In Bank of America’s Merrill Deal,

Thursday, February 5, 2009 A9

U.S. Played Hardball

In Merrill Deal, U.S. Played Hardball

USA Inc.
The State of Capitalism

Kenneth Lewis is getting a hard lesson in the new balance of power between Washington and Wall Street.

The Bank of America Corp. chairman and chief executive had agreed to buy brokerage giant Merrill Lynch & Co. in September, possibly saving it from collapse. But by early December, Merrill’s losses were spiraling out of control. Internal calculations showed Merrill had a horrid pretax loss of $13.3 billion for the previous two months, and December was looking even worse.

Mr. Lewis had had enough. On Wednesday, Dec. 17, he flew to Washington, ready to declare that he was through with Merrill, people close to the executive say.

“Ttie need you to know how bad the picture looks,” Mr. Lewis told then-Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke, according to accounts of the conversation by people inside the government. Mr. Lewis said Bank of America had a legal basis to abandon the deal.

Messrs. Paulson and Bernanke forcefully urged Mr. Lewis not to walk away, praising the bank’s earlier cooperation—but warning that abandoning the deal would be a death sentence for Merrill. They said the move also could undercut confidence in Bank of America, both in the markets and among government officials. Despite the blunt talk, Bank of America executives interpreted the comments as a signal that the government was willing to work out a compromise.

Two days later, in a follow-up conference call, federal officials struck a harder tone. Mr. Bernanke said Bank of America had no justification for ditching Merrill, according to people who heard the remarks. A Federal Reserve official warned that if Mr. Lewis did so and needed more government money down the road, Bank of America could expect regulators to think hard about their confidence in management. Mr. Lewis was told that the government would consider ousting executives and directors, people close to the bank say.

The threats left no doubt: The federal government saw itself as firmly in charge of U.S. financial institutions propped up since October by infusions of taxpayer-funded capital.

During the four weeks that followed Mr. Lewis’s conference call, federal officials and Bank of America hashed out a deal to salvage the Merrill takeover. The government agreed to provide $20 billion in additional aid for the Charlotte, N.C., bank, and to provide protection against losses on $118 billion in troubled assets.

The money is coming at a price. Six months into the great bailout of U.S. finance, Washington’s rescue attempt has helped shore up the system. But that emergency effort, planned on the fly, has taken the government on a risky journey deep into the heart of American capitalism.

Bureaucrats are calling the shots behind the scenes at some of the nation’s largest enterprises. Critics of the bailout program say its rules are opaque and its execution ad hoc, leading to a lingering lack of confidence in the financial system. Some law-

Please turn to page A9
USA Inc.
The State of Capitalism

Continued from Page One

makers are scrambling to steer funds to favored lenders.

Federal officials have said little publicly about their oversight of the institutions that received capital from the Troubled Asset Relief Program. Initially, the government seemed reluctant to use the ownership stakes it got in banks ranging from J.P. Morgan Chase & Co. to Saigon National Bank as leverage over bank executives.

But the tough negotiations with Bank of America, along with recent moves by federal officials related to executive compensation and other issues, suggest that the government’s attitude toward the troubled banking industry has changed, as financial markets have deteriorated further and political ire has risen.

When Citigroup Inc. took $25 billion in TARP funds in October, the executive-pay section of its pact with Treasury was just two sentences long and vaguely worded. A second rescue, for $20 billion in December, limits Citigroup’s executive bonus pool for 2008 and 2009, requiring that a majority of 2008 bonuses be paid on a deferred basis.

Tough talk by President Barack Obama and other officials about bonuses and perks is making bank executives uncomfortable. Last week, under pressure from Treasury officials, Citigroup canceled its order for a corporate jet. The bank recently has explored its options for modifying the terms of a nearly $400 million marketing deal with the New York Mets.

On Wednesday, Mr. Obama unveiled a series of executive pay curbs, including a strict limit on executive salaries for companies that receive an “exceptional” level of government assistance.

The story of Merrill Lynch’s troubles and subsequent rescue negotiations, pieced together from interviews with people who participated in the process, suggests that the government’s extension of control over the U.S. banking system is evolving on a makeshift basis. Despite agreeing to pump $25 billion into Bank of America and Merrill in October, the government had no idea the securities firm was hemorrhaging money until it was too late to avoid a second bailout.

By the end of November, two months into the fourth quarter, Merrill had accumulated $13.34 billion in pretax quarterly losses, according to an internal document reviewed by The Wall Street Journal. Some Bank of America executives expressed concern about proceeding with the takeover, people close to the bank say. On the advice of their lawyers, the bank decided to go ahead with Dec. 5 shareholder votes on the deal. Shareholders of both Merrill and Bank of America gave their approval.

In September, when the deal was announced, it was viewed as a rare piece of good news during a week when much of Wall Street appeared to be teetering on the brink. On the same weekend that Lehman Brothers Holdings Inc. prepared to seek bankruptcy protection, the 61-year-old Mr. Lewis found a motivated seller in John Thain, Merrill’s chairman and chief executive. Mr. Thain was worried that Merrill might follow Lehman down the drain.

After less than 48 hours of due diligence, Bank of America struck an agreement to buy the battered securities firm for $50 billion in stock, or $29 a share. (The value of the deal has since declined along with Bank of America’s share price.) “I look forward to a great partnership with Merrill Lynch,” Mr. Lewis said, toasting the deal with a glass of champagne.

A month later, Mr. Lewis was at the Treasury Department along with eight other chief executives of large U.S. financial institutions, summoned there by Mr. Paulson. The Treasury secretary wanted the executives to accept a round of government capital totaling $125 billion as a way of shoring up confidence in the banking system.

Mr. Paulson explained that saying no wasn’t an option, according to a person who attended the meeting.

“We are going to do this,” Mr. Lewis replied, urging the other CEOs to call their boards if they needed approval.

After persuading the nine financial institutions to take taxpayer money, the government, at first, refrained from flexing its muscles.

Bank of America executives remained confident about the deal. Doubts began to creep in shortly before Thanksgiving. With more than a month to go until the end of the fourth quarter, the pretax quarterly losses at Merrill were approaching $9 billion, according to people familiar with the figures. By month’s end, the figure had exceeded $13 billion, or $9.29 billion after taxes.

Most of the losses were coming from the securities firm’s sales and trading department. But business was even suffering in Merrill’s lucrative wealth-management unit, which saw its revenue drop to $797 million in December, from $1.08 billion in October. Still, not all of the losses, which included expected write-downs on assets such as Merrill’s investment in rental-car company Hertz Global Holdings Inc., should have come as a surprise to Bank of America.

In meetings with Merrill managers, Mr. Thain acknowledged big losses, but said they weren’t any worse than those of the firm’s Wall Street rivals, noting that November had been a horrible month for everyone, say people who heard his remarks.

At Bank of America, executives debated whether Merrill’s losses were so severe that the bank could walk away from the deal, citing the “material adverse effect” clause in its merger agreement. Merger agreements typically specify certain “adverse” conditions that give an acquirer the right to abandon a deal.

But lawyers from inside and outside the bank concluded that the losses likely were in line with
ous years.

Mr. Lewis told Bank of America directors in a conference call that the bank might abandon the acquisition, which was supposed to close in two weeks.

In mid-December, Edward Herlihy, a partner at law firm Wachtell, Lipton, Rosen & Katz who had helped set the merger talks in motion, reached out to Ken Wilson, a former Goldman Sachs Group banker and a top deputy of Mr. Paulson. By then, Merrill’s losses had reached almost $21 billion on a pretax basis, roughly equivalent to about $15 billion in net losses, and some of Bank of America’s lawyers felt there was sufficient grounds to invoke the legal clause to torpedo the deal.

Mr. Herlihy, a longtime adviser to Bank of America, expressed concern to Mr. Wilson about the size of the losses, according to people familiar with the matter. Mr. Wilson was stung by the news. Get Mr. Lewis to call Mr. Paulson, Mr. Wilson said, according to people familiar with the conversation.

At the meeting the next day, Dec. 17, Messrs. Paulson and Bernanke asked Mr. Lewis to give government officials time to think through their options, according to people with knowledge of the discussions. Mr. Lewis agreed and returned to Charlotte.

People close to Mr. Thain say he was unaware of Bank of America’s concerns. On Dec. 19, he hopped a plane to Vail, Colo., with his family, people familiar with the matter said.

That same day, about 20 people in Charlotte and Washington dialed into a conference call that included Mr. Lewis, other Bank of America executives, Messrs. Paulson and Bernanke, and other Treasury and Fed officials. Mr. Bernanke told Mr. Lewis that Fed staff members had concluded there was no way for the bank to invoke the material-adverse-change clause in the takeover agreement that would allow it to abandon the deal.

Government officials also warned Mr. Lewis that withdrawing from the deal would frazzle the markets, spark a flurry of lawsuits against Bank of America and tarnish the bank for years. A senior Fed official ratcheted up the pressure, telling Mr. Lewis that any future requests for government assistance would cause officials to consider taking a heavier hand in Bank of America’s operations.

The government’s tone wasn’t hostile. But the implication was obvious, people close to Bank of America say. As the bank’s primary regulator, the Fed can force out executives if the agency concludes they are behaving irresponsibly. Mr. Lewis responded matter-of-factly that that government should do what it had to do, and Bank of America would do the same.

As an answer to move ahead with the deal, Mr. Lewis responded that Bank of America wanted additional capital and protection against future losses on Merrill’s assets—something akin to the protection J.P. Morgan Chase & Co. received from the government when it agreed to take over Bear Stearns Cos. last March. Messrs. Paulson and Bernanke agreed to keep talking.

Over the next several days, government officials sifted through the books at Bank of America and Merrill, wrangling over which toxic assets to guarantee and how to value them, people close to the bank say. It became increasingly clear that Bank of America’s balance sheet was also packed with assets that faced bruising write-downs, these people say.

Later, talks slowed because bank executives were concerned about the 8% interest rate the government wanted on new preferred shares it would take in Bank of America, these people say. Executives also complained that executive-compensation restrictions were being forced on it, despite government assurances that officials didn’t want to punish the bank. The bank wound up agreeing to limit total compensation, including bonuses, to a fraction of the amounts awarded in recent years.

On Jan. 16, Bank of America announced the new bailout. At the same time, it disclosed Merrill’s fourth-quarter net loss of $15.31 billion. Shareholders were floored. Bank of America reported a net quarterly loss of $1.79 billion.

Asked by an analyst about his decision to go ahead with the Merrill deal, Mr. Lewis responded: “We did think we were doing the right thing for the country.”