

Billion-Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years

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**Preface to the Paperback Edition
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Make that “Trillion-Dollar Lessons.”

When the economy fell off a cliff, just as our book was coming out in the fall of 2008, any number of friends, colleagues and reviewers suggested we should quickly update it, to incorporate the lessons from the mistakes that caused the crisis. So, what are those new lessons?

The short answer is: There aren't any.

At least, there aren't any new strategy mistakes that led to the latest crop of staggering failures. However, our experience in working with clients to leverage the lessons to be learned from failures *has* provided new insight into how companies can avoid making the same old mistakes and, as a result, can increase their odds of success. So, we'll use the foreword for the paperback to explain what those insights are and to suggest ways that executives can dig themselves out of the current mess—and maybe even to profit from it.

No New Mistakes

The mistakes that precipitated the economic crisis are certainly bigger in magnitude than the 2,500 failures that we and a team of 20 researchers investigated for some two years as the basis for “Billion-Dollar Lessons.” The writeoffs we studied totaled hundreds of billions of dollars, which we thought was a staggering number, yet Wall Street firms alone have written off more than \$1 trillion of assets since the financial crisis began. We seem to have aimed low. Maybe we should have called the book “Trillion-Dollar Lessons.”

But the lessons from the current crisis aren't any different from the earlier lessons. In fact, the story of Green Tree Financial, which we tell in detail in Chapter Two, is exactly analogous to what happened more recently. In the 1990s, Green Tree devised a new mortgage product that took the market by storm. It booked enormous profits. It assured investors that all its financial assumptions were hopelessly conservative. But the mortgages were fatally flawed, eventually resulting in an avalanche of defaults. Green Tree's blinders about the mortgage's problems even occurred for the same reason that

sub-prime lenders didn't see the problems with their financial innovation. Green Tree booked all its profit up front, so the whole game was to generate as many loans as possible, then exceed that number the following quarter, and the quarter after that, and the quarter after that. No one was accountable for the profitability of the loans five or 10 years down the road, so potential problems were glossed over until it was too late.

The analogies don't stop with Green Tree. Conseco bought Green Tree in 1998, making the same mistake that Bear Stearns, Lehman Brothers, Merrill Lynch, AIG and many others made when they bought investments based on subprime loans. Conseco reasoned that buying Green Tree was a simple move into an adjacent market. After all, Conseco was a major insurance company, and mortgages looked like just another form of financial service. When the problems with Green Tree's mortgages became apparent, Conseco wrote off all the profits that Green Tree ever booked on its mortgages and filed for bankruptcy. The bankruptcy was the third largest in U.S. history at the time. True, the Conseco bankruptcy is dwarfed by the recent crisis. Conseco is just one company, not a whole industry, and the bankruptcy filing didn't precipitate a recession that has analysts drawing analogies to the Depression. Still, Conseco made the same errors of omission a decade ago that others made this time around.

At the Wall Street Journal, there is a saying, "There are no new stories, just new reporters." It seems the same is true of businesses. There are no new mistakes, just new executives and new companies.

You'd think that, with the lessons of the crisis now in full view, companies might learn some of the lessons that failures have to offer. Instead, the same old mistakes continue to be made.

Bank of America made what it thought was a great move into an adjacent market when it agreed to buy Merrill Lynch in September 2008 for \$50 billion. BofA had long coveted Merrill and decided that the collapse in Merrill's stock price made it a bargain that couldn't be passed up. In the process, BofA made many of the mistakes that show up in our chapters on adjacency moves (Chapter Five) and on industry consolidation (Chapter Seven). BofA focused so much on what it was going to gain that it underestimated potential problems. BofA didn't take the time to understand the full extent of Merrill's toxic mortgage assets. BofA also underestimated the cultural conflicts that would arise when it tried to combine its brokerage arm, which aimed at the middle-class market, with Merrill's white-shoes types. Finally, BofA assumed it would gain by taking over Merrill's investment-banking business even though it isn't a clear fit with BofA's retail banking—and even though BofA had tried on its own to get into investment banking and had run, kicking and screaming, from the market.

Bay Harbour Management, an investment firm, likewise made a mistake when it agreed to buy clothing retailer Steve & Barry's out of bankruptcy proceedings for \$168 million in August 2008. Steve & Barry's turned out to have a business model based on faulty financial engineering. The company only made money from the up-front payments that mall operators gave the company to open stores, a model that clearly wasn't sustainable.

Three months after the purchase, Bay Harbour announced it was liquidating Steve & Barry's nearly 300 stores.

We're not just saying in hindsight that BofA and Bay Harbour made mistakes. We said so at the time in our blog, www.billiondollarlessons.com, that both BofA and Bay Harbour were making grand errors. We started the blog in 2006, during our research phase, as a way of testing our hypotheses. We wanted to be sure that the lessons we were deriving from failure could be applied in real time to spot bad ideas. And it turns out that identifying flaws isn't that hard—our record has been nearly flawless, even though we're operating only with information available to the general public, not the nitty gritty that the companies involved possess.

The problem isn't identifying bad ideas, at least if a thorough review of past failures is done. The problem is doing so early enough and in a constructive fashion, so that flawed plans can be fixed or killed before the momentum is so great that almost nothing can stop them.

Being Careful Is Not Enough

Marshall McLuhan famously said, "I'm not sure who discovered water, but I'm pretty sure it wasn't a fish." The same notion applies to business: It's not likely that people swimming around in an environment that creates a bad idea are going to be able to spot that bad idea, much less do something about it. Even after the financial crisis began, when companies were being especially careful, they still made the same old mistakes.

This fact underscores the point we make in Part Two of the book, that it isn't enough to just try to be more aware of potential pitfalls. Some outside mechanism needs to be applied as a safeguard to head off bad deals and bad strategies.

Look at what has happened with risk management. Following the collapse of Long-Term Capital Management in the late 1990s, a problem that almost caused the kind of meltdown of the financial system that occurred this time around, some companies ginned up new models and new procedures to manage risk more closely. The models and procedures almost universally made sense on paper. Almost universally they failed.

The problems with the models can be myriad:

--They may rely too heavily on historical data, even though new situations can render history meaningless. The models at Fannie Mae, for instance, didn't even allow for the possibility of a decline in housing prices, because there had never been one.

--Models often don't reflect the full dynamism of markets. In the case of subprime mortgages, for instance, no model that we're aware of allowed for the possibility that liquidity would dry up in markets instantly. Everyone seemed to assume that they'd be able to sell securities, albeit at a lower price.

--Models are hard to challenge. They tend to be cooked up by small armies of people with PhDs in exotic specialties, so it's difficult for an executive to dig into the details and objectively question the predictions.

--Even when models work perfectly, they create a false sense of security. Tools that were developed by financial firms typically said that losses could be capped at a certain level 99% of the time. Well, 99% sounds an awful lot like 100%, especially after a long stretch has passed during which no major losses occurred. Yet that final 1% can be awfully dangerous, as we've learned. AIG, for one, thought it was collecting free money by selling insurance on securities that were based on subprime mortgages. AIG's models had convinced the company that there was virtually no chance the securities would go bad. And yet they did.

New procedures, such as those referred to as Enterprise Risk Management, suffered from the human factor. Citigroup, for instance, instituted elaborate procedures for evaluating risk. These were done at the direction of Robert Rubin, who knew just what world-class risk management looked like, because of his decades at Goldman Sachs, where he was CEO before leaving to be Treasury Secretary, then a special counselor of Citigroup. But the person who was in charge of evaluating risks was a friend of the two executives who were in charge of building new businesses for Citigroup by taking on risks. The three became such close pals that the risk management executive often waited outside the office of one of the risk-taking executives for 45 minutes so they could drive home together. It's no wonder, then, that the person in charge of saying "no" didn't, in fact, utter the dreaded word very often. Even when friendship wasn't involved, the financial crisis shows that it's awfully hard to kill dangerous ideas when the need for earnings (and bonuses) is very real and short-term while the potential problems are ephemeral or long-term.

An outside perspective could have spotted many of the problems with the models and procedures that were adopted to manage risk. Indeed, there were many outsiders who said for years that the mortgage industry's models were flawed. For instance, Edward M. Gramlich, a governor of the Federal Reserve Board, published a book in mid-2007 called "Subprime Mortgages: America's Latest Boom and Bust." As for procedures, it didn't take a genius to figure out that the person determining the propriety of a risk shouldn't carpool with the person who wants to take the risk.

The trick is to not only get the outside perspective that was missing at Fannie Mae and Citigroup, among many others, but to make sure people act on it.

We'll say that a different way: It isn't enough to know that an idea is probably flawed. There has to be a method, agreed on ahead of time, for discussing possible problems and making sure they are given due weight. Otherwise, once a strategy starts to build momentum it will steamroll any possible objections.

Our research shows that this is a perennial problem. But it is particularly pertinent in the face of the economic meltdown, which brings with it myriad opportunities and pitfalls.

Beyond Fear and Greed

Even more than most economic downturns, the withering recession that we're undergoing seems likely to fundamentally change the business landscape over the next two years. Many companies, long venerated, will fall by the wayside. Many others, perhaps not currently thought of as leaders, will emerge dominant when the recovery comes. Where companies end up will depend on their strategic choices in response to the current crisis.

History is replete with success stories about those who made the most of recessions. Several of the "robber barons," including Andrew Carnegie and John D. Rockefeller, took advantage of the Panic of 1873, which occurred after the bursting of the post-Civil War railroad bubble. They bought competitors at fire-sale prices and built empires. Southwest Airlines expanded rapidly in the recession in the early 1980s. Although it was a small upstart at the time, Southwest became a major force by the end of the decade, and CEO Herb Kelleher soon became a household name. After 9/11, while other airlines cut back, Southwest lowered fares and stepped up advertising to gain market share. It is now the most successful in the industry. Similarly, in the early 1980s, Intel was skating on the edge of bankruptcy. Yet it responded to horrible problems in the memory-chip market by making a bold move into microprocessors, where the company soon won a near-monopoly in the personal-computer market. Since then, Intel has consistently invested in additional capacity during downturns. In the process, it has outdistanced IBM, Sun, Motorola, Advanced Micro Devices and many other formidable competitors—making heroes out of Gordon Moore, Andy Grove and other Intel CEOs.

As Grove has said, "Bad companies are destroyed by crisis. Good companies survive them. Great companies are improved by them."

To be numbered among the great companies, it makes sense to follow Warren Buffett's guiding principle: to "be fearful when others are greedy and greedy when others are fearful." There's certainly plenty of fear out there, and thus plenty of opportunities to get greedy. As Buffett well understands, greed does not necessarily translate into wealth. It might well send overzealous executives down the wrong path. So, it's important to be both greedy and prudent at the same time.

A Note about Mergers and Acquisitions

Acquisitions are tempting for a CEO. While many issues such as organizational change get filtered through level after level of a business, the CEO can, almost alone, transform a company by making the right, strategic purchase. Besides, CEOs typically don't want to just occupy the chair for a few years. They're usually bold people and want to attempt something that will leave a mark on their companies and their industries. Acquisitions can accomplish that goal.

The environment in which CEOs operate practically demands acquisitions. Securities analysts often argue for them. Investment bankers and consultants offer a steady stream

of targets, along with assurances that buying them would be guaranteed successes. If earnings ever falter, investors insist on having a story—ready by the next earnings report—about how the company will soon return to prosperity. Boards may share investors' impatience. Often, M&A offers the only quick fix.

If history is any guide, some time in the next few years there will be a burst of M&A activity. That's because lulls, such as the recession has caused, are almost always followed by a stretch of heavy deal-making.

Yet acquisitions usually fail, partly because decisions have to be made fast when an opportunity arises. Something is for sale. Do you want it? Well, do you? The clock is ticking. (BoFA CEO Ken Lewis spent less than an hour negotiating the Merrill deal because he was so sure someone else might snatch up this once-in-a-lifetime opportunity.)

The other main problem is that the evaluation of deals can happen in an echo chamber. If the senior executive team perceives that the CEO wants something to happen, they often censor objections and gloss over potential problems. Even the best investment bankers and consultants become too optimistic about the chances for success. (Studies have shown that, try as they might, their judgment is influenced by the prospect of getting big deal fees or additional work following a merger.) Boards can spot problems, but directors are sometimes reluctant to speak up because they don't have as much information as the CEO and seldom have as much background in the industry. In addition, vetoing a deal or demanding major changes to a strategy is usually a bring-on-the-next-guy decision, so, when in doubt, boards tend to acquiesce in silence. Even Warren Buffett says in *Snowball*, the recent biography of him, that, while on the board of Coca-Cola, he failed to challenge the CEO about an issue even though he was quite sure the CEO was making a serious mistake and was right.

Given the tough environment, CEOs should utilize independent devil's advocate reviews as a way to get a fast, objective read on the potential problems with deals, perhaps as a warning that a deal should be avoided at all costs but more often to shape negotiations and to warn ahead of time about where problems with post-merger integration will occur.

While it might seem at first that installing an additional check into a process that necessitates speed and daring is counterproductive, such a check provides four key benefits. First, it helps get to the best answer. No plan is perfect; the devil's advocate helps get to the strongest option as quickly as possible. Second, the process identifies key risks up front. It helps the CEO be clear-eyed about the implementation challenges, rather than let the process of selling the strategy paper over potential issues. Third, the process helps to build real consensus. The best way to achieve consensus is to have a constructive yet contentious deliberation, so that key issues are considered. Doing so helps avoid self-censorship, which makes problems fester. Fourth, the process preserves a graceful exit. Too often, the political capital expended to launch an initiative commits leaders to see it through, even to a bitter end. By installing a formal review, even as he drives the acquisition process forward, the CEO preserves a politically tenable exit.

While the temptation might be to wait until a deal is on the table before deciding whether to conduct a devil's advocate review, that would be a mistake. Those advocating the deal will want to dispense with any reviews, lest they kill the potential acquisition. The result will be emotional arguments about how, "Well, we have to do something."

Our colleague Dan Ariely, author of the engaging best-seller *Predictably Irrational*, has conducted research that shows that people act very differently when they're in what he calls a hot state than when they're in a cold state. A potential deal creates a hot state in which thinking is clouded. So, it's important to take advantage of the current lack of deals to consider, coldly and rationally, what the best possible process is for heading off mistakes. That way, when deals become possible—as they surely will, in droves—the advocates for those deals can't argue for dispensing with a devil's advocate review. They'll have already agreed that it's necessary.

The Role of the Board of Directors

If the blame game goes as it usually does, criticism about the mistakes that led to the current recession and to poor performance at so many companies won't stop with the CEO. Aspersions will be tossed at boards, too. To see how this might look, read the withering complaints about the Lehman Brothers board that failed to stop the CEO from running the company out of existence.

While it's obviously not possible to reset the clock and avoid mistakes that have already been made, it's possible to learn from errors and protect yourself from future attacks. This is true even for companies and boards that aren't having problems: You can learn from others' mistakes.

Interestingly, directors often saw problems coming but failed to prevent them. In those cases, the board's interaction with the CEO took one of three forms:

- Because outside directors have less information than management does and generally have less experience in the industry in which the company operates, board members may censor themselves. Why take the chance of looking silly? At Samsung, as discussed on page xxx, directors had doubts about moving from electronics into car manufacturing in 1997 but deferred to the chairman, even though there was already too much capacity in the Korean auto market and Samsung had no particular strength in cars. Samsung spent \$5 billion on the venture, which went into receivership and was sold three years later for some \$700 million.
- Even when board members speak up, the CEO may outmaneuver them. At Ames Department Stores, a case we discuss on page xxx, two directors objected to the purchase of another discount department store chain in 1988, in a misguided attempt to match Wal-Mart's scale. The CEO cut them out of conversations on the topic and had them go last in any voting, so their opinions wouldn't influence others. Ames bought the chain — and soon filed for bankruptcy protection.

- Directors sometimes objected so strongly to a bad idea that they went public — and still failed to head off disaster. At Oglebay Norton, a case discussed on page xxx, directors concurred with a decision to move away from the iron ore business and into limestone, but two objected strenuously when the CEO went on a buying spree and paid inflated prices for limestone operations. The two resigned in protest, but the CEO cowed the rest of the board, arguing that he hadn't been hired to be a custodian. Oglebay Norton filed for bankruptcy protection in 2004, then was sold.

In looking for approaches to head off embarrassing strategic errors, we found that the key lies in the board's ability to change the dialogue with management. Boards and management agreed ahead of time that major decisions would be discussed openly, with numerous alternatives on the table, before management committed to a strategy.

Although there are numerous ways to change the dialogue, we have found the devil's advocate process to be useful for boards, as well. We've used the process to head off any number of bad strategies, and many successful companies do something similar. At Intel, the board discusses possible strategies with management before they get so far along that rejecting an idea becomes a bring-in-the-next-CEO proposition. It's hard to argue with Intel's results.

If you, too, will embrace the devil's advocate process, you'll greatly increase the odds you'll be viewed more like Intel, not like Samsung, Ames, Oglebay Norton and the other failures we describe in the pages that follow.

Paul B. Carroll and Chunka Mui are co-founders and managing directors of the Devil's Advocate Group, an alliance of critical thinkers that helps executives stress test their business strategies.

To learn more about "Billion-Dollar Lessons," including how to get access to free chapters and audio excerpts of the book, devilsadvocategroup.com. The authors email addresses are paul.carroll@devilsadvocategroup.com and chunka.mui@devilsadvocategroup.com.
