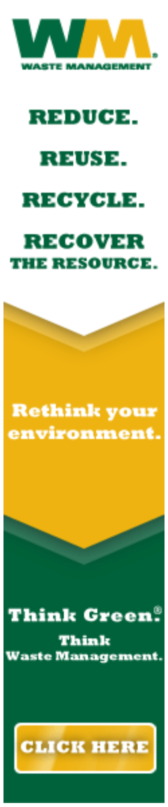

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The Week That Shook Wall Street: Inside the Demise of Bear Stearns

By ROBIN SIDEL, GREG IP, MICHAEL M. PHILLIPS and KATE KELLY
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The past six days have shaken American capitalism.

Between Tuesday, when financial markets began turning against Bear Stearns Cos., and Sunday night, when the bank disappeared into the arms of J.P. Morgan Chase & Co., Washington policy makers, federal regulators and Wall Street bankers struggled to keep the trouble from tanking financial markets and exacerbating the country's deep economic uncertainty.


Henry Paulson—Treasury Secretary

The mood changed daily, as did the apparent scope of the problem. On Friday, Treasury Secretary Henry Paulson thought markets would be calmed by the announcement that the Federal Reserve had agreed to help bail out Bear Stearns. President Bush gave a reassuring speech that day about the fundamental soundness of the U.S. economy. By Saturday, however, Mr. Paulson had become convinced that a definitive agreement to sell Bear Stearns had to be inked before markets opened yesterday.

Bear Stearns's board of directors was whipsawed by the rapidly unfolding events, in particular by the pressure from Washington to clinch a deal, says one person familiar with their deliberations.

"We thought they gave us 28 days," this person says, in reference to the terms of the Fed's bailout financing. "Then they gave us 24 hours."

In the end, Washington more or less threw its rule book out the window. The Fed, which has been at the forefront of the government response, made a number of unprecedented moves. Among other things, it agreed to temporarily remove from circulation a big chunk of difficult-to-trade securities and to offer direct loans to Wall Street investment banks for the first time.

The terms of the Bear Stearns sale contained some highly unusual features. For one, J.P. Morgan retains the option to purchase Bear's valuable headquarters building in midtown Manhattan, even if Bear's board recommends a rival offer. Also, the Fed has taken responsibility for $30 billion in hard-to-trade securities on Bear Stearns's books, with potential for both profit and loss.

BEAR STEARNS FALLOUT

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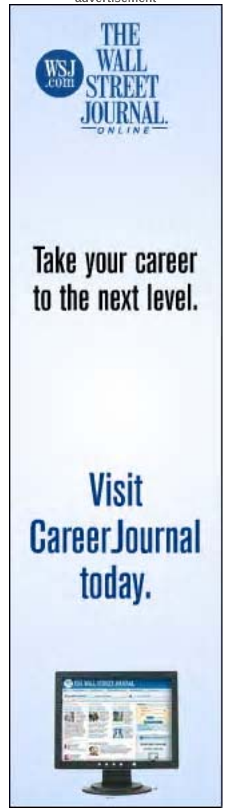
The question now looming over the transaction: Has the government set a precedent for propping up failing financial institutions at a time when its more traditional tools don't appear to be working? Cutting interest rates -- which the Fed is expected to do again today, by between a half percentage point and a full point -- hasn't yet done much to loosen capital markets gummed up by piles of bad debt.

Even though the transaction ultimately could leave taxpayers on the hook for losses, the political response so far has been fairly positive. "When you're looking into the abyss, you don't quibble over details," said New York Democratic Senator Charles Schumer.

Tuesday, March 11

From the earliest days of the financial crisis that began last year, the Federal Reserve had been working on contingency plans to lend to investment banks. Such firms regularly asked for government help to finance their large inventories of securities such as mortgage-backed bonds. They hoped to get the same favorable terms the Fed also gave to banks that borrow from its "discount window." But the Fed is barred from making such loans to firms that aren't banks, except by invoking a special clause which it hadn't used to lend money since the Great Depression. Officials worried that the drama surrounding a decision to do something for the first time since the 1930s could be damaging to confidence.

On Tuesday, officials unveiled what they thought came close: a promise to lend up to $200 billion in Treasury bonds to investment banks for 28 days. In return, the Treasury would get



securities backed by home mortgages, whose uncertain values helped spark the current crisis, and other hard-to-trade collateral. The first swap was scheduled for March 27. At first, the firms were elated.

That same day, the market began turning on Bear Stearns. Phones were ringing off the hook at rival firms such as Goldman Sachs Group Inc., Morgan Stanley and Credit Suisse Group. Clients of those firms were growing worried about trades they had entered into with Bear Stearns -- about whether Bear Stearns would be able to make good on its obligations. The clients asked the other investment banks whether they would be willing to take the clients' places in the trades. But credit officers at Goldman, Morgan Stanley and others -- worried themselves about Bear Stearns's condition -- began to say no.


Alan Schwartz—CEO, Bear Stearns Cos.

At Bear Stearns, Chief Financial Officer Samuel Molinaro, along with company lawyers and Treasurer Robert Upton, were trying to make sense of the situation. They felt comfortable with their capital base of roughly $17 billion and were looking forward to reporting Bear Stearns's first-quarter earnings, which had been respectable amid the market carnage.

One theory began developing internally: Hedge funds with short positions on Bear -- bets that the company's stock would fall -- were trying to speed the decline by spreading negative rumors.

For the first part of the week, Chief Executive Officer Alan Schwartz was out of pocket. Although Bear Stearns had been struggling with mortgage-related losses and problems in its wealth-management unit, Mr. Schwartz was hosting a Bear Stearns media conference in Palm Beach, Fla. On Wednesday morning, he left the conference briefly to do an interview with CNBC in an effort to deflect rumors about liquidity issues at the firm.

Thursday

On Thursday evening, after customers had continued to pull their money out of Bear Stearns, the bank reached out to J. P. Morgan, looking to discuss ways the Wall Street giant could help ease Bear's cash crunch.

By then, Bear Stearns's cash position had dwindled to just $2 billion. In a conference call at 7:30 p.m., officials at Bear Stearns and the Securities and Exchange Commission told Fed and Treasury officials that the firm saw little option other than to file for bankruptcy protection the next morning.

Bear Stearns's hope was that the Fed would make a loan from its discount window to provide several weeks of breathing room. That, the firm hoped, would perhaps halt a run on the bank by allowing it to swap bonds for the cash necessary to return to customers.

The Fed's standard preference in dealing with a troubled institution is to first seek a private-sector solution, such as a sale or financing agreement. But the possibility of a bankruptcy filing Friday morning created a hard deadline.

A trigger point was looming for Bear Stearns in the so-called repo market, where banks and securities firms extend and receive short-term loans, typically made overnight and backed by securities. At 7:30 a.m., Bear Stearns would have to begin paying back some of its billions of dollars in repo borrowings. If the firm didn't repay the money on time, its creditors could start selling the collateral Bear had pledged to them. The implications went well beyond Bear Stearns: If other investors questioned the safety of loans they made in the repo market, they could start to withhold funds from other investment banks and companies.

The $4.5 trillion repo market isn't a newfangled innovation like subprime-backed collateralized debt obligations. It is a decades-old, plain-vanilla market critical to the smooth functioning of capital markets. A default by a major counterparty would have been unprecedented, and could have had unpredictable consequences for the entire market.


Timothy Geithner
President, Federal Reserve Bank of New York

Federal Reserve Bank of New York President Timothy Geithner worked into the night, grabbing just two hours of sleep near the bank's downtown Manhattan headquarters. His staff spent the night going over Bear's books and talking to potential suitors including J. P. Morgan. The hard reality was that even interested buyers said they needed more time to go over the company.

The pace and complexity of events left Bear's board of directors groping for answers. "It was a traumatic experience," says one person who participated. Sleep deprivation set in, with some of the hundreds of attorneys and bankers sleeping only a few hours during a 72-hour sprint. Dress was casual, with neckties quickly shorn.

Friday

At 5 a.m. Friday, Mr. Geithner, Mr. Paulson and Federal Reserve Chairman Ben Bernanke, calling in from home, joined a conference call to debate whether Bear should be allowed to fail or whether the Fed should lend it enough money to get through the weekend. At 7 a.m. they settled on the lifeline option. Mr. Bernanke assembled the Fed's other three available governors to vote for the loan, the first time since the Depression the Fed would use its extraordinary authority to lend to nonbanks.

The Fed announced that it would lend Bear money, through J.P. Morgan, for up to 28 days to get the venerable investment bank through its cash crunch. At 9 a.m., Mr. Geithner, Mr. Paulson and aides addressed a conference call of bond dealers and bankers. Mr. Paulson took the lead, saying the dealer community had "a stake" in the overall deal working out.

But the markets didn't take well to the news that a major investment bank was on the brink of failure. Stocks sank. Other investment banks were seeing lenders turn cautious. Fed officials led by Bill Dudley, head of open-market operations, began planning a more direct response: opening the discount window to all investment banks, a request the Fed had resisted for months.

J.P. Morgan's effort to buy Bear kicked into high gear on Friday afternoon, just hours after the big bank and the Fed had provided Bear with the 28-day lifeline. Steve Black, co-head of J.P. Morgan's investment bank, returned early from vacation in the Caribbean, spearheading the bank's efforts with his J.P. Morgan counterpart in London, Bill Winters.

Mr. Black's role was pivotal. He was a longtime associate of J.P. Morgan Chief Executive James Dimon. And Mr. Black had a long relationship with Bear's CEO, Mr. Schwartz, dating back to the 1970s, when the two were fraternity brothers at Duke University.

J.P. Morgan bankers were broken into some 16 teams -- all with specific due-diligence assignments. Some focused on Bear's prime-brokerage business, which was attractive to J.P. Morgan. Others concentrated on technical operations, commodities, and the like.

As some Fed staffers worked from a conference room on Bear's 12th floor, Federal Reserve officials insisted that the firm complete a deal that weekend. Officials made it clear the loan was only for the short term to ensure a deal got done as quickly as possible. Their priority was that Bear's counterparties -- the parties that stood on the other side of its trades -- would be able to arrive at work Monday knowing their contracts were good, minimizing the risk of a generalized flight from the markets.

Treasury Secretary Paulson knew that the day's work wouldn't be enough to keep Bear afloat over the long term. Still, Mr. Paulson, a former Goldman Sachs chief executive and the administration's point man for financial markets, thought Bear Stearns would survive through the weekend.

Saturday

That illusion was shattered Saturday morning, when Mr. Paulson was deluged by calls to his home from bank chief executives. They told him they worried the run on Bear would spread to other financial institutions. After several such calls, Mr. Paulson realized the Fed and Treasury had to get the J.P. Morgan deal done before the markets in Asia opened on late Sunday, New York time.

"It was just clear that this franchise was going to unravel if the deal wasn't done by the end of the weekend," Mr. Paulson said in an interview yesterday.

A year ago, Mr. Paulson wouldn't have considered Bear Stearns big enough that its collapse would present a threat to the U.S. financial system. But confidence in the economy and financial sector are so shaky now that he had no doubt that the Fed and government had to act to prevent its bankruptcy, according to a senior Treasury official.

At 8 a.m. Saturday, the J.P. Morgan bankers assembled to receive instructions in the bank's executive offices, located on the 8th floor of its Park Avenue headquarters. One hour later, they headed down the street to Bear Stearns's headquarters to pore over Bear's books. Due diligence had begun.

Back at J.P. Morgan's headquarters, top executives set up war rooms on the executive floor, commandeering offices of colleagues who weren't directly involved in the negotiations. Bankers darted in and out of offices searching for the top brass, who were also moving from room to room. Mr. Dimon, wearing slacks and a dark sweater, urged the bankers to stay calm and focused. "Everyone take a deep breath," he said at one point.

By 7:30 p.m., hunger pangs had taken hold. Someone ordered Chinese food. A security guard lay out a buffet spread.

That evening, Mr. Black got on the phone to Mr. Schwartz, Bear Stearns's CEO. J.P. Morgan would be willing to buy Bear Stearns, subject to the conclusion of due diligence, he told Mr. Schwartz. The J.P. Morgan executives didn't set a specific price, instead providing a dollars-per-share range, according to people familiar with the matter. At the high end was a figure in the low double digits, these people say.

By 1 a.m., the bankers headed home for a few hours of sleep.

Sunday

Early the next morning, Messrs. Dimon and Black and other top executives sat around a conference-room table to discuss the situation. One by one, they began expressing concern about the speed at which the situation was progressing. They weren't comfortable with the level of due diligence being conducted. Were there more problems hidden deep in Bear's balance sheet that they hadn't found yet? Would market turmoil result in more problems? Was J.P. Morgan really willing to take such a risk without full information?

"Things didn't firm up -- they got more shaky," according to one person familiar with the meeting.

Finally, they came to a conclusion. J.P. Morgan wouldn't buy Bear Stearns on its own. The bank needed help before it would do the deal.

Mr. Paulson was frequently on the phone with Bear and J. P. Morgan executives, negotiating the details of the deal, the senior Treasury official said. Initially, Morgan wanted to pick off select parts of Bear, but Mr. Paulson insisted that it take the entire Bear portfolio, the official said.

This was no normal negotiation, says one person involved in the matter. Instead of two parties, there

were three, this person explains, the third being the government. It is unclear what explicit requests were made by the Fed or Treasury. But the deal now in place has a number of features that are highly unusual, according to people who worked on the transaction.

In addition to its option to purchase Bear's headquarters building, J.P. Morgan has the option to purchase just under 20% of Bear Stearns's shares at a price of $2 each. That feature gives J.P. Morgan an ability to largely block a rival offer, says a person with knowledge of the contract.

The deal also is highly "locked up," meaning that J.P. Morgan cannot walk, even if there is a heavy deterioration in Bear's business or future prospects. Bear Stearns holders can, of course, vote the deal down. But the effect that would have on J.P. Morgan's ongoing managerial oversight and the Fed's guarantees is largely unknown.

"We're in hyperspace," says one person who worked on the deal. All these matters are very likely to be litigated in court eventually, this person adds.

The Fed spent the weekend putting together a plan to be announced Sunday evening, regardless of the outcome of Bear's negotiations, that would enable all Wall Street banks to borrow from the central bank. Mr. Bernanke called the Fed's five governors together for a vote Sunday afternoon. All five voted in favor, using for the second time since Friday the Fed's authority to lend to nonbanks.

The steps were announced at the same time the Fed agreed to lend $30 billion to J.P. Morgan to complete its acquisition of Bear Stearns. The loans will be secured solely by difficult-to-value assets inherited from Bear Stearns. If the assets decline in value, the Fed -- and therefore the U.S. taxpayer -- will bear the cost.

Aware of the potential political backlash, Fed and Treasury officials briefed Democrats throughout the weekend. Events moved so fast that there was little time for much substantive outreach. Mr. Bernanke spoke with Massachusetts Democrat and House Financial Services Committee Chairman Barney Frank on Friday. Fed staffers emailed updates to Mr. Frank's office on Sunday.

"I believe this is the right action that was taken over the weekend," said Senate Banking Committee Chairman Christopher Dodd of Connecticut, a Democrat, who spoke with Messrs. Bernanke and Paulson on Sunday during deliberations. "To allow this to go into bankruptcy, I think, would have [created] some systemic problems that would have been massive."

--Dennis K. Berman, Damian Paletta and Sarah Lueck contributed to this article.

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