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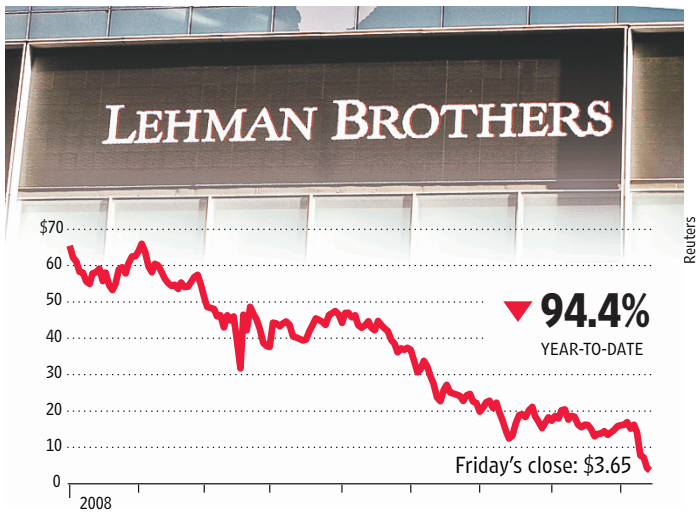
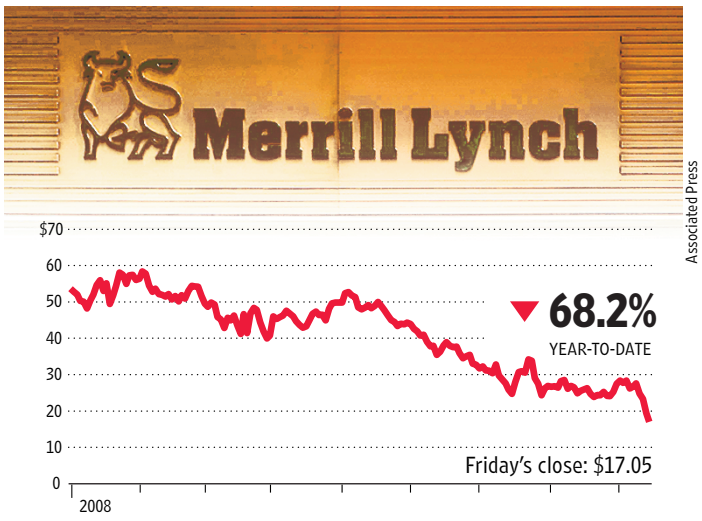
Last week: **DJIA** 11421.99 ▲201.03 1.8% **NASDAQ** 2261.27 ▲0.2% **NIKKEI** 12214.76 unch. **DJ STOXX 50** 2858.68 ▲3.8% **10-YR TREASURY** ▼20/32, yield 3.730% **OIL** $101.18 ▼$5.05 **EURO** $1.4217 **YEN** 107.87



Reuters



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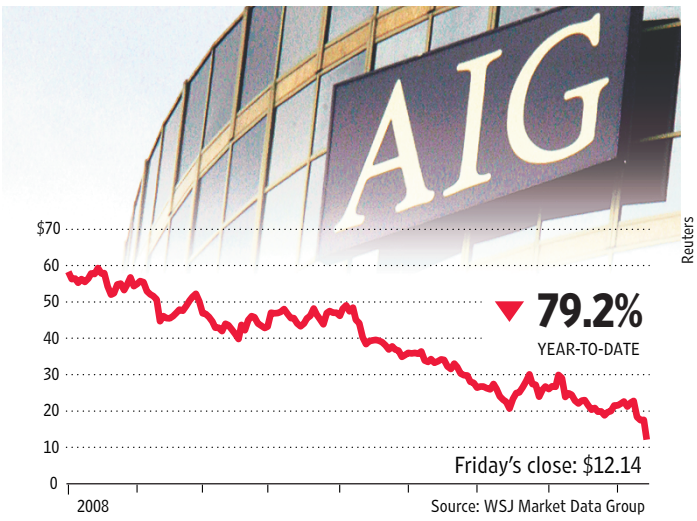

Reuters

Source: WSJ Market Data Group

Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash

Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance

The American financial system was shaken to its core on Sunday. Lehman Brothers Holdings Inc. faced the prospect of liquidation, and Merrill Lynch & Co. agreed to be sold to Bank of America Corp.

By Carrick Mollenkamp, Susanne Craig, Serena Ng and Aaron Lucchetti

The U.S. government, which bailed out Fannie Mae and Freddie Mac a week ago and orchestrated the sale of Bear Stearns Cos. to J.P. Morgan Chase & Co. in March, played much tougher with Lehman. It refused to provide a financial backstop to potential buyers.

Without such support, Barclays PLC and Bank of America, the two most interested buyers, walked away. On Sunday night, Bank of America struck an all-stock deal to buy Merrill Lynch for $29 a share, or $50 billion. Lehman was working on a possible bankruptcy filing that would allow most of its subsidiaries to continue operating as the firm is wound down.

Though it steered clear of a bailout, the Federal Reserve is expected to take new steps to stabilize the broader financial system. These steps, expected to be temporary, would make it easier for banks and securities firms to borrow from the central bank by using a wider range of collateral. Bankers say these financial institutions might need short-term funds as they unwind their many trading positions with Lehman.

In addition, 10 major commercial and investment banks announced Sunday night that they would pool $70 billion of their own money to create a borrowing facility. The 10 institutions, which include Citigroup Inc., Credit Suisse Group, Deutsche Bank AG, could tap the pool to help them ride out the crisis. The banks also said they are mutually committed to trying to mitigate market volatility.

A sense of foreboding gripped Wall Street as top executives feared collateral damage from a Lehman liquidation. Attention was focused on Merrill Lynch, which boasts the largest force of retail brokers, and American International Group Inc., the insurance giant. Both firms have seen their stocks get hammered on worries that they needed capital.

"Monday will be a day of reckoning for the financial markets," said Carlos Mendez, senior managing director of ICP Capital, a boutique investment firm in New York. On Sunday, he said, "it was like a fire alarm went off and people ran in all directions."

AIG executives spent the weekend trying to raise $40 billion to avoid a costly downgrade of its credit rating. AIG Chief Executive Robert Willumstad made an extraordinary appeal to the Fed for temporary funding to tide it through the crisis. (Please see related article on Page C1.)

As worries spread across Wall Street that Lehman wouldn't survive, brokerage firms, hedge funds and other traders moved to disentangle themselves from trades with Lehman. When hopes of a potential sale dimmed, a quiet Sunday on Wall Street turned into a mad rush. Executives and traders hurried to their offices or worked their phones to unwind outstanding contracts with Lehman and to gauge their overall exposure.

Merrill, whose brokerage force is known as the "thundering herd," entered into discussions with Bank of America, which has retail bank branches stretching from coast to coast and has long coveted Merrill. Wall Street executives said the Federal Reserve may have been involved in orchestrating the sale, figuring that it was "better to save the relatively

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Ultimatum By Paulson Sparked Frantic End

One of the most tumultuous weekends in Wall Street's history began Friday, when federal officials decided to deliver a sobering message to the captains of finance: There would be no government bailout of Lehman Brothers Holdings Inc.

Officials wanted to prepare the market for the possibility that Lehman could simply fail. The best way to do that in an orderly way would be to get everyone together in a room.

Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke and his top New York lieutenant, Timothy Geithner, summoned some 30 Wall Street executives for a 6 p.m. Friday meeting at the Fed's offices in Lower Manhattan.

"There is no political will for a federal bailout," Mr. Geithner told

By Deborah Solomon, Dennis K. Berman, Susanne Craig and Carrick Mollenkamp

the assembled executives, according to a person familiar with the matter. "Come back in the morning and be prepared to do something."

Over the next 48 hours, these marching orders developed into a nerve-wracking test of the ability of the U.S. financial system to hold itself together amid the worst series of shocks it has faced in decades.

By taking the rescue option off the table, the U.S. government was declaring that there are limits to its role as backstop-in-chief. A week earlier it had seized mortgage giants Fannie Mae and Freddie Mac, and months prior had brokered the sale of Bear Stearns & Co. to J.P. Morgan Chase & Co. But now, Washington appears to want Wall Street to largely fix its own problems, and feels that flailing institutions shouldn't expect the government to commit money to save them.

"We've re-established 'moral hazard,'" said a person involved in the talks, referring to

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What's News—

Business & Finance

Lehman faces the possibility of liquidation, and Merrill Lynch agreed to be sold to Bank of America in a $50 billion deal on Sunday, a day in which the U.S. financial system was shaken to its core. The Federal Reserve is expected to take new steps to stabilize the broader financial system. Meanwhile, AIG sought to raise cash and craft a survival plan amid investor pressure. **A1, A18, A19, C1, C2**

■ **Regulators and investors** prepare for Monday as Lehman's collapse, an AIG deal and talks between Bank of America and Merrill could rattle investors. **C1**

■ **Oil futures pushed** lower Sunday even after Hurricane Ike forced shutdowns of Gulf Coast refineries and platforms. Crude fell $2.09, or 2.1%, to $99.09 a barrel. **C1**

■ **Exit packages** for the deposed CEOs of Fannie Mae and Freddie Mac highlight a weak link in efforts to link executive pay with performance: severance deals. **B4**

■ **Charles Prince**, former Citigroup chairman and CEO, has a new job: using his contacts to drum up business for a Washington consulting firm. **C5**

World-Wide

■ **Ike left a trail of damage from Texas to Louisiana.** Destruction from the hurricane could squeeze energy supplies and strike a blow to the strong regional economy. More than 2.5 million homes and businesses lost power. Despite a broad evacuation effort, tens of thousands refused to leave their homes. Thirteen people were reported dead by Sunday. **A3**

Gulf Coast oil refineries appeared to have escaped major damage, but power problems prevented many from returning to service.

■ **The NTSB was trying** to determine the cause of a commuter-train crash in a Los Angeles suburb Friday. The train barreled into an oncoming freight train, and 25 people were killed. The wreck highlights the absence of key safety equipment on the nation's rail network. **A4**

■ **In New Delhi, bombings** in popular shopping areas on Saturday killed 21. The five blasts followed three similar attacks that have hit other cities since May. **A10**

■ **Obama raised** a record $66 million from donors in August, but the money race

Bank of America to Buy Merrill

Associated Press

Merrill Lynch CEO John Thain leaving the Federal Reserve Bank of New York Saturday, where U.S. officials and Wall Street executives met to discuss the turmoil facing U.S. financial institutions. **More coverage on C1, C3 and C8.**

By Matthew Karnitschnig, Carrick Mollenkamp and Dan Fitzpatrick

In a rushed bid to ride out the storm sweeping American finance, 94-year-old Merrill Lynch & Co. agreed late Sunday to sell itself to Bank of America Corp. for $50 billion.

The deal, worked out in 48 hours of frenetic negotiating, could instantly reshape the U.S. banking landscape, making the nation's prime behemoth even bigger. Late Sunday night, the companies' boards had approved the deal, but lawyers were negotiating over last-minute details.

Driven by Chief Executive Kenneth Lewis, Bank of America has already made dozens of acquisitions large and small, including the purchase of ailing mortgage lender Countrywide Financial Corp. earlier this year. In adding Merrill Lynch, it would control the nation's largest force of stock brokers as well as a well-regarded investment bank.

The combination, if approved by shareholders, would create a bank of vast reach, involved in nearly every nook and cranny of the financial system, from credit cards and auto loans to bond and stock underwriting, merger advice and wealth management.

Through the weekend, federal officials, including Federal Reserve Bank of New York head Timothy Geithner, made it clear that they strongly encouraged a deal to sell Merrill. They worried the firm could be the next to approach the brink of failure after Lehman Brothers Holdings Inc., said people familiar with the matter.

The all-stock deal came together quickly. With Merrill stock dropping sharply last week, Merrill President Gregory Fleming, a former financial-institutions adviser, urged Merrill Chief Executive John Thain to

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Lehman Totters as U.S. Opts to Avoid Financial Rescue

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healthy patient instead of the dying one," said a lawyer involved in the discussions.

Lehman, a 158-year-old firm that started as an Alabama cotton brokerage, and Merrill, with its trademark bull logo, have been pillars of Wall Street for much of the past century. With the demise of Bear Stearns, three of the Street's five major independent brokers could end up disappearing, leaving only Goldman Sachs Group Inc. and Morgan Stanley.

'One-Way Market'

"We have never seen anything like this," said analyst Glenn Schorr, who covers the investment banks for UBS AG. "There have been tough situations like Long-Term Capital Management and the crash of 1987, but the problem here is there is leverage in the securities under the microscope and in the banks that own them. And to try and unwind it all at once creates a one-way market where there are only sellers, and no buyers."

The convulsions could lead to even tighter credit, higher borrowing costs and moribund capital markets, as securities firms and commercial banks try to further limit risk and preserve capital. Those moves could cause the U.S. economy to slow further.

The future of about 25,000 employees at Lehman and an additional 60,000 at Merrill is up in the air. Lehman's work force already has shrunk by about 3,000 in the past year. If the firm essentially goes out of business, most of the remaining employees are likely to lose their jobs. That would deal another blow to New York City's economy, resulting in lower tax revenues on personal income, real-estate transactions and corporate income.

The damage on Wall Street is the latest consequence of a storm that began last year with the sharp decline in American housing prices and losses on loans and other assets tied to home values. Massive capital infusions have failed to stem write-offs and losses, and financial firms are running out of options to escape the damage.

Regulators and others were preparing for a hectic Monday. The New York Stock Exchange prepared contingency plans over the weekend to reassign the approximately 200 blue-chip stocks that Lehman's specialist unit trades, according to people familiar with the matter. If Lehman is forced into liquidation, the exchange will likely transfer the stocks to one or more of the remaining specialist firms, most likely using the same technology and staff that currently trade the stocks.

Dozens of Wall Street desks have trades with Lehman. As word spread that the Barclays deal was falling apart, worries that the company could be thrown into bankruptcy mounted, and traders labored to get out of those contracts.

At approximately 2:30 p.m., government officials hosted a call, and a trading session was opened to ease fears. One trader said it was agreed that other brokers would pick up contracts that trading desks have with Lehman. If Lehman does open on Monday, the deals struck on Sunday, often at a worse price, would be void. "It is utter chaos here," the trader said.

Concerned Investors

At many Wall Street firms, traders of credit-default swaps—contracts that act as insurance against debt defaults—were told to come to work immediately. Concerned investors were rushing to buy swaps tied to other brokerages and corporations, sending the cost of protection on investment banks such as Goldman Sachs and others sharply higher.

In a statement Sunday, the International Swaps and Derivatives Association, a trade group whose members include many large dealers, said a "netting trading session" took place between 2 p.m. and 6 p.m. on Sunday. The idea was to allow firms to try to unwind their derivatives transactions with Lehman by finding other parties to step into Lehman's shoes.

"The purpose of this session is to reduce risk associated with a potential Lehman Brothers Holdings Inc. bankruptcy filing," it said. It added that trades conducted during this period "are contingent on a bankruptcy filing on or before 11:59 p.m. New York time" on Sunday. If no filing takes place, the trades will be canceled, ISDA said.

Some traders said it was difficult to find new counterparties for many of their outstanding trades with Lehman. The snags included different terms and maturity dates on derivatives contracts, and market prices changed rapidly Sunday afternoon. "People were screaming at each other over the phone, asking: How can this work?" one trader said.

William Gross, chief investment officer at bond-fund giant Pacific Investment Management Co., said very few Lehman trades were offset. "There's an immediate risk related to the unwind of these positions," he said.

Many Wall Street firms are hopeful that a liquidation of Lehman's assets will proceed in an orderly fashion. If that happens, those firms could quickly buy real estate, securities and other investments, preventing the assets from flooding the market. Because of that, said people familiar with the situation, some participants in the New York Fed talks decided that liquidation was no worse an option than selling Lehman to a buyer such as Barclays.

"There will be an orderly wind down," said one banker involved in the matter. "This was the default option. It happens when you have no buyer."

The firms decided that instead of making guarantees for Barclays or some other purchaser of Lehman, they would prefer to pool their resources and buy the assets themselves, taking on the risks and carrying costs, along with the possibility of profiting down the road.

Those firms would likely then buy assets such as mortgage-backed securities, leveraged loans, private-equity positions and investments in real estate or hedge funds.

Roger Freeman, a nine-year Lehman employee who analyzes brokerage firms, spent the weekend gathering cellphone numbers and email addresses from colleagues who also are likely to lose their jobs. He plans to clean out his desk Monday morning. "We worked long hours here, we've made some of our best friends here. We're suddenly being ripped apart," he said. "It's just unbelievable."

—Jon Hilsenrath, Jeffrey McCracken and David Enrich contributed to this article.

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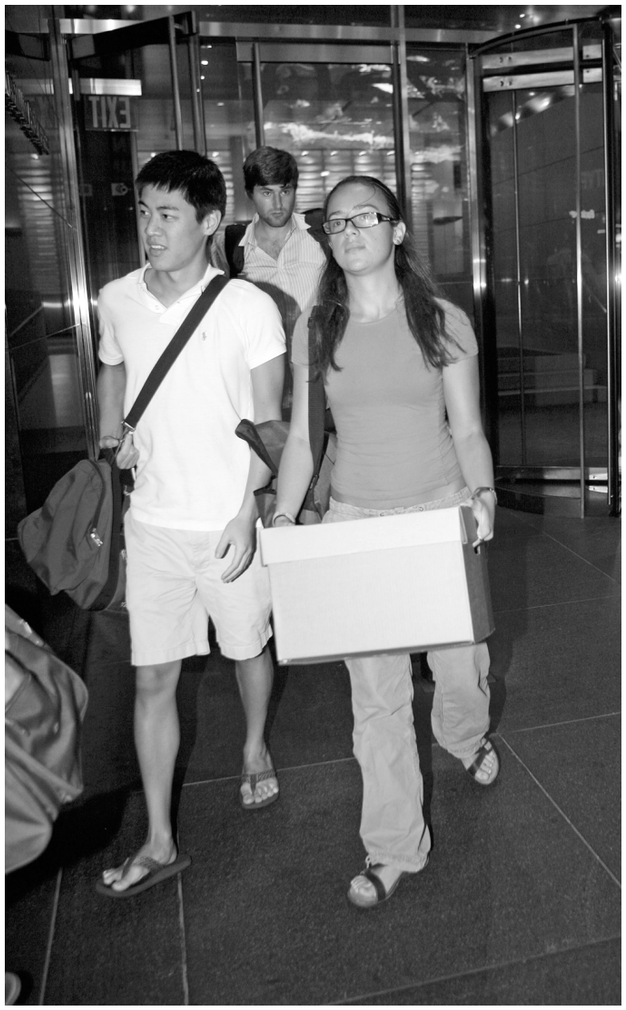


Associated Press

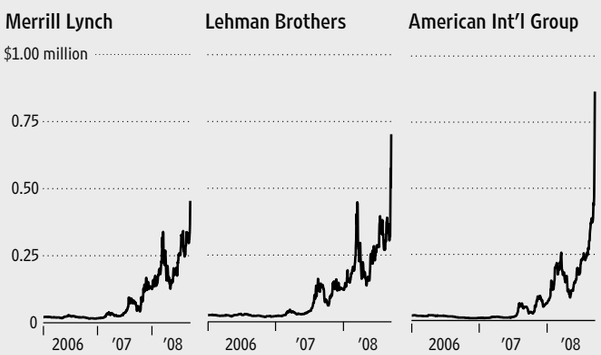
Employees of Lehman Brothers leave the company's headquarters Sunday as they clear their offices after hearing the news about Lehman.

Reuters

The world headquarters of **Lehman Brothers** in New York. On Sunday night, the firm faced the possibility of liquidation.

Credit Check

The amount an investor must pay annually for protection against a default on $10 million in debt over five years.



Note: Data as of Sept. 12

Source: Markit Group

A summary of credit default swaps and how they play into Lehman's woes

What they are: Credit default swaps are contracts between two parties that act like insurance against debt defaults. They are also used by hedge funds, investment banks and others to bet on a company's fortunes.

How they work: CDS buyers make regular payments to sellers, who in turn promise to make big payouts if a company's bonds default or it files for bankruptcy. Buyers and sellers don't need to hold the underlying debt when they enter into the contracts, which can be for periods such as one year or five years.

Size of the market: CDS have been written on over $62 trillion worth of bonds and loans

How they trade: CDS trade 'over the counter,' or directly between buyers and sellers.

The problem with Lehman: Lehman is a large buyer and seller of CDS and entered into many contracts with different firms. In addition, other banks and investors have bought CDS tied to Lehman's own debt. A bankruptcy filing could trigger large payouts from institutions that have sold swaps on Lehman debt. Lehman's own counterparties, meanwhile, may have to re-hedge their positions with other firms.

Ultimatum Sparked Frantic End

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the notion that the government should eschew bailouts, since financial firms might take more risks if they're insulated from the consequences. "Is that a good thing or a bad thing? We're about to find out."

One immediate impact: As Lehman's future darkened, Merrill Lynch & Co., another vulnerable firm, raced into the arms of Bank of America Corp.

Now, however, barring some last-minute, late-night alternative, Lehman will likely file for liquidation, people familiar with the situation said.

This account of the weekend's events was compiled from interviews with Wall Street executives, traders, government officials and other participants in the talks.

The decline of Lehman—a storied, 158-year-old firm—occurred in slow motion this year. Heavily exposed to troubled real-estate investments, the firm tried to raise fresh capital, only to be thwarted. The most recent disappointment came last Monday when a possible deal with a Korean bank faded, sending Lehman's shares down 45% the next day. They had already fallen 80% since the start of 2008.

On Tuesday and Wednesday, when Mr. Paulson called Wall Street CEOs to give them early notice of his no-bailout stance, some argued to him that the government needed to structure a rescue like that of Bear Stearns, according to people familiar with the matter. To prevent Bear Stearns's collapse in March, the Fed agreed to put up $30 billion to help complete the acquisition of the failing bank by J.P. Morgan Chase.

Around midweek, Messrs. Paulson and Bernanke spoke privately and affirmed their mutual intention to stand firm on the question of using taxpayer funds.

Repeating that move with Lehman would create a terrible precedent, Mr. Paulson worried. Which other firms would take that as a cue to ask for U.S. government help, and from what other industries? Detroit auto makers were already knocking at the door.

Mr. Paulson was also irked that Wall Street saw him—former CEO of Goldman Sachs—as someone who would always ride to their rescue. And because Lehman's troubles have been known for a while, Mr. Paulson felt the market had had time to prepare.

In addition, Lehman had access to special emergency lending from the Fed, something Bear Stearns didn't have when it was struggling. This was another reason Mr. Paulson there shouldn't be a Bear-like rescue for Lehman.

The government's no-bailout decision emerged as serious obstacle for Lehman's two most likely buyers, Bank of America and Barclays PLC. Indeed, this past Friday, federal officials monitoring talks to sell Lehman to Bank of America realized that deal probably wouldn't be consummated without federal backing.

That triggered the call for the Friday-evening meeting of financial titans. The gathering was attended by at least 30 executives, a Who's Who of Wall Street.

Mr. Geithner laid out two potential scenarios. One involved an orderly dismantling of Lehman that would essentially end its existence. But he also suggested that Wall Street firms come up with their own solution—perhaps by joining forces among themselves to remove Lehman's riskiest and most toxic assets. That move would make Lehman more attractive to potential buyers, but would also require Wall Street firms to commit their own scarce money to the cleanup.

Mr. Paulson told the group it was in their interest to find a solution. "Everybody is exposed" to Lehman, Mr. Paulson said, according to two people in attendance.

Most of the Wall Street executives present at the meeting listened and asked questions, but didn't show what hand they might play. The meeting broke up just after 8 p.m. Friday.

Finding a Buyer

Saturday morning, the CEOs and their closest advisers reconvened at about 9 a.m. and broke into groups to discuss various scenarios. Lehman representatives weren't present.

One group focused on the possible dismantling of Lehman; it included both government officials and Wall Street representatives. Among the things the group discussed was having every bank borrow from the Fed under an emergency lending provision it has offered since the collapse of Bear Stearns. With that borrowed money, the banks would buy up Lehman's assets, preventing it from filing for bankruptcy.

The other main track focused on finding a buyer. Either Barclays or Bank of America would buy Lehman's "good assets," such as its stock-trading and analysis business, people familiar with the matter say. Lehman's more toxic real-estate assets would be placed in a "bad" bank containing about $85 billion in souring assets. Other Wall Street firms would inject some capital into the bad bank to keep it afloat. The goal would be to avoid a flood of bad assets pouring into the market, pushing prices even lower.

But getting Wall Street firms to cooperate among themselves, without government assistance, was proving tough. Several CEOs openly questioned why they should bear the cost of Lehman's problems when others who also face exposure—such as institutional investors, hedge funds and foreign investors—aren't being asked to do the same.

Morgan Stanley CEO John Mack raised serious questions, saying that this time it was Lehman and next time it would be Merrill, according to people in attendance. "If we're going to do this deal, where does it end?" he said, according to a person familiar with the matter. Other bankers in the room felt the same way, this person added.

By noon on Saturday, Bank of America hadn't budged from its position that it needed government support to consummate a deal. The bottom line: It was effectively out of the running. Little known to others in the room, it was about to start flirting with Merrill.

Outside the Fed's downtown New York headquarters, a fortress-like building of stone and iron, a fleet of black limousines waited for the bankers inside. At one point, they blocked the narrow streets around the building, causing a traffic jam that had to be broken up by the Fed's uniformed guards.

Bankers and Fed staffers milled outside, smoking cigarettes and talking on their cellphones about subjects such as counterparty risk, a normally arcane matter of contract law, suddenly front and center. On one occasion, in the men's bathroom, a trio of bank CEOs debated the merits of a rescue plan.

The bond- and derivative-trading heads of major investment banks, assuming that a deal to save Lehman was a diminishing possibility, gathered to discuss how to deal with their exposure to minimize havoc Monday when markets opened.

Shortly after 5 p.m., a clutch of Fed staffers left the building. The day hadn't gone well. The government and potential buyers remained miles apart, mainly due to the bailout issue. Wall Street executives left in cars parked in a garage to avoid being photographed by the waiting press.

One person in the Fed meetings Saturday night described them as "the world's biggest game of poker."

With different doomsday scenarios being batted around the meeting rooms, some participants felt the government would blink and do a bailout. "This is going to go down to the last second," one participant said.

With Bank of America backing away from a deal, the enormity of a potential bankruptcy filing by Lehman started settling in. Even understanding Lehman's current trading positions was tough. Lehman's roster of interest-rate swaps (a type of derivative investment) ran about two million strong, said one person familiar with the matter.

Overnight, the outlines of possible deals started to crystallize. The idea that Wall Street firms would fund a "bad bank" full of Lehman's problematic assets was dead. Unlike when Wall Street firms stepped in to bail out hedge fund Long-Term Capital Management a decade ago, today's banks are much weaker. Some were loath to provide support when a rival like Barclays might still buy Lehman.

By Sunday morning, the U.K.'s Barclays looked like the sole potential buyer. That further minimized the chances of a government bailout: If the Bush administration wouldn't help to fund a Wall Street solution, aiding a foreign buyer was even less likely.

Lehman employees followed their firm through news reports. One manager said he was encouraging his staff to show up Monday and hang tough for a few more days. "It is not like there are a million jobs to go to," he said.

The Chance to Transform

Barclays pushed ahead, eager at the chance to transform itself into a U.S. powerhouse at potentially a fire-sale price. Its advisers thought the U.S. Treasury could be persuaded to support a foreign buyer. By Sunday morning in London, after working around the clock for three days, the British bank—whose roots date to the late 1600s as a goldsmith banker in London—thought it had a shot. Documents were drawn up to pitch the deal to investors and journalists.

During the afternoon on Sunday, two Fed policeman wheeled a large, double-decker cart filled with cakes, cookies, sandwiches, chips and bottles of water into the Fed building.

But soon after, Barclays was threatening to walk as it argued with the Fed and Treasury over seemingly mundane matters, such as whether it would have to hold a shareholders' meeting to ratify any deal. Barclays was still insisting on some kind of federal financing.

By the middle of Sunday afternoon, Barclays was out. Its plan—to buy Lehman's subsidiaries—was contingent on government support, which wasn't coming.

At a meeting held at the Fed offices, Mr. Paulson, Mr. Geithner and Securities and Exchange Commission Chairman Christopher Cox addressed a group of about one dozen banking chiefs. Their message was steadfast: They would not put up money to assist in salvaging Lehman. In the meetings with Mr. Paulson were his chief of staff, Jim Wilkinson, and two advisers, Dan Jester and Steve Shafran, both of whom used to work at Goldman Sachs.

The mood turned somber as it became clear that the group would have to turn its attention to dismantling Lehman in a way that didn't seriously disrupt the financial system. Soon the group began discussing the mechanics of such a plan.

A sense of foreboding descended over the rival bankers. They focused on the fear that drove down shares in Lehman, worried that would now spread to Merrill, another storied name facing losses from mortgage-related holdings, despite the reputation of its wealth-management business.

"I think the government is playing with fire," said a top executive of a big bank.

The worry for Merrill, said people briefed on the conversations, was that as its stock tumbles, its credit rating could change, increasing its cost of borrowing. Faced with rising borrowing costs—a key expense for giant Wall Street financial firms—its business might be severely crimped. As well, as concerns mount, its trading partners might stop doing business with it.

Many in the room began to wonder when Merrill would sell itself. "Tonight, or tomorrow?" said one of these people in an interview.

In fact, within a few hours, the bankers learned that 94-year-old firm agreed to sell itself to Bank of America for $50 billion, a deal that all by itself could reshape the U.S. banking landscape.

As word that a Barclays deal was off filtered across Wall Street, traders scrambled to extricate themselves from their financial transactions with Lehman. Traders at many Wall Street firms were told to come to work immediately.

Amid the uncertainty over Lehman, another crisis loomed. Sunday afternoon, insurance giant American International Group Inc.—racing to shore up its balance sheet—approached Mr. Geithner, hat in hand, looking for a bridge loan so AIG could complete some asset sales. Expanding this kind of Fed lending beyond securities firms to other institutions would be a major step. Mr. Geithner was noncommittal about the AIG request.

The U.S. tumult meant that the European Central Bank was also in a state of high alert on Sunday, with employees in divisions from money-market operations to financial stability camped out in the bank's 37-story glass-and-steel tower in Frankfurt, preparing for what Monday might bring. "We are in the hands of the Americans," said one employee.

—Aaron Lucchetti, Serena Ng, Jon Hilsenrath, David Enrich, Joellen Perry and Matthew Karnitschnig contributed to this article.

The Lingering Storm

Major events in Wall Street's credit crunch since June 2007:

June 14, 2007: News that a hedge fund managed by Bear Stearns Cos. is scrambling to sell large amounts of mortgage securities takes the subprime-mortgage problem to another level. The same day, the Dow Jones Industrial Average has its biggest rally of the year, closing at 13482.35.

July 10: S&P and Moody's announce a wave of downgrades on bonds backed by subprime mortgages, an acknowledgment they had misjudged the risk.

July 24: Extent of Countrywide Financial Corp.'s mortgage pressures emerge.

Associated Press

Oct. 28: Merrill Lynch, besieged by the subprime pullback, announces retirement of CEO Stan O'Neal.

Nov. 4: Charles Prince, resigns as Citigroup CEO.

Dec. 10: UBS announces major write-downs.


Agence France-Presse/Getty Images

Charles Prince

March 16: Bear Stearns is sold to J.P. Morgan Chase.

Getty Images

April 15: 'The worst of the impact on the financial-services industry is behind us,' Lehman CEO Richard Fuld says after the Wall Street firm's annual meeting. Despite the firm's record earnings in 2007, investors are nervous about the firm's mortgage exposure.

June 2: Wachovia Corp. forces out CEO G. Kennedy Thompson.

Sept. 7: The U.S. government seizes Fannie Mae and Freddie Mac and replaces their CEOs.

Sept. 13-14: Lehman scrambles for survival and Merrill seeks a buyer. DJIA stands at 11421.99, about 15% below the level of 15 months earlier.

Sources: Staff reports; WSJ Market Data Group

BofA to Acquire Merrill for $44 Billion

Continued from Page One

contact Mr. Lewis to see if he would be interested in a sale. The two banks had had preliminary discussions in the past, so the interest was there, according to a person familiar with the matter.

The Better Deal

On Saturday afternoon, Mr. Thain called Mr. Lewis, who responded favorably. Bank of America, which by then had been considering a bid for Lehman as well, decided that Merrill was the better deal and felt more comfortable with Merrill since the two had engaged in prior discussions. Mr. Thain then went to the Federal Reserve Bank of New York. He quickly saw that a deal for Lehman was unlikely, according to a person close to him, which strengthened his resolve to pursue a deal with Bank of America.

With a deal looming, Mr. Thain canceled a previously planned trip to Asia. The two camps began a marathon series of meetings at Wachtell, Lipton, Rosen & Katz, the law firm which has long represented Bank of America in its deals.

Word began to leak out on Sunday at the New York Fed, where top Wall Street executives had been huddled to discuss the fate of Lehman. Executives were relieved that Merrill had found a buyer. "Who was the magician who pulled this rabbit out of a hat?" exclaimed a top executive of one bank.

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The deal shows how the credit crisis has created opportunities for financially sound buyers. At $50 billion, Merrill is being sold at about two-thirds of its value of one year ago and half its all-time peak value of early 2007.

The deal values Merrill at $29 a share. Merrill's shares changed hands at $17.05 each on Friday, after falling sharply in the wake of Lehman's looming demise.

"Why would Bank of America do this?" said analyst Nancy Bush at NAB Research LLC in Annandale, N.J. "Ken Lewis always likes to buy the biggest thing he can. So why not this? You are master of the universe, basically."

Merrill could give Bank of America strength around the world, including emerging markets such as India. And Merrill is also strong in underwriting, an area Bank of America identified last week at an investors' conference where it would like to be more aggressive.

Bank of America and Merrill Lynch wouldn't comment on any discussions.

The deal is all the more dramatic because Merrill, upon the arrival of Mr. Thain, did more than many U.S. financial giants to insulate itself from the financial crisis that began last year. It raised large amounts of capital, purged itself of toxic assets and sold big equity stakes, such as its holding in financial-information giant Bloomberg LP. That Merrill has opted to sell itself thus underscores the severity of the crisis.

The integration of Merrill, known for its proud and sometimes testy brokerage force, could turn out to be the biggest test of Mr. Lewis's career. Typically, the bank has made one big deal and then taken time to carefully merge the two institutions. But in recent years, acquisitions have come at a furious pace. In 2004, the bank bought FleetBoston Financial Corp. A year later, the bank agreed to buy MBNA Corp., the credit-card firm. In 2007, Bank of America bought Chicago's LaSalle Bank as part of the breakup of Dutch bank ABN-Amro Holding NV. Then came this year's purchase of Countrywide.

'The Ultimate Realist'

Absorbing Merrill comes with huge risks. Merrill had the highest ratio of "problem assets" subject to write-downs to capital of the top three independent securities firms, according to Fox-Pitt, Kelton. Analysts were already betting it would have to write down another $3 billion or more in the third quarter beyond what it had announced in July.

"I think John Thain at Merrill is the ultimate realist," said Ms. Bush, the NAB Research analyst, who expected federal regulators to bless the deal. "He knows if Lehman goes under he is not far behind. He wants to cut the best deal he can."

In the past 15 months, Merrill and Lehman have both had tens of billions of dollars worth of risky, hard-to-sell assets carried on balance sheets that were piled high with debt. When the credit crunch hit in mid-2007, the assets kept deteriorating in value and couldn't easily be sold, eating into both firms' capital cushions. Recently, Lehman's balance sheet topped $600 billion and Merrill's $900 billion.

Merrill's previous chief, Stan O'Neal, was ousted in October 2007. His successor, Mr. Thain, tried to repair the firm's balance sheet by arranging an infusion of more than $6 billion in capital starting last December, tapping investors led by Temasek Holdings, a Singapore government investment fund.

But the losses kept coming this year. Mr. Thain was forced in July to sell a huge slug of more than $30 billion in collateralized debt obligations, or securities backed by pools of mortgages or other assets, at a price of just 22 cents on the dollar. That step required the firm to raise still more capital, under painful terms that re-priced some of the December stock sales at about half the original price.

During the flurry of historic deal making this weekend, Merrill also put out feelers to Morgan Stanley about a possible deal, which would have united two of Wall Street's oldest brands, according to a person familiar with the talks. But the talks didn't go anywhere because there wasn't enough time for Morgan Stanley to review the idea and Merrill wanted to do a deal quickly, this person said. Merrill was also stepping up talks with commercial banks both in Europe and the U.S.

Mr. Thain would collect an exit package worth about $9.7 million if Bank of America completes its takeover, according to David M. Schmidt, a pay consultant for James F. Reda and Associates LLC in New York.

That figure represents accelerated vesting of restricted stock units that Mr. Thain got when he took command last December. Only two thirds of those 500,000 units would become shares that he could sell.

One top Merrill executive lamented the sale of the venerable company, saying, "It's sad but inevitable." This executive said that he was pleased it was Merrill, rather than rival broker Morgan Stanley, that was hatching a deal with Bank of America.

Front and Center

The futures of both Morgan Stanley and Goldman Sachs will be front and center Monday morning, as Wall Street wakes up to a world where the independent broker-dealers are increasingly few in number. They would be the last of the big five independent firms, with Merrill and Bear Stearns Cos. having been sold and Lehman likely to close down.

This tumultuous year has made it clear that investment banks like Lehman and Bear Stearns face vulnerabilities that commercial banks such as J.P. Morgan and Bank of America are less prone to. The investment banks must constantly depend on short- and medium-term money markets to fund their operations. Commercial banks, meanwhile, can count on more stable consumer deposit bases.

Winthrop H. Smith Jr., a former Merrill executive whose father helped build the firm, said the acquisition would represent "a very sad moment for myself and my family and the thousands of families who worked for Merrill Lynch over our 94-year history, sad to see a firm that always prided itself on its independence absorbed" into another.

—Randall Smith, Susanne Craig and Aaron Lucchetti contributed to this article.

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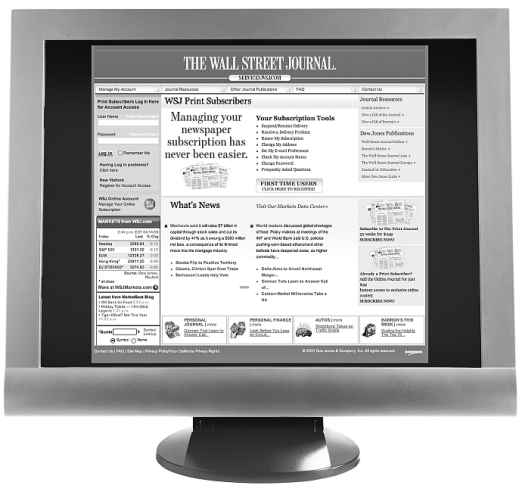

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AIG Scrambles to Raise Cash, Talks to Fed

Insurer Looks to Sell Automotive Business, Annuities Unit; It Seeks $10 Billion in Fresh Capital as Downgrade Threatens

By Matthew Karnitschnig, Liam Pleven And Peter Lattman

Insurer American International Group Inc., succumbing to relentless investor pressure that drove its shares down 31% on Friday alone, is pulling together a survival plan that includes selling off some of its most valuable assets, raising more capital and going to the Federal Reserve for help, people familiar with the situation said.

The measures are aimed at staving off a downgrade by major credit-rating firms. AIG executives worried that such an action would set off a chain reaction that could be fatal to the firm. The insurer, which has already raised $20 billion in fresh capital so far this year, was seeking to raise an additional $40 billion to avoid a downgrade.

During a weekend scramble to shore up its finances, AIG turned down a capital infusion from a group of private-equity firms led by **J.C. Flowers** & Co. because an option tied to the offer would have effectively given them control of the company, an 89-year-old giant that does business in nearly every corner of the world.

The proposed option would have allowed the firms to acquire AIG for $8 billion under certain conditions. That price is just one-fourth of AIG's current market value.

J.C. Flowers didn't respond to messages seeking comment.

When AIG's board rejected the capital infusion, the company's recently appointed chairman and chief executive, Robert Willumstad, took the extraordinary step of reaching out to the Federal Reserve for help. Mr. Willumstad asked New York Federal Reserve President Timothy Geithner if the Fed could backstop some asset sales.

Two other private-equity firms—**Kohlberg Kravis Roberts** & Co. and **TPG**—offered to inject capital into AIG if the Fed agreed to provide the insurer with a bridge loan until its restructuring plan was completed.

AIG viewed the request to the Fed not as a bailout but rather as a temporary measure that would give the insurer some breathing room until it was able to dispose of the assets.

As of late Sunday, the Fed had yet to decide whether to offer the assistance. The Fed usually deals with banks and brokers, and it wasn't clear what it could do. An AIG spokesman had no comment.

The Fed may not draw the line with AIG's request for support as clearly as it has with Lehman, distinguishing between its lending programs and the use of taxpayer funds. But any Fed action to help the firm still would

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A Chaotic Sunday Opens Wall Street's Week

Moral Hazard's Exit Leaves Investors To Sort Out the Mess

By Annelena Lobb

Investors are going to be staring in the face of moral hazard when markets open Monday.

The collapse of Wall Street firm **Lehman Brothers Holdings** Inc. coupled with a restructuring of insurer **American International Group** Inc. and a deal by **Merrill Lynch** & Co. to sell itself to **Bank of America** could cause a decline, particularly among financial stocks, when markets open.

ABREAST OF THE MARKET

Despite serious efforts by potential bidders and Lehman, a deal never came together over the weekend, largely because the federal government refused to put up any cash. After backstopping Bear Stearns, Fannie Mae and Freddie Mac, the Treasury and Federal Reserve said no more.

The government's logic was that if investors were bailed out again, they would expect a bailout every time, and the so-called moral hazard would disappear, making people willing to take massive risks in the belief they would be saved.

On Sunday afternoon, word spread that **Barclays** PLC appeared unlikely to strike a deal for Lehman. Hedge-fund managers logged onto computers at home or went into their offices, as they sought to prepare for the anticipated fallout of the news. The markets on Monday "will have all the elements of chaos," said one hedge-fund manager at a multibillion-dollar firm.

Regulators and others were preparing for a busy Monday. The New York Stock Exchange prepared contingency plans over the weekend to reassign the roughly 200 blue-chip stocks that are traded by Lehman's "specialist" unit (the floor-trading firms at the NYSE that are assigned to specific stocks), according to people familiar with the matter.

Crisis on Wall Street

The plight of several U.S. financial companies led to ups and downs in the market.

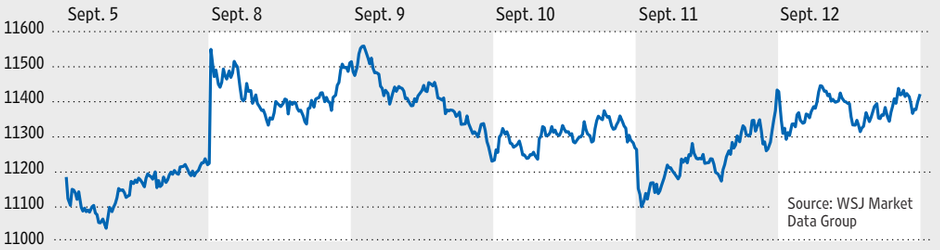
Lehman Chairman and CEO Richard Fuld

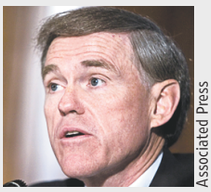
Associated Press

Friday, Sept. 5: The Treasury Department puts the finishing touches on a plan to put Fannie and Freddie into conservatorship, capping a week in which investors bailed out of the mortgage-finance firms' shares.

Sunday, Sept. 7: The U.S. seizes Fannie and Freddie, ousting their CEOs. Washington Mutual ousts longtime CEO Kerry Killinger (below left).

Dow Jones Industrial Average at 5-minute intervals





Associated Press

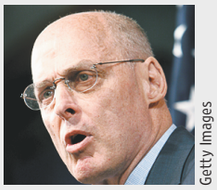
Monday, Sept. 8: Despite skepticsm at the Fannie/Freddie rescue, stocks surge world-wide. The Dow jumps 289.78 to 11510.74.

Tuesday, Sept. 9: Korea Development Bank ends talks to invest in Lehman Brothers, sending the Wall Street firm's shares down 45%. The Dow slides 280.01.

Wednesday, Sept. 10: Lehman unveils a plan to shed most of its real-estate assets, sell half of its Neuberger Berman money-management arm and slash its dividend. Its shares bounced up, then fell 6.9% as doubts grew. The Dow edged up 38.19.

Thursday, Sept. 11: Lehman, with the Fed and Treasury pitching in, actively pursued a sale, something CEO Richard Fuld had been resisting. Its shares slid 42%, though the Dow gained 164.79.

Friday, Sept. 12: The New York Fed convenes an emergency meeting with the Treasury and key financial-industry executives to determine the fate of Lehman and determine how to halt the credit crisis. Treasury Secretary Hank Paulson (right) is reluctant to put further government funding behind any move to save Lehman. The Dow fell 11.72, before news of the meeting.



Getty Images

Saturday and Sunday, Sept. 13-14: Talks went on throughout the weekend, with Bank of America and Barclays among high-profile potential saviors. But the government was reluctant to lend financial support, so potential suitors pulled away, pushing Lehman toward liquidation. Bank of America struck a pact to acquire Merrill Lynch for around $44 billion.

With shares of Lehman at $3 apiece, stock investors have almost priced in a bankruptcy-protection filing. But it's not clear how Lehman's bonds and credit-default swaps will fare.

Sunday was effectively a work day on Wall Street, and traders at fully staffed desks sold off Lehman bonds and tried to buy protection against default by Lehman and other big Wall Street firms. There were worries that downgrades or margin calls could cause investors to dump securities to raise cash.

There are several scenarios for Monday's markets and an equal number for the months ahead. The worst case is if markets tumble Monday as investor anxiety about a financial meltdown grows. Markets are already in bear territory due to the credit crunch and the economic slowdown, but a big decline would show that investors remain afraid of how bad things could still get.

After having seen shares of Bear Stearns, Lehman, Fannie and Freddie get wiped out, value investors who normally dive in to buy battered stocks could be more reluctant, especially with financial stocks. Many of those investors have had big losses recently and are suffering investor redemptions, further reducing the chance they would be buyers. That could allow the stocks to fall a lot farther than they normally would.

Several investors said the reaction will be more muted because markets had seen this coming. "Everybody's prepared this time—it's different from Bear Stearns," said Jim Awad, managing director of Zephyr Management. He added: "There could be a brief relief rally. You won't get a 1,000-point shock drop because we're all ready for it. But a grueling, long bear market will resume."

The AIG move to sell off assets and the Merrill sale to Bank of America, especially if the price is seen as good, could also calm investors.

Financials broadly are priced for terrible news and sentiment is awful. The Dow Jones Financial Sector index has fallen 30% over the past 12 months, compared with 14% for the Standard & Poor's 500-stock index. Many analysts don't expect a broad recovery in the sector anytime before 2009.

Brokerage firms should underperform for several more quarters as they continue to deleverage and as asset prices fall, Meredith Whitney, an analyst for Oppenheimer, wrote in a research note.

Financials "are going to be screaming buys at some point, but it's too soon to be calling a bottom," says Jeff Harte, a managing director who covers banks and brokers for Sandler O'Neill & Partners in Chicago.

But some investors are starting to see past the current mess. Despite the bad news over the past

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AIG Scrambles to Raise Cash, Talks With Fed

Continued from the prior page

have a high bar. Central bank officials took an extraordinary step in expanding the discount window to securities firms earlier this year. Expanding it to other firms would be another big step, though it could be considered if a case can be made for how such a lending lifeline would be critical to overall financial stability.

The assets AIG intends to sell include its domestic automotive business and its annuities unit, according to people familiar with the matter. It also looked into selling its aircraft-leasing arm, International Lease Finance Corp., but it isn't clear whether action on ILFC will be part of the emergency steps.

Timothy Geithner

AIG also considered shifting assets from its regulated insurance business to its holding company, which would help the holding company respond to demands for cash or collateral. But that plan was met with resistance from regulators and by late Sunday it appeared unlikely it would come together.

The rush for cash represents a remarkable comedown for AIG, whose role in global finance is in many ways as critical as investment banks such as Lehman Brothers. AIG's troubles were one of the subjects at the weekend meeting of Wall Street chiefs and regulators at the New York Fed.

Eric Dinallo, the insurance superintendent in AIG's home state of New York, took a significant role in the talks over the weekend, according to a person familiar with the matter. One key issue, the person said, was the proposed shift of assets. Insurers typically face stringent regulations on how they use their assets, as regulators seek to make sure that they can meet their obligations to policyholders.

The turmoil in housing and credit markets has hammered AIG, largely because of contracts it sold protecting others against losses tied to subprime loans and other risky assets. AIG's stock has fallen nearly 80% this year. It reported a second-quarter net loss of $5.36 billion last month after a first-quarter loss of $7.81 billion.

Among its challenges: It doesn't have access to the Fed's lending window, as some other troubled financial firms do. It could face significant claims from Hurricane Ike, which battered the Texas coast over the weekend. It had to pay a stiff premium in August when it borrowed money in the corporate bond market.

As recently as Thursday, AIG said it was sticking to a schedule to unveil its strategic plan on Sept. 25. But its shares fell 31% on Friday alone. Late that day, Standard & Poor's warned that it could cut AIG's credit rating by one to three notches, citing concerns that AIG would have difficulty raising capital. Such a step would make it more expensive for AIG to borrow and further undermine investor confidence in the company.

Earlier this year, AIG considered selling or spinning off ILFC, the aircraft-leasing arm, but it decided against the idea in June. Since then, AIG's position has deteriorated, making it more likely that it would try again to unload the unit.

AIG could also raise cash by selling its investments in **Blackstone Group** LP, which is also helping to advise the insurer on its restructuring. AIG owns a stake in Blackstone worth about $700 million. It also has roughly $1 billion in investments in Blackstone's funds, according to regulatory filings, that it could sell in the secondary market.

It's not clear whether AIG has buyers lined up for any of the assets it wants to sell. Also unclear is how much interest private-equity firms would take in an AIG investment, and whether they have enough capital to make a dent in AIG's problems.

"The numbers are too daunting," said a senior executive at a large private-equity firm. Given AIG's huge balance sheet, "we just don't have enough capital to fill the hole."

Robert Willumstad

Over four decades, former Chief Executive Maurice R. "Hank" Greenberg built AIG into one of the world's largest financial firms. He made major acquisitions, and pushed AIG into businesses beyond the world of traditional insurance. For years, investors paid a hefty premium to buy AIG shares.

Now AIG is not even the most valuable insurer in the U.S., as measured by market capitalization.

A 2005 accounting scandal precipitated Mr. Greenberg's departure. He has denied wrongdoing. A protégé, Martin Sullivan, ran the company until this summer when he was replaced under shareholder pressure with Mr. Willumstad, a former Citigroup Inc. executive who has been AIG's chairman since 2006.

When Mr. Willumstad said in June that he would release his turnaround plan in a few months, some wondered whether that gave him enough time to get his hands around such a multifaceted enterprise. But rapid shifts in the market have forced his hand.

Mr. Willumstad reached out to Mr. Greenberg after taking over in June, But a spokesman for Mr. Greenberg said the former CEO wasn't involved in the weekend talks, "though he repeatedly offered to assist in anyway he could"—suggesting that Mr. Willumstad was pursuing his own strategy.

The aircraft-leasing arm could be part of his efforts. Founded in 1973, ILFC boasts a fleet of more than 900 airplanes valued at more than $50 billion. It is the largest single customer for both **Boeing** Co. and **European Aeronautic Defence & Space** Co.'s Airbus. Given that ILFC logged record operating income of $352 million in the second quarter, its value may be relatively high at the moment compared to some other AIG units.

S&P said AIG had enough money to pay claims and post collateral, if needed—an important statement, given that AIG could have to post billions of dollars if it got downgraded.

AIG had over $1 trillion in assets at the end of the second quarter. Its shareholders equity—assets minus liabilities—stood at about $78 billion at that point.

—Sudeep Reddy contributed to this article.

Stocks to Be Tested Today

Continued from the prior page
week, financial stocks in the S&P 500 are still about 20% above the low hit in July.

David Ellison, a fund manager at FBR Capital Markets Corp. who had been deeply bearish on the sector, said he has recently bought "a few" financial stocks.

At the end of June, cash levels in his Large Cap Financial Fund and Small Cap Financial Fund stood at 50% and 38%, up from 2% and 0% at the start of 2007, respectively, according to Morningstar Inc. He says cash levels are lower now than in June, but only slightly.

ABREAST OF THE MARKET

"What you're seeing now is the development of haves and have-nots," Mr. Ellison says. "You have names like Wells Fargo on one side, which seems to be doing a good job of dealing with its negatives. Meantime, you have WaMu and Lehman on the other side."

Joining Mr. Ellison in this tentative optimism are fund managers at Ceredex Value Advisors, IronOak Advisors, and Silvant Capital Management, subsidiaries of Atlanta-based **RidgeWorth Capital Management**.

They have shifted to a neutral position in financial stocks from an underweight position in their large-cap equity funds over the past few months, says Alan Gayle, RidgeWorth's senior investment strategist. "We felt that the sector had discounted a lot of bad news," Mr. Gayle says.

Once investors digest this weekend's news, they can start to worry about the coming earnings season. Lately, the market has fallen into a pattern. First comes a pullback as everyone braces for the bad news.

"Every quarter, brokers prepare to report and the stock market gets cautious," says Marc Pado, U.S. market strategist at Cantor Fitzgerald. "The rumors go around, how bad, how much."

Next comes a relief rally—at least, that has been the case for the previous two quarters—as investors tell themselves the worst is over. "We see this every quarter, caution going in and optimism coming out," Mr. Pado says.

Manic Monday?

❖ **The Situation:** With Wall Street's day of reckoning gaining pace, investors are poised to return to a different market from the one left Friday.

❖ **The Latest:** Lehman Brothers, Merrill Lynch and AIG all had a tumultuous weekend of talks to try and solve problems.

❖ **Bottom Line:** Perhaps bargains exist, but it may be best to wait and see.