Teaching Note

Lehman Brothers (A) and (B)

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TEACHING NOTE

Lehman Brothers (A) and (B)

SYNOPSIS

The Lehman Brothers (A) and (B) cases give two different reference frames to ascertain the performance of this global financial services company. The first case presents the company in early 2008 after the release of its 2007 annual accounts and first quarter SEC 10-Q filing. The second case refers to late 2008 after the bank filed for Chapter 11 bankruptcy protection on September 15 as an attempt to present what really happened and thereby explain why things could evolve the way they eventually did.

Lehman Brothers (A) does not reveal anything about the bank's subsequent demise and thus encourages readers to assess the bank's financial standing and potential exposures based on public data accessible at the time.

The first case, Lehman Brothers (A) factually describes the performance and risk management practices of the bank based on publicly available information including the company's audited annual reports and official SEC filings. The description of the bank's formal risk management practices and governance policies is garnered with industry-specific information and provides an overview of essential risk management dimensions.

This uncovers Lehman Brothers, Inc. as a very successful financial institution in terms of an impressive global business expansion, high profitability, and recognized investment banking services from rather spectacular historical origins.

History

The company was founded by Jewish emigrants from Bavaria, three brothers (Henry, Emanuel, and Mayer) with last name Lehman, who established Lehman Brothers in 1850 in Montgomery, Alabama as a dry-goods store. As part of business practice, they accepted cotton from local plantations as payment and from that established a significant commodity trading business. As trade in commodities gradually moved to New York, they opened a branch at 119 Liberty Street. In challenging times during the Civil War, the company merged with a cotton merchant to form *Lehman, Durr & Co* in 1862. The headquarters moved to New York City, and they entered the *New York Cotton Exchange* at its start in 1870, expanding into trading of railroad bonds and financial-advisory services. The firm became member of the *Coffee Exchange* in 1883 and the

New York Stock Exchange in 1887 underwriting its first initial public offering (IPO) in 1899 for the *International Steam Pump Company*.[1]

Lehman partnered with *Goldman, Sachs & Co.* in 1906 to underwrite issues for the *General Cigar Co.* and *Sears, Roebuck and Company* establishing the firm as a leading investment bank. During the Great Depression in the 1930s, the company refocused its business on venture capital while the stock market gradually recovered although still underwriting public issues for, e.g., *DuMont Laboratories* and *Radio Corporation of America (RCA)*. In the 1950s, Lehman underwrote an IPO for *Digital Equipment Corporation* and subsequently arranged funding for *Compaq*'s acquisition of Digital.

Lehman faced problems in the early 1970s but turned things around acquiring *Abraham & Co.* in 1975 and merging with *Kuhn, Loeb & Co.* in 1977 to form *Lehman Brothers, Kuhn, Loeb Inc.* as the fourth-largest investment bank after *Salomon Brothers*, *Goldman Sachs* and *First Boston*. After a turnaround, the company experienced several years with record profits, although internal frictions eventually forced the firm to merge with, or be acquired by *Shearson/American Express*, the securities company owned by *American Express*, in 1984 to form *Shearson Lehman/American Express*. The firm acquired *E.F. Hutton* in 1989 and formed *Shearson Lehman Hutton*.

In 1994, *American Express* spun off the investment bank as *Lehman Brothers Holdings, Inc.* and Dick Fuld became its CEO leading the firm through the Asian Financial Crisis in 1997 and the loss of trading facilities on floors 38-40 in the World Trade Center on September 11, 2001 displacing more than 6,000 employees. Lehman Brothers later acquired the private-client business of *Cowen & Co.*, the asset-management business of *Crossroads Group*, and fixed-income activities of *Lincoln Capital* and *Neuberger Berman* to substantiate its investment banking activities.

What may be learned from this?

We observe an organization that overcame many intriguing challenges of rather tumultuous changes and abrupt events to each time managing, intervening, or meddling against the odds maneuvering through various corporate restructurings, acquisitions, and mergers in a highly dynamic and intensely competitive industry.

The entrepreneurial, industrious, and at times rather tempestuous developments may trigger a discussion about how corporate values and organizational cultures emerge influenced by the actions taken by executive decision-makers.

It may also provide a better understanding of the representative nature of directors appointed to front corporate governance activities.

Lehman Brothers (B) outlines the circumstances that led to the firm's bankruptcy in September 2008 based on more detailed analyses of financial market mechanisms, regulatory practices, and common use of analytical methodologies.

It presents how the politics of financial crisis affected Lehman's destiny, while it might have been saved, had it not been too aggressively levered preventing any of its industry peers from taking over its financial positions.

[1] Wikipedia [https://en.wikipedia.org/wiki/Lehman_Brothers]

It also analyses Dick Fuld's leadership style to explain the unfolding of events in Lehman Brothers based on insights from cognitive science.

TEACHING OBJECTIVES AND LEARNING POINTS

The financial industry is dynamic and complex, which is expressed in periodic extremely turbulent market developments. This raises many fundamental issues about how to manage, lead, and govern the various exposures of financial institutions that operate under these volatile and competitive conditions.

While financial and economic exposures are considered quantifiable due to the ready availability of data, it turned out that under extreme crisis conditions, the conventional analytical techniques fell short.

On the other hand, the publicly available financial information from Lehman Brothers' accounts clearly indicates an increasingly aggressive and levered strategy, which must have been condoned by the board since it is so visible.

In other words, it calls for a better understanding of human cognition as decision-makers interpret the reported data, concerted executive behaviors where major banks attempt (or are forced) to be as profitable as their industry peers, and possibly intriguing rivalries among leading figureheads in the industry.

This implicates a diversity of perspectives on corporate governance, executive leadership, public policymaking, and regulatory issues.

Some considerations, or underlying issues:

Corporate governance. What type of expertise, industry experience, background diversity, committee structure, monitoring and control practices should secure effective oversight of corporate business activities? How can the board challenge and support executive leaders? What is the right balance between challenge and support? How can the organization retain a sober and unbiased interpretation of economic conditions?

Executive leadership. What are the potential triggers for excessive (over-)confidence, and narcissistic, hubristic behaviors and how can they be avoided? What are some structural features that may inhibit executive governance diversions? How can management and control processes help alleviate development of potentially adverse personality traits? How can we ensure openness and inclusion within the organization?

Policymaking. What are the important societal issues to guard against as potential financial and economic crises emerge? How do policymakers balance the need for commercial risk-taking with societal concerns for downside losses? How can we avoid the moral hazards of protecting overly aggressive (financial) institutions. How do we proactively monitor developments and take timely actions for prudent protection?

Regulation and enforcement. Is it 'sufficient' to regulate based on quantitative measures on operational loss propensities, liquidity ratios, and capital reserve positions? How do we safeguard against biased judgment and collective industry behaviors? How can we deal with hard-to-quantify strategic exposures? How do we ensure timely interventions as the evolving subprime crisis was observed by industry insiders.

SUGGESTED READINGS

Articles

Perception and human biases

Charles Schwenk (1984). Cognitive simplification processes in strategic decision-making, *Strategic Management Journal*, 5(2), 111-128. https://www.jstor.org/stable/2486171

Hammond, J., Keeney, R. and Raiffa, H. (2006). The hidden traps in decision making, *Harvard Business Review* 83(1), 118-126. https://hbr.org/1998/09/the-hidden-traps-in-decision-making-2

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Finkelstein, S., Whitehead, J. and Campbell, A. (2009). Think again: Why good leaders make bad decisions. *Business Strategy Review*, 20(2), 62-66. http://dx.doi.org/10.1111/j.1467-8616.2009.00601.x

Owen, D. and Davidson, J. (2009). Hubris syndrome: An acquired personality disorder? A study of US Presidents and UK Prime Ministers over the last 100 years. *Brain*, 132(5), 1396-1406. https://doi.org/10.1093/brain/awp008

Jacquart, P. and Antonakis, J. (2015). When does charisma matter for top-level leaders? Effect of attributional ambiguity. *Academy of Management Journal*, 58(4), 1051-1074. https://doi.org/10.5465/amj.2012.0831

Financial institutions context

Stein (2002). The risk taker as shadow: A psychoanalytic view of the collapse of Barings Bank. *Journal of Management Studies*, 37(8), 1215-1230. https://doi.org/10.1111/1467-6486.00222

Greener (2006). Nick Leeson and the collapse of Barings Bank: Socio-technical networks and the 'rogue trader', *Organization*, 13(3), 421-441. https://doi.org/10.1177/1350508406063491

Gilligan (2011). Jerome Kerviel the 'rogue trader' of Société Générale: Bad luck, bad apple, bad tree, or bad orchard? *The Company Lawyer*, 32(12), 355-362. https://ssrn.com/abstract=2014487

Johnson, M. A., & Mamun, A. (2012). The failure of Lehman Brothers and its impact on other financial institutions. *Applied Financial Economics*, 22(5), 375-385. https://doi.org/10.1080/09603107.2011.613762

Dumontaux, N., & Pop, A. (2013). Understanding the market reaction to shockwaves: Evidence from the failure of Lehman Brothers. *Journal of Financial Stability*, 9(3), 269-286. https://doi.org/10.1016/j.jfs.2013.04.001

Books

McDonald, L. G. and Robinson, P. 2009. *A Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers*. Deckle Edge.

Callan Montella, E. (2016). *Full Circle: A Memoir of Leaning in Too Far and the Journey Back*. Triple M Press.

Ball, L. M. (2018). *The Fed and Lehman Brothers: Setting the Record Straight on a Financial Disaster*. Cambridge University Press.

<u>Reports</u>

Immediate responses

The RiskMinds (2009) Risk Managers Survey: The Causes and Implications of the 2008 Banking Crisis. Moore, Carter & Associates and Cranfield University, March 2010. http://www.moorecarter.co.uk/RiskMinds%202009%20Risk%20Managers'%20Survey%20Report.19March2010.pdf

Subsequent rules/regulation

BIS. (2015). *Guidelines: Corporate Governance Principles for Banks.* Bank for International Settlements, Basel, Switzerland. https://www.bis.org/bcbs/publ/d328.htm

Anderson, D. J. and Eubanks, G. (2015). Leveraging COSO across the three lines of defense. Committee of Sponsoring Organizations of the Treadway Commission. https://www.coso.org/Documents/COSO-2015-3LOD.pdf

VIDEOS

The Bank that Bust the World https://www.youtube.com/watch?v=yyOnR2AMs-k

The collapse of Silicon Valley Bank, what caused it? https://www.pbs.org/newshour/show/the-factors-behind-silicon-valley-banks-collapse

TEACHING SUGGESTIONS

The two cases provide different perspectives on the performance of Lehman Brothers before and after bankruptcy. Case (A) before bankruptcy paints a rather positive picture of the firm's spectacular development expressing the official approaches adopted to manage corporate risks although the reported data reveal increased exposures in terms of VaR positions, mortgage investments, and financial leverage.

This is a natural topic for class discussion, i.e., how to interpret the reported exposure to the seemingly profitable mortgage-backed securities business also seen in the context of prior abilities to handle critical market conditions.

It can be pursued by asking students to first discuss the three case questions in smaller groups, if that is a possibility (dependent on class size and available facilities). These discussions will include considerations about the effectiveness of prevailing risk management process and governance structure of the firm.

The general outcomes of prior considerations, whether from individual pondering or group discussions can be entertained in class plenum.

Although most will know about the fate of Lehman Brothers, the discussion based on contemporary information, is likely to invoke reflections about how one would respond to the data if being a prominent member of the board at the time.

Case (B) provides the hindsight view of Lehman Brothers that may be read after class as a deeper reflection of what happened and what caused the eventual bankruptcy. It is undoubtedly true, that the institution had been too aggressive and in the crisis was beyond bailout through mergers or acquisitions by industry peers. Although some will claim that the real cause of its demise was the unwillingness of authorities to bail out the company as was done with several other major financial institutions.

From this perspective, Lehman Brothers became the principled policy case to show that excessive risk-taking should have consequences as the means to avoid the moral hazards from covering for too aggressive market behaviors.

This can lead to a general discussion about the policymaking and regulatory aspects of financial institutions. In this context it is interesting to note how professional market participants ascribed the crisis to amoral and overconfident behaviors among executive decision-makers and not because there was a lack of risk management skills and reporting as appears from reading the Lehman Brothers (A) case.

How interesting then to observe that policymakers and financial regulators not long after the crisis increased their focus exactly on these aspects introducing the Chief Risk Officer concept as a proxy for formal enterprise risk management.

In short, executive personalities and traits like overconfidence, narcissism, and hubris seem to be the real culprits. Yet, these factors are hard to regulate.

A closer examination of Dick Fuld, the CEO of Lehman Brothers might be helpful.

Richard Severin Fuld Jr.

Richard Fuld received a BSc. from the University of Colorado Boulder in 1969 and his attempted career as Air Force pilot was said to end in a fistfight with a commanding officer where he claimed to stand up for a young cadet being taunted by the officer. Instead Fuld changed career and started working at Lehman Brothers dealing commercial paper to eventually become an accomplished fixed-income trader. Meanwhile he earned an MBA from the Stern School of Business, New York University in 1973.

He ended up working with Lehman Brothers for almost 40 years, an unusual feat by modern standards. He witnessed various reorganizations first hand including merging with Kuhn, Loeb & Co, the acquisition by American Express, the merger with E.F. Hutton, and the final spin-off from American Express in 1994. He survived the executive in-fighting that led to the sale of Lehman to Shearson/American Express in 1984 and was running the firm as its CEO when it was spun off.[2] He experienced the preceding loss of $102 million in 1993 and weathered the worst effects of the Asian Financial Crisis in 1997 otherwise producing steady profits leading up to the record result of $4.2 billion in 2007.

He was Wall Street's longest-tenured CEO when the financial crisis emerged in 2007–2008. Named America's top chief executive by *Institutional Investor* in 2006 and included in

[2] Christian Plumb and Dan Wilchins: Lehman CEO Fuld's hubris contributed to meltdown, Reuters, September 15, 2008. [https://www.reuters.com/article/idUSN1341059120080914/]

Barron's list of best CEOs earning the nickname "Mr. Wall Street".[3] He was generally respected by his peers at times referred to as "The Gorilla" reflecting an intimidating demeanor.[4]

He was handsomely rewarded for these accomplishments and was among the highest paid CEOs in the US receiving a total compensation of $22 million in 2007 including a base salary of $750,000, a cash bonus of $4,2 million, and stock grants of $16,9 million.

After the collapse

Fuld testified for the US House Committee on Oversight and Government Reform about causes and effects of the bankruptcy. Asked if he wondered why Lehman Brothers was the only firm that was allowed to fail, he allegedly responded: "*Until the day they put me in the ground, I will wonder*."[5]

He remained critical of the decision not to bail Lehman out pointing to his longtime rival, Henry Paulson, who ran Goldman Sachs before heading the US Treasury during the 2007-2008 crisis.[6] Economist Laurence M. Ball has argued that Lehman could have received a government loan while others claimed that Lehman's asset values were highly uncertain at the time of the bankruptcy.[7]

Fuld sold his Florida mansion bought for $13.75 million to his wife for $100 in November 2008.[8] He joined Matrix Advisors in New York City in March 2009.[9] He was employed by Legend Securities, a New York investment banking outfit from May 2010 to early 2012.[10]

Matrix Advisors under Fuld’s leadership grew to some twenty employees focused on advising small and medium-sized enterprises on corporate matters including mergers and acquisitions, private equity and venture capital funding. The company expanded and opened offices in Los Angeles and Palm Beach in 2017.

Dick Fuld subsequently headed Matrix Private Capital as was able to ‘release’ wealth from the about US$ 500 million he was paid over the last eight years of his reign as CEO of Lehman Brothers. He sold a Manhattan apartment for US$ 25 million in 2009, an art collection for US$ 13.5 million, and other properties including his 71-acre estate in Sun Valley, Idaho for just over US$ 20 million in September 2015.[11]

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[3] Wikipedia, Richard S. Fuld, Jr. [https://en.wikipedia.org/wiki/Richard_S._Fuld_Jr.]
[4] Christian Plumb and Dan Wilchins: Lehman CEO Fuld's hubris contributed to meltdown, Reuters, September 15, 2008. [https://www.reuters.com/article/idUSN1341059120080914/]
[5] Rachelle Younglai and Kim Dixon, Lehman's Fuld: Where was our U.S. bailout? Reuters, October 7, 2008. [https://www.reuters.com/article/us-financial-lehman-idUSTRE4954DL20081007/]
[6] Justin Baer and Gregory Zuckerman, Branded a Villain, Lehman’s Dick Fuld Chases Redemption, wsj.com, September 6, 2018. [https://www.wsj.com/articles/branded-a-villain-lehmans-dick-fuld-chases-redemption-1536238802]
[7] Ball, Laurence M. (2018). *The Fed and Lehman Brothers: Setting the record straight on a financial disaster*. Cambridge, United Kingdom.
[8] Reuters, Lehman's Fuld sold Florida mansion to wife for $100, January 26, 2009. [https://www.reuters.com/article/topNews/idUSTRE50P04A20090126/]
[9] Deal Journal, Lehman Brothers&#8217: Dick Fuld Has a New Gig, *The Wall Street Journal*, April 3, 2009. [https://www.wsj.com/articles/BL-DLB-7857]
[10] Post Staff Report, Fuld: I’m not built for Street life, *New York Post*, February 24, 2012. [https://nypost.com/2012/02/24/fuld-im-not-built-for-street-life/]
[11] Ahiza Garcia, Ex-Lehman CEO Richard Fuld to auction off Idaho estate,CNN Money, July 9, 2015. https://money.cnn.com/2015/07/08/news/lehman-brothers-ceo-richard-fuld-idaho-estate/index.html

No wonder then that he at age 72 in 2015 during a rare public appearance apparently uttered that "*whatever it is, enjoy the ride. No regrets*."[12]

While some find it hard to understand how Dick Fuld can reemerge as financial executive after the damage his prior leadership has caused, he remains actively involved in the financial markets.[13] Hence, he was recently appointed strategic adviser to Oasis Pro Markets, a blockchain company in Darien, Connecticut.[14]

Erin Callan (a lawyer of background) joined Lehman in 1995, became its CFO in late 2007, and was fired two months before the bankruptcy. She was criticized for being underqualified short of basic accounting skills, ignoring 'red flags', and using misleading tactics to boost Lehman's balance sheet. She worked briefly with Credit Suisse before retiring. In her memoirs, "*Full Circle*", she reveals taking an overdose of sleeping pills in late 2008 and regretted putting career ahead of personal relations.

Ben Bernanke, (then) Chairman of the US Federal Reserve Bank became adviser to Pimco (Pacific Investment Management Company) and Citadel (hedge fund company) and visiting fellow at the Brookings Institution. He led the Fed when it was cutting interest rates to stimulate the economy and counteract recession.

Henry Paulson, (then) US Treasury secretary became the Chair of University of Chicago's Paulson Institute. As Lehman was reeling, he was adamant not to rescue Lehman not to be seen as "Mr. Bailout". He since warned against new laws to prevent other banking crises, e.g., the Dodd-Frank legislation imposing tighter regulation on big 'systemic' banks urging instead to focus on key lessons from the crisis.[15]

Some reflections

Can we link the observed personality traits of Dick Fuld to his cognitive perceptions of reality and eventual decision-making behaviors in Lehman Brothers?

Do we see emerging traits of a hubris syndrome due to his prior success and undisputed power as CEO of a major global investment bank?

What was the (potential) role of prior relationships between leading industry leaders?

These could be interesting issues for further class discussions.

[12] Sean Farrell, Lehman Brothers collapse: where are the key figures now? The Guardian, September 11, 2018. https://www.theguardian.com/business/2018/sep/11/lehman-brothers-collapse-where-are-the-key-figures-now
[13] Kelly Ferraro, Where Is Dick Fuld? *Grit Daily News*, December 12, 2022. https://gritdaily.com/where-is-dick-fuld/
[14] Max Reyes, Blockchain Firm Names Former Lehman Chief Richard Fuld Adviser, *Bloomberg News*, September 12, 2022. https://news.bloomberglaw.com/crypto/blockchain-firm-names-former-lehman-chief-richard-fuld-adviser
[15] Sean Farrell, Lehman Brothers collapse: where are the key figures now? The Guardian, September 11, 2018. https://www.theguardian.com/business/2018/sep/11/lehman-brothers-collapse-where-are-the-key-figures-now