# BOOK REVIEW

# TOO BIG TO FAIL, TOO BLIND TO SEE

TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM–AND THEMSELVES. By Andrew Ross Sorkin. New York: Viking. 2009. Pp. 624. $32.95.

*Reviewed by Tom C.W. Lin*[*]

> "We just hit the iceberg. The boat is filling with water, and the music is still playing. There aren't enough lifeboats. [Someone is going to die.]"
>
> - Jamie Dimon, CEO of JP Morgan, on the eve of Lehman Brothers' bankruptcy.[1]

## INTRODUCTION

The sky was falling in 2008. In March, investment bank Bear Stearns, having been founded in 1923 and survived the Great Depression, was sold for $2 a share to JP Morgan in a government-backed fire sale (p. 37). That September, the world witnessed the bankruptcy filing of the venerable investment bank Lehman Brothers and the largest point-drop in the Dow Jones Industrial Average's history.[2] The *New York Times* reporter, Andrew Ross Sorkin, in his book, *Too Big to Fail*, chronicles the fall of these financial institutions and the economic crisis that enveloped the world during this tumultuous period

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1 P. 336.

2 *See* Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill is Sold*, N.Y. TIMES, Sept. 15, 2008, at A1.

from the ultimate insider's perspective of key executives, public officials, attorneys, and regulators.

In the burgeoning market of books that chronicle the events of the recent financial crisis,[3] *Too Big to Fail* stands out for its sheer size (coming in at 624 pages and 2.1 pounds) and its meticulous insiders' account of crucial meetings, decisions, and (even) thoughts of key players. According to Sorkin, his tome is a "product of more than five hundred hours of interviews with more than two hundred individuals who participated directly in the events surrounding the financial crisis" (p. xi). Sorkin's well-sourced narrative paints a tale that places the reader in important meetings, critical conference calls, and sometimes, into the minds of key principals—often revealing the profound, the private, and occasionally, the petty. The book reveals a secret ethics waiver obtained by then Treasury Secretary Hank Paulson, which allowed him to participate in discussions with his former employer, Goldman Sachs (p. 424).[4] The reader also learns that Paulson said, "[t]hat makes me want to vomit!," upon hearing that JP Morgan was elevating the purchase price of Bear Stearns from $2 to $10 (p. 36), and that he *actually* vomited in his office from stress and exhaustion during the height of the crisis (p. 468).

For attorneys, legislators, and regulators, the book highlights the inadequacy of the current regulatory apparatus to handle a modern financial crisis. The banking and securities rules of the 1930's, 1940's, and 1950's are simply not meant for

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[3] *See, e.g.*, GREGORY ZUCKERMAN, THE GREATEST TRADE EVER: THE BEHIND-THE-SCENES STORY OF HOW JOHN PAULSON DEFIED WALL STREET AND MADE FINANCIAL HISTORY (2009); HENRY M. PAULSON, ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM (2010); ROGER LOWENSTEIN, THE END OF WALL STREET (2010); WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET (2009); LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (2009); GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE (2010); KATE KELLY, STREET FIGHTERS: THE LAST 72 HOURS OF BEAR STEARNS, THE TOUGHEST FIRM ON WALL STREET (2009).

[4] An image of the waiver is included in the pictorial inserts in the middle of the book; *see also* Andrew Ross Sorkin, *Paulson's Secret Waiver to Work on Goldman Matters*, Oct. 19, 2008, *available at* http://www.andrewrosssorkin.com/?p=174.

a world created by what Sorkin calls "American-style financial engineering" (p. 3), with complex securities instruments marketed by uber-interconnected financial institutions that serve as financial wholesalers and supermarkets to each other and the masses. At various points in the book, we see the ad hoc approaches that regulators concocted in order to put out simultaneous fires because they lacked proper regulatory tools.[5] Current Treasury Secretary Timothy Geithner, then New York Federal Reserve President, encouraged bank mergers of various permutations to stave off a financial collapse; his persistence led some CEOs to refer to him as "'eHarmony,' after the online dating service" (p. 480).

*Too Big to Fail* offers a meticulous re-telling of one of the most important periods in recent history. As regulators, bankers, lawyers, scholars, and other interested parties sift through the rubble in search of knowledge about the crash, *Too Big to Fail* serves both as a chronicle of the recent past and a cautionary tale for the immediate future. Acknowledging past missteps, uncovering root causes, and correcting systemic shortcomings to prevent similar failure is arguably the key economic and regulatory challenge of our time.

Part I of this Essay summarizes key episodes of the financial crisis as covered by *Too Big to Fail*. Part II examines a potential explanation of the crisis unexplored in the book in light of the decline of neoclassical economic theory and the emergence of behavioral economic theory. Finally, this Essay closes with a brief conclusion.

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[5] Nearly two years following the maelstrom of the financial crisis, Congress passed landmark financial regulatory reform legislation aimed at providing more tools to regulators to prevent and to manage similar crises in the future. *See, e.g.*, Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, July 22, 2010, at B3 (reporting on the expansion of federal regulatory powers in the new financial reform law); Edward Wyatt & David M. Herszenhorn, *In Deal, New Authority Over Wall Street*, N.Y. TIMES, June 26, 2010, at A1 ("The final bill vastly expands the regulatory powers of the Federal Reserve and establishes a systemic risk council of high-ranking officials, led by the Treasury secretary, to detect potential threats to the overall financial system."); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h41 73enr.txt.pdf.

## I. THE CHRONICLES OF A CRASH AND RESCUE(S)

According to Sorkin, *Too Big to Fail* is structured like the 2004 Oscar-winning movie *Crash*, consisting of several seemingly independent storylines—the forced closeout sale of Bear Stearns, the precipitous failure of Lehman Brothers, and the colossal collapse of AIG—that form a collective narrative about a financial system (and the world) pushed to the brink.[6] The book opens in the Park Avenue apartment of JP Morgan CEO, Jamie Dimon, on September 13, 2008, with Lehman treading the thin line between rescue and ruin. Dimon summons his brain trust on a conference call and warns them "to prepare right now for Lehman Brothers filing . . . [a]nd for Merrill Lynch filing . . . [a]nd for AIG filing . . . [a]nd for Morgan Stanley filing . . . [a]nd potentially for Goldman Sachs filing" (p. 3). In doing so, Dimon was essentially commanding his senior executives to prepare for financial Armageddon. With that brief prologue, Sorkin begins his detailed chronicle of the crash and rescue(s) of the financial system.

### *The End of Bear Stearns*

The end of Bear Stearns, in March of 2008, sent shock waves through the financial system, many of which continued to be felt for years after. Based on Sorkin's reporting, we discover that then Treasury Secretary Paulson was personally and secretly behind the "original paltry sale price" of $2 per share (p. 37). JP Morgan's purchase of Bear required a government backstop of $29 billion, for which "Paulson did not want to be seen as a patsy, bailing out his friends on Wall Street," so he insisted on a very low, nominal price (p. 37). Much to the chagrin and disgust of Paulson, Dimon would ultimately elevate the $2 price to $10 in order to secure a smooth shareholder ap-

[6] *See* Gabriel Sherman, *The Information Broker*, NEW YORK MAGAZINE, Nov. 8, 2009 ("The structure of *Too Big to Fail* is 'modeled almost shamelessly on the movie *Crash*,' Sorkin says. 'I thought you could sort of structure each of these various story lines, which seemed to be happening in this almost autonomous, semi-independent way, sort of like *Crash* does. And of course as the story progresses, they cataclysmically come together and you start seeing the connections between things.'").

proval vote. Dimon, in congressional testimony, compared the purchase of Bear Stearns to "buying a house on fire" (p. 71).

The rescue of Bear by the government was necessitated by the lack of tools in the federal regulatory apparatus. Because Bear was a pure investment bank, the Federal Reserve and Treasury had limited means to provide direct assistance. As a result, the Federal Reserve had to work through a regulated bank, like JP Morgan, which had a major commercial banking arm, in order to save Bear. This lack of regulatory authority becomes a recurring theme during the financial crisis, as government officials continuously struggled to fend off massive failure with limited resources, and more troublingly, a limited legislative mandate.

### *The Fall of Lehman Brothers*

With the specter of Bear's death looming large in the spring of 2008, senior executives at Lehman Brothers and the federal government attempted to stave off another shock to the financial system by stabilizing Lehman. Dick Fuld, the then longtime CEO of Lehman, made various attempts at capitalization as institutional clients made runs at the bank and the market battered the stock in the wake of the subprime mortgage crisis. Fuld and senior federal officials discussed possible deals with Bank of America, Barclays, Warren Buffett, Morgan Stanley, and the Korean Development Bank.[7] In the book, Sorkin portrays Fuld as an intensely hard-charging executive bent on fighting back the rising tide against his firm, often to the detriment of his cause. Fuld was convinced that his firm was on solid ground, that market sanity would return, and that Lehman would weather this storm. "*They'd survive*, he told himself. *They always did*" (p. 12). Fuld's confidence, and bunker mentality, perhaps inadvertently forced him to sabotage a

[7] *See* Eric Dash, *5 Days of Pressure, Fear and Ultimately, Failure*, N.Y. TIMES, Sept. 16, 2008 ("Fuld redoubled efforts to execute his plan to sell parts of the firm. The once unthinkable notion of selling Lehman in its entirety was also put on the table . . . [and when Lehman] shares plunged to a bargain-basement price below $4, potential suitors came out of hiding, including Barclays of Britain and Bank of America.").

deal with the Korean Development Bank at the eleventh hour by insisting on renegotiating a material term (pp. 215-16).

As the fall of Lehman seemed imminent, Fuld came off as a paranoid and stubborn man who refused to accept the hard truth about the coming financial tsunami and continued to insist that his empire was simply being attacked by malicious rumors and short-sellers. "The shorts! The shorts!," Fuld bellowed. "That's what's happening here!" (p. 14). In the end, Fuld lost sympathy from both his peers and government officials, who also came to believe that he had no credibility. In meeting with the heads of the major banks to save Lehman, Paulson declared, "Dick is in no condition to make any decisions. . . . He is in denial" (p. 303). On September 15, 2008, after much effort, but no success by both public and private actors, Lehman Brothers filed for bankruptcy.[8] It was the largest bankruptcy of all time, with assets totaling over $600 billion.[9] The Dow dropped over 500 points that day.[10]

*The Shotgun Merger of Bank of America/Merrill Lynch*

As Wall Street and Washington worked feverishly to stave off the bankruptcy of Lehman, many sensed that the next domino to fall would be Merrill Lynch. Greg Fleming, the President and COO of Merrill, and John Thain, the new CEO, knew that they were the financial tsunami's next target as they scrambled to find capital to stabilize their firm. "If Lehman was swallowed up, there would be a run on the next biggest broker-dealer—and that was his [Thain's] firm. Merrill Lynch, perhaps the most iconic investment bank in the nation, was on the brink of ruin" (p. 310). With their very existence at risk, Merrill's senior executives turned to Morgan Stanley and Bank of

[8] *See* Sorkin, *supra* note 2 (talking about how Lehman filed for bankruptcy); *see also* Carrick Mollenkamp et al., *Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash*, WALL ST. J., Sept. 16, 2008, at A1.

[9] *See* Sam Mamudi, *Lehman folds with record $613 billion debt*, MARKETWATCH, Sept. 15, 2008 ("Lehman Brothers Holdings is closing its doors with more than $600 billion of debt—the biggest bankruptcy in U.S. history.").

[10] *See* Stephen Labaton, *Wall St. in Worst Loss Since '01 Despite Reassurances by Bush*, N.Y. TIMES, Sept. 16, 2008, at A1 ("By the end of the day, the Dow Jones industrial average had dropped 504.48 points.").

America for a capital infusion. Once a deal with Morgan Stanley became unfeasible, Merrill turned its attention to Bank of America.

According to Sorkin's astute reporting, unbeknownst to Thain and Fleming, Bank of America had attempted to purchase Merrill the year before, without success, in a seller's market (p. 314). Now, the tide had changed, and it was a buyer's market and Bank of America was one of only a few potential buyers. While Merrill was only looking to sell a percentage of itself, Bank of America was looking to buy the whole company. With very little leverage and even less time, the Merrill team was able to convince Bank of America to make the purchase at a significant premium and fund its bonus pool with government support (p. 359).[11] Given the ethnography of the firms, many were surprised by their marriage. "Merrill Lynch, with a history of nearly one hundred years as one of the most storied names on Wall Street, would be sold to Bank of America for the biggest premium in the history of banking mergers. It was . . . as if Wal-Mart were buying Tiffany's" (p. 359).

The Bank of America-Merrill Lynch deal was done in such haste and under such pressure that more than a year after the merger, regulators, legislators, and shareholder advocates continue to examine the steps and missteps that led to the shotgun marriage. As of this writing, Ken Lewis and John Thain, the respective CEOs of Bank of America and Merrill, are no longer with the merged firm, and lawsuits and investigations relating to the merger persist.[12]

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[11] *See generally* Matthew Karnitschnig et al., *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1.

[12] *See, e.g.*, *In re* Bank of America Corp. Sec. Litig., No. 09 MDL 2058 (S.D.N.Y. 2010); Dan Fitzpatrick & Kara Scannell, *Ex-BofA Chief Sued for Fraud*, WALL ST. J., Feb. 5, 2010, at A1 ("Former Bank of America Corp. Chief Executive Kenneth D. Lewis and the company's current consumer-banking chief were accused in a civil complaint of duping investors by failing to disclose mounting losses at Merrill Lynch & Co. before shareholders approved the securities firm's takeover by the giant bank."); Stephen Majors, *Bank of America Hid Losses, Lawsuit Says*, WASH. POST, Sept. 29, 2009, at A15 ("Bank of America executives improperly concealed billions of dollars in losses and billions in bonuses paid by Merrill Lynch before a shareholder vote on their proposed merger, Ohio's attorney general argued in a class-action securities lawsuit he described as among the largest in history.").

*The Survival of Morgan Stanley & Goldman Sachs*

Following the merger of Bank of America and Merrill Lynch, Wall Street shifted its focus to the last two pure investment banks—Morgan Stanley and Goldman Sachs. According to *Too Big to Fail*, Morgan Stanley sought capital from various sources, including the Chinese and Japanese, and contemplated merging with Citigroup, Wachovia, or JP Morgan among others (pp. 411, 415-16, 462-63, 478). Despite heavy pressure from the Treasury Department and the Federal Reserve to merge with another institution at a steep discount, John Mack refused to cower to the pressure and decided to seek another path to survival (p. 481). After intense negotiations, Mack was able to secure a $9 billion capital infusion from the Japanese bank, Mitsubishi. In a final twist of drama, the deal was set to close on Columbus Day, when banks in America and Japan were closed, so a wire transfer was not possible (p. 513). To facilitate the closing on an intercontinental bank holiday, a check was written—a check that read: "Pay Against this Check to the Order of Morgan Stanley. $9,000,000,000.00" (p. 518).[13]

Goldman Sachs, the widely held top investment bank of Wall Street, like Morgan Stanley, faced similar market and regulatory pressures. It was in need of a significant capital infusion at a time when funds were extremely scarce. Treasury officials initially pushed Goldman to merge with Wachovia, but subsequently declined to support the deal because of the public relations concerns stemming from the fact that many of the interested parties had significant ties to Goldman. As Warren Buffett succinctly put it:

> By tonight the government will realize they can't provide capital to a deal that's being done by the firm of the former Treasury secretary with the company of a retired vice chairman of

[13] An image of the $9 billion check that saved Morgan Stanley is included in the pictorial inserts in the middle of the book; *see also* Andrew Ross Sorkin, *Morgan Stanley's $9,000,000,000.00 Check. That's $9 Billion!*, Nov. 20, 2008, *available at* http://www.andrewrosssorkin.com/?p=355.

> Goldman Sachs . . . . They'll all wake up and realize even if it was the best deal in the world, they can't do it.[14]

Goldman ultimately secured $5 billion of funding through Buffett's Berkshire Hathaway by giving Buffett a very generous deal in exchange for the capital and the oracle's imprimatur.[15]

In late September 2008, amid all the deal-making, both Morgan Stanley and Goldman Sachs—the last two independent investment banks—announced that they were becoming bank holding companies in order to gain access to more federal funds in exchange for greater regulatory oversight.[16] It was the end of a gilded era on Wall Street.

*The Rescue of AIG (and Everyone Else)*

Even as the individual institutions found remedies to their serious ills, the financial system as a whole remained at risk. A holistic remedy was needed for the financial system, and part of that remedy involved curing an institution that was not even an investment bank, but an insurance company—American International Group (AIG). For many years prior to the financial crisis, a unit of AIG sold credit default swaps, a form of "insurance" for bonds.[17] Investment banks would buy these swaps in order to hedge their holdings in the event of a bond default, in which case AIG would redeem the swap like an insurance payout. The banks purchased hundreds of billions of dollars of swaps as insurance, which incidentally was great for

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[14] P. 473.

[15] *See generally* Susanne Craig et al., *Buffett to Invest $5 Billion in Goldman*, WALL ST. J., Sept. 24, 2008, at A1 (explaining the conditions behind Warren Buffet's investment in Goldman Sachs).

[16] *See* Andrew Ross Sorkin & Vikas Bajaj, *Radical Shift for Goldman and Morgan*, N.Y. TIMES, Sept. 22, 2008, at A1 ("Goldman Sachs and Morgan Stanley, the last big independent investment banks on Wall Street, will transform themselves into bank holding companies subject to far greater regulation.").

[17] *See* Michael Lewis, *The Man Who Crashed the World*, VANITY FAIR, Aug. 2009 (describing the process by which AIG Financial Products sold the swaps); *see also* Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1 ("AIG's credit-default-swaps operation was run out of its AIG Financial Products Corp. unit.").

AIG's bottom line.[18] But the problem was that AIG's assumptions for their swap business did not properly account for a major real estate market downturn and the potential for massive payouts—which was exactly what happened in 2008.[19] AIG was like a casino that took bets but did not have the funds to pay winners.

As the federal regulators examined the problem, they realized that AIG was the thin thread holding the financial system back from the brink. "As Paulson and Bernanke both knew, AIG had effectively become a linchpin of the global financial system," and failure was not an option (p. 394). AIG reported obligations on credit default swaps that were in excess of $300 billion in 2008 (p. 395). If AIG failed, the banks would be forced to "mark down assets and raise billions of dollars—a frightening prospect in the current markets" (p. 395). Moreover, if AIG failed, millions of average Americans, who purchased life and health insurance policies with AIG, would also be adversely affected. When President Bush was briefed on the issue he posed a pedestrian yet profound question: "An insurance company does all this?" (p. 401).

After false starts with a private bailout, the Federal Reserve structured a historic $85 billion loan to AIG in exchange for an 80% equity stake in the company.[20] The federal loan benefited not only AIG, but the numerous investment banks that had purchased the swaps since the loan made it possible for AIG to pay its swap obligations.[21] "More than a quarter of the bailout funds left AIG immediately and went directly into the

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[18] *See* Mollenkamk, *supra* note 8 ("AIG became one of the largest sellers of credit-default-swap protection . . . [and f]or years, the business was extremely lucrative.").

[19] *See id.* ("AIG relied on . . . models to help figure out which swap deals were safe. But AIG didn't anticipate how market forces and contract terms not weighed by the models would turn the swaps, over the short term, into huge financial liabilities.").

[20] *See* Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1 ("Under terms hammered out Tuesday night, the Fed will lend up to $85 billion to AIG, and the U.S. government will effectively get a 79.9% equity stake in the insurer in the form of warrants called equity participation notes.").

[21] *See, e.g.*, Mark Pittman, *Goldman, Merrill Collect Billions After Fed's AIG Bailout Loans*, BLOOMBERG, Sept. 29, 2008 (describing how AIG used the loans that it received from the Federal Reserve to meet collateral calls).

accounts of global financial institutions like Goldman Sachs, Merrill Lynch, and Deutsche Bank, which were owed the money under the credit default swaps that AIG had sold them" (p. 532).[22]

### *Passing TARP and Bailing Out America*

A day after the historic loan to AIG, Treasury Secretary Paulson and Federal Reserve Chairman Ben Bernanke met with key legislators to propose a systemic stabilizing solution in the form of a bailout bill in order to stem the spreading contagion that was the toxic financial assets on the books of major banks.[23] The proposal came in the form of a $700 billion program, now known as the Troubled Asset Relief Program (TARP), that would give the Treasury Secretary great authority to buy troubled financial assets and take other actions necessary to stabilize the financial system.[24] At the meeting, Bernanke made it gravely clear how much the country needed such a program: "If we don't do this . . . we may not have an economy on Monday."[25]

According to Sorkin, the genesis of TARP was a then-five-month-old document that Paulson had asked his deputies to prepare in the event of a financial doomsday scenario (p. 419). The document was entitled the "'Break the Glass' Bank Recapitalization Plan."[26] The first draft of the TARP bill presented to Congressional leaders was only three-pages long and gave the Treasury Secretary unbridled authority for oversight and post-hoc review (pp. 467-68).[27] After much political posturing—after

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[22] *See* Richard Teitelbaum, *Secret AIG Document Shows Goldman Sachs Minted Most Toxic CDOs*, BLOOMBERG, Feb. 23, 2010 ("Paris-based Societe Generale got the biggest payout from AIG, or $16.5 billion, followed by Goldman Sachs, which got $14 billion, and then Deutsche Bank and Merrill Lynch.").

[23] *See* Joe Nocera, *As Credit Crisis Spiraled, Alarm Led to Action*, N.Y. TIMES, Oct. 2, 2008, at A1.

[24] *See generally Summary of Financial Bailout Legislation*, REUTERS, Sept. 28, 2008, *available at* http://www.reuters.com/article/idUKTRE48R48220080928.

[25] Nocera, *supra* note 23.

[26] Andrew Ross Sorkin, *Source Document: Treasury's Confidential 'Break The Glass' Plan*, Nov. 29, 2008, *available at* http://www.andrewrosssorkin.com/?p=368.

[27] *See Text of Draft Proposal for Bailout Plan*, N.Y. TIMES, Sept. 21, 2008.

all, it was a presidential election year—a bill was brought to the floor of the House of Representatives for a vote and it was rejected.[28] "Stock prices plunged, with the Dow Jones Industrial Average tumbling 7 percent, or 777.68 points, its biggest one-day point drop ever" (p. 499). After more political maneuvering, TARP was passed by Congress and signed into law by President Bush on October 3, 2008, giving the federal government more tools and resources to deal with the financial crisis.[29]

*Too Big to Fail* ends with a dramatic secret meeting in Washington where Paulson gathered the heads of the "Big 9" Wall Street firms and strongly encouraged them, in unequivocal terms, to sell tens of billions of dollars of preferred stock to the U.S. Government in exchange for TARP money in order to stabilize the system and avoid a second Great Depression (pp. 519-24). Some commentators compared the meeting to a "reverse holdup" because the banks were essentially forced to take government bailout money.[30] While there was some initial reluctance to sign the agreements, the banks ultimately had no choice, given the overwhelming pressure from their regulators. After all nine banks signed the agreements, Paulson felt like the country had "just crossed the Rubicon" (p. 528).

For most of the book, Sorkin does very little editorializing, explaining, and forecasting. Like a good reporter, he focuses on reporting the facts and events as they happened. However, in the book's brief *Epilogue*, Sorkin does wonder aloud: "Could the financial crisis have been avoided?" (p. 534); "[D]id the government's response mitigate it or make it worse?" (p. 534); and,

[28] *See* Carl Hulse & David M. Herszenhorn, *House Rejects Bailout Package, 228-205; Stocks Plunge*, N.Y. TIMES, Sept. 30, 2008, at A1 ("In a moment of historic import in the Capitol and on Wall Street, the House of Representatives voted on Monday to reject a $700 billion rescue of the financial industry.").

[29] *See* David M. Herszenhorn, *Bush Signs Rescue Bill After House Vote*, N.Y. TIMES, Oct. 3, 2008, at A1 ("The House of Representatives gave final approval on Friday to the $700 billion bailout for the financial system, reversing course to authorize what may be the most expensive government intervention in history.").

[30] *See, e.g.*, Donald L. Barlett & James B. Steele, *Good Billions After Bad*, VANITY FAIR, Oct. 2009, at 204 (showing how bank executives were told to clear matters with their boards and accept TARP money in the aftermath of a meeting with Secretary Paulson).

Did Lehman have to fail? (pp. 535-37). While he does not provide judgment or answers to these questions, he does acknowledge that the financial system is in need of much reform and that the events chronicled in *Too Big to Fail* need to be studied for years to come to prevent similar calamities in the future (pp. 538-39).

## II. An Unexplored Explanation In A Messier Model

*Too Big to Fail* contains little in terms of thorough diagnosis or explanation of the crisis, as Sorkin states that the book's purpose is to provide "the first detailed, moment-by-moment account of one of the most calamitous times in our history" and not necessarily to diagnose it (p. xii). While lacking in diagnoses and explanations, Sorkin's account offers diagnostic value for scholars who are searching for root causes of the crisis, much like a diligent fossil collector's find is to paleontologists theorizing about the extinction of dinosaurs. One explanation of the financial crisis, unexplored but insinuated in the book, is the fallacy of the neoclassical economic model that is at the foundation of our financial system. The financial crisis is in some ways a tragic tale about blind faith in false parables about perfectly efficient markets with uber-rational actors, and the need for a better economic archetype to augment the existing paradigm.

### *A. The End of Everything (As We Know It)*

The American economy, and particularly the financial industry, is built on an elegant neoclassical free market ideology that is premised on rational actors and efficient markets. Prior to the financial crisis, unbridled free market capitalism was thought by many to be the superior, most evolved, economic system that should be adopted by the world over. At the beginning of *Too Big to Fail*, we hear this echoed by Sandy Weil, the former CEO of Citigroup, shortly before the crisis: "The whole world is moving to the American model of free enterprise and capital markets" (p. 4). Faith in the free markets and its self-corrective nature was strong and pervasive. Such fervent faith, coupled with continuous economic growth, made deregulation *the* guiding regulatory principle of the last few decades.[31] Deregulation, in part, made it possible for certain institutions to become too big to fail, and it also sowed the seeds for many of the financial crisis' poisonous fruits, such as dangerous short-selling, over-leveraged banks, and unsupervised investment banks.[32] The thinking among many in government, industry, and academia was: *why regulate when markets self-correct? After all, markets are smarter and more efficient than government bureaucrats.*[33] That line of thinking changed for many with the recent financial crisis, which brought the entire global economic system to the verge of collapse.

In the aftermath of the crisis, and in search of answers, many have begun to question our fundamental assumptions and understandings about our economy and our financial markets. *If free markets are self-correcting, then why did it need over a trillion dollars worth of government bailouts to survive? If investors are rational, why did so many invest in toxic assets?* In the wake of the crisis, both true believers and loyal critics of our free market system have expressed their either newly-founded or long-held doubts. Following the financial crisis, former Federal Reserve Chairman Alan Greenspan, an Ayn Rand apologist and free market proselytizer, expressed his "shock[]" and "distress[]" upon discovering a flaw in the free market ideology "that define[d] how the world works."[34] Simi-

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[31] *See, e.g.*, SARKIS J. KHOURY, THE DEREGULATION OF THE WORLD FINANCIAL MARKETS: MYTHS, REALITIES, AND IMPACT (1990); Éric Tymoigne, *Securitization, Deregulation, Economic Stability, and Financial Crisis, Part I - The Evolution of Securitization* (Levy Econ. Inst. Of Bard College, Working Paper No. 573.1, 2009), *available at* http://www.levyinstitute.org/pubs/wp_573_1.pdf (last visited Nov. 1, 2010).

[32] *See* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 782 (2009) ("[E]xcessive deregulation was a principal cause of the 2008 financial crisis.").

[33] *See, e.g.*, Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 3 (2003) ("Under the Efficient Capital Market Hypothesis, the 'smart' money will set prices and through the process of arbitrage will swamp the influence of the poorly informed or foolish. Even the unsophisticated therefore can rely on market efficiency to ensure that the price he pays for a security will be 'fair.'"); *see generally* A.C. Pritchard, *The SEC at 70: Time For Retirement?*, 80 NOTRE DAME L. REV. 1073 (2005).

[34] *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Government Reform*, 110th Cong. 36-37 (2008) (statement of

larly, Richard Posner, the prominent federal judge, legal scholar, and free-market ideologue from the University of Chicago, also expressed his doubts about the coventional understandings of American capitalism and our economy.[35] Posner went so far as to call himself a Keynesian now,[36] and call into question the practical utility of the works of his colleagues from the University of Chicago, the St. Peter's Cathedral of free market, laissez-faire economics.[37] These new views from Greenspan, Posner, and other purist free-market thinkers, amounted to apostasy to true believers, and forced everyone to re-examine the fundamental assumptions of our free market economic model. *Are free markets always self-correcting? Is deregulation always the better alternative to government intervention? Are individuals truly uber-rational actors?*

### *B. A New and Messier Model*

In light of the financial crisis, the long-cherished, elegant free market economic model appeared inaccurate and inadequate. A new model, based on newly discovered understandings, is needed to make sense of the mess that was the financial crisis. One of the central tenets of the elegant neoclassical economic model is that individuals are wholly-rational and uber-disciplined.[38] In fact, much of financial regulation is pre-

Dr. Alan Greenspan), *available at* http://oversight.house.gov/images/stories/documents/20081024163819.pdf.

[35] *See* Richard A. Posner, *How I Became a Keynesian*, NEW REPUBLIC, Sept. 23, 2009 ("We have learned since September that the present generation of economists has not figured out how the economy works."); *see generally* RICHARD A. POSNER, THE FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009); RICHARD A. POSNER, THE CRISIS OF CAPITALIST DEMOCRACY (2010).

[36] *See* Posner, *supra* note 35 (saying that Keynes' views are still as relevant today as they were when Keynes published them).

[37] *See* John Cassidy, *After the Blowup*, THE NEW YORKER, Jan. 11, 2010, at 28 ("I think the challenge is to the economics profession as a whole, but to Chicago most of all.").

[38] *See, e.g.*, GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 14 (1976) ("[A]ll human behavior can be viewed as involving participants who [(1)] maximize their utility [(2)] from a stable set of preferences and [(3)] accumulate an optimal amount of information and other inputs in a variety of markets."); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477-79 (1998) (discussing the perception of individuals in the standard model, and showing how

mised on the reasonable investor as the homo economicus, the rational man.[39] Creating policies for the rational man is easy—give them access to all relevant information and all the possible choices and they will make the utility maximizing choice.[40] Yet extraordinary financial crises and ordinary daily life tell us that real individuals deviate greatly from their neoclassical uber-rational brethren. Real people lack perfect self-control and are not entirely logical,[41] and as a result, markets are not always perfectly efficient. A newer and messier model, premised on real individuals, who are inherently flawed, has been gaining prominence in the wake of the financial crisis.

Over the last few decades, a growing body of literature in behavioral economics has provided a strong case against the perfect rationality of individuals and the elegant efficient markets by placing greater emphasis on the messier human aspects of markets and their participants. For Richard Thaler, the prominent University of Chicago behavioral economist, the choice between neoclassical economics and behavioral economics is a "choice between being precisely wrong or vaguely

bounded rationality, bounded willpower, and bounded self-interest, causes people to depart from the classical economic model).

[39] *See* Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99, 111 (2005) ("[M]any courts appear to view the reasonable investor as referring to a normative idealized type of behavior, instead of a descriptive realistic depiction of actual behavior."); Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 297 (2009) ("Decisional law and the related literature support the view that the reasonable investor is a rational investor."); David A. Hoffman, *The "Duty" to be a Rational Shareholder*, 90 MINN. L. REV. 537, 545 (2006) ("Rational shareholders know what they want and select it in the most efficient way available.") (emphasis omitted); *see generally* Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law,* 50 STAN. L. REV. 1551 (1998).

[40] *See* Richard H. Thaler, *Mortgages Made Simpler*, N.Y. TIMES. July 5, 2009, at 4; *see also* Hoffman, *supra* note 39, at 560 (pointing out that the "[c]lassical theory asserts that rational shareholders are presumptively able to evaluate the thousandth page in a prospectus just as well as the first" and use that information to make a rational decision).

[41] *See* Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 669 (1999) ("[I]ndividuals often will be swayed by the force of their affective responses to events and decisions, regardless of whether their rational, sequential, analytical system would opt for a different course.").

right."[42] For Thaler, and others like him, the behavioral model is messy "[b]ecause human nature is a mess."[43] An explanation for the financial crisis unexplored by Sorkin, in *Too Big to Fail*, is the fundamental fallacy of the rational man assumption lying at the heart of our financial model and economy. While unexplored, Sorkin alludes to the notion that the root of the crisis may be more anthropomorphic than technical, more a failure of man than system. "[W]hether an institution—or the entire system—is too big to fail has as much to do with the people that run these firms and those that regulate them as it does any policy or written rules" (p. 539). Behavioral economists have convincingly challenged the neoclassical tenet of the rational actor by identifying certain cognitive limitations that bind our rationality, such as mental biases, heuristics, and other irrational impetuses.

Three types of interrelated cognitive limitations are worth noting in terms of the financial crisis: overconfidence, herd behavior, and cultural cognition. The meticulous narrative of *Too Big to Fail* serves as a wonderful case study into irrational behavior and its severe consequences.

## Overconfidence

Individuals generally have an overabundance of confidence in their own abilities and an overabundance of optimism in their futures, despite facts to the contrary.[44] The story of the financial crisis is in many ways a story of hubris. It is a tale about individuals who bought homes that they could not af-

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[42] JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET 298 (2009).

[43] *Id.*

[44] *See, e.g.*, David A. Armor & Shelley E. Taylor, *When Predictions Fail: The Dilemma of Unrealistic Optimism*, *in* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 334, 334 (Thomas Gilovich et al. eds., 2002) ("One of the most robust findings in the psychology of prediction is that people's predictions tend to be optimistically biased. By a number of metrics and across a variety of domains, people have been found to assign higher probabilities to their attainment of desirable outcomes than either objective criteria or logical analysis warrants."); *see also* Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 806 (1980) (showing how individuals can be overcome by unrealistic optimism).

ford,[45] bankers who thought that the market would only rise,[46] financial engineers who felt that they had mastered risk, and regulators who believed that they had control over financial risk.[47] A financial crisis is often thought of as a crisis of confidence—too little confidence.[48] But behavioral studies in economics and psychology suggest that financial crisis may also be caused by too much confidence, and that sometimes humility is all that stands between stability and collapse.

Sorkin chronicles many instances of overconfidence on the part of key players in *Too Big to Fail*. There was Hank Paulson telling a Senate committee that if he was given temporary authority and funding ("bazooka[s]") to help Fannie Mae and Freddie Mac, then he may not have to use it, and Fannie and Freddie would stabilize, and he knew this because "[he has] been around [the] markets for a long time" (p. 200). Paulson, of course, turned out to be wrong. Then there was the strange

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[45] *See* Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 23, 2009, at A15 ("It cannot just be assumed that most people who during the housing boom bought homes with adjustable-rate mortgages, or mortgages with prepayment penalties, or mortgages that required a low or even no down payment, were fools or victims of fraud."); Bianna Golodryga, *Do Homeowners Share Blame for Mortgage Mess?*, ABC NEWS, Oct. 7, 2008 ("More Americans than ever have become first-time homeowners in the last decade. It's become increasingly clear, however, that many of them couldn't keep up with home payments."); John Carney, *20 Year Old Buys Home With $183,000 FHA Loan And Just 3.5% Down*, BUS. INSIDER, Oct. 18, 2009 (giving an example of an overly optimistic homeowner).

[46] *See, e.g.*, *Hearing Before the Financial Crisis Inquiry Commission*, 12 (2010) (testimony of Lloyd C. Blankfein, Chairman and CEO, The Goldman Sachs Group, Inc.), *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Blankfein.pdf; David Ewing Duncan, *A Crisis of Overconfidence*, FORTUNE, Dec. 8, 2009 (stating that bankers were not immune from the wave of overconfidence that preceded the financial collapse); Malcolm Gladwell, *Cocksure*, NEW YORKER, July 27, 2009, at 24 (suggesting the roots of the financial crisis were partially psychological and the result of bankers believing that the market would continue to rise).

[47] *See* Anthony Faiola, Ellen Nakashima & Jill Drew, *What Went Wrong*, WASH. POST, Oct. 15, 2008, at A1 (reporting on the failure of regulators to curb financial risk); *see also* PRESIDENT'S WORKING GROUP ON FIN. MKTS., OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 5 (1999), *available at* http://www.ustreas.gov/press/releases/reports/otcact.pdf.

[48] *See* Jonathan Alter, *America's New Shrink*, NEWSWEEK, Feb. 21, 2009, at 19 ("Too much confidence makes people and nations hubristic, while those on the receiving end feel conned. Too little confidence breeds timidity and uncertainty, which can be fatal.").

case of Dick Fuld, who despite overwhelming facts to the contrary, still believed that his company was salvageable at a premium to its market price. This overconfidence in his firm, and his own abilities, led him to inexplicably destroy a deal with the Korean Development Bank at the eleventh hour that may have saved his beloved Lehman empire (pp. 215-16).

### Herd Behavior

Herd behavior exists when people behave in a certain way simply because many other people are acting and thinking similarly.[49] The gravitational pull of the herd can lead individuals to make irrational decisions. In the financial context, herd behavior can result in stock market bubbles and crashes, as well as bank runs.[50]

During the financial crisis, there were many examples of herd behavior and its effects. Burgeoning investments in real estate by many led many others, for no rational reason, to invest in real estate, leading to a domestic real estate market bubble, which in turn led to a collapse in the mortgage securities market that was heavily invested in by investment banks. As a result, both weak and healthy financial institutions felt the thundering of the irrational herd, as every major bank in America tried to steel itself for the stampede. The herd mentality, as detailed in *Too Big to Fail*, was also evident in short sellers of bank stocks (pp. 81, 201), runs on the banks (pp. 10, 82), and efforts by regulators to minimize their impact. Herd behavior also reared its head in executive suites where some senior officers foresaw a looming crisis, yet did not take prudent action to swim against the tide. Chuck Prince, the then CEO of Citigroup, infamously said: "When the music stops, in terms of

[49] *See generally* ROBERT R. PRECHTER, JR., THE WAVE PRINCIPLE OF HUMAN SOCIAL BEHAVIOR AND THE NEW SCIENCE OF SOCIONOMICS 152-53 (1999); *see also* Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797, 798 (1992) (herd behavior involves "everyone doing what everyone else is doing, even when their private information suggests doing something quite different"); Laurens Rook, *An Economic Psychological Approach to Herd Behavior*, 40 J. ECON. ISSUES 75, 75 (2006) (showing how herd behavior influences individual behavior).

[50] *See, e.g.*, ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 149-53 (2000) (describing how crowd behavior can potentially have an effect on market dynamics).

liquidity, things will be complicated, . . . [b]ut as long as the music is playing, you've got to get up and dance. We're still dancing."[51] Prince meant that so long as everyone else was making money off dangerously risky behavior, his firm was going to do the same.

## Cultural Cognition

Based on a growing body of studies and literature, individuals tend "to conform their beliefs about disputed matters of fact . . . to values that define their cultural identities."[52] This tendency is known as cultural cognition.[53] In the run up and aftermath of the financial crisis, many public officials have railed against a seedy and avaricious "wall street culture" for bringing down the global economy. If there is a "wall street culture," then recent cultural cognition studies would imply that some of the irrational, suboptimal decisions made by key players during the crisis may not be completely attributable to avarice alone, but can, in part, be attributable to a cognitive over-identification with that culture and its values.[54] *Too Big to Fail* highlights many instances of the incestuous nature of the financial industry.[55] The regulators and the regulated often came from and traveled in the same circles.[56] Divergent backgrounds and dissenting views were often few and far between.

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[51] Rhys Blakely, *Should Chuck Prince go from Citigroup? The Web's Verdict*, TIMES ONLINE, Oct. 2, 2007, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2573692.ece.

[52] Yale Law School, The Cultural Cognition Project (including such matters of fact as "whether global warming is a serious threat; whether the death penalty deters murder; whether gun control makes society more safe or less"), *available at* http://culturalcognition.net (last visited Nov. 1, 2010).

[53] *See* Dan M. Kahan & Donald Braman, *Cultural Cognition and Public Policy*, 24 YALE L. & POL'Y REV. 149, 150 (2006) ("[W]hat citizens believe about . . . empirical consequences . . . *derives* from their cultural worldviews.").

[54] *See generally* KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET (2009) (exploring the belief systems and structure of the American financial industry).

[55] P. 437 (highlighting the close ties of key players to Goldman Sachs).

[56] *See* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 94 (2010) (identifying high level government officials during the financial crisis who were former Wall Street executives); OpenSecrets.org, Report: Revolving Door Spins Quickly Between Congress, Wall Street (June 3, 2010), http://opensecrets.org/news/2010/06/report-revolving-door-spins-quickly.html.

This absence of diverse and dissenting voices perhaps made signs of a calamitous crisis harder to identify and accept.[57]

Some critics have even suggested that *Too Big to Fail* may be an inaccurate account of the crisis because Sorkin is too close to his sources to be objective.[58] At his book party, the attendees included Jamie Dimon, the CEO of JP Morgan, John Mack, the then CEO of Morgan Stanley, hedge fund titan Ken Griffin of Citadel and other top echelon Wall Street players.[59]

The behavioral perspective of the financial crisis by no means excuses the poor, and often times troubling, decisions made by key players; instead, the behavioral perspective offers a possible explanation for how we came so close to the brink of collapse. Sorkin was right when he wrote that, "this drama is a human one, a tale about the fallibility of people who thought they themselves were too big to fail" (p. 7). *Too Big to Fail* may ultimately prove to be a tale about people who were too (cognitively) blind to see.

## CONCLUSION

In the end, it may take years or even decades for journalists, legislators, regulators, and scholars to truly unravel and fully comprehend the causes of the financial crisis. While behavioral economics may be gaining prominence in the wake of the financial crisis, as we re-examine our current models and understandings, widespread policy acceptance and application of its tenets will likely, and rightfully so, take more time and study. To that end, Sorkin's reporting and narrative in *Too Big to Fail* is of great utility because it serves as a good first draft of history for those studying the failures of our economic system and exploring possible explanations.

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57 CASS R. SUNSTEIN, GOING TO EXTREMES 85-93 (2009) (discussing how discussions of like-minded individuals can lead to extremism and group polarization).

58 *See* Sherman, *supra* note 6 ("At bottom, [Sorkin's critics] see him as far too cozy with his sources . . . [and] wonder what, in the end, his privileged access is in the service of.").

59 *Id.*