *Id.* at 139.