Subject: Full Committee Hearing: "Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout?"

Hearing Date: Thursday, June 11, 2009, 10:00 a.m.

On Thursday, June 11, 2009, at 10:00 a.m., in room 2154 of the Rayburn House Office Building, the Committee will hold a hearing entitled, "Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout?" This is the first in a series of hearings the Committee plans to hold on this subject.

The Majority Staff Memorandum lays out background information about the hearing, which will feature just one witness, Kenneth D. Lewis, Chief Executive Officer and President of Bank of America Corporation. This memorandum includes supplemental information, including excerpts from internal Federal Reserve documents reviewed by Committee staff at the Federal Reserve and obtained under subpoena.[1] It lays out the key questions to be addressed at the hearing as well as the Minority's views about why the hearing's sole witness will be unable to answer these questions in full, necessitating the need for further hearings on this matter.

Background:

On September 15, 2008, Bank of America announced its intention to merge with Merrill Lynch. However, Merrill's condition deteriorated rapidly as the financial crisis deepened. Shortly before Thanksgiving, Merrill's after-tax losses for the 4th quarter of 2008 had increased to over $9 billion. However, Bank of America decided to proceed with the deal and the two companies' shareholders voted to approve it on December 5.[2] By mid December, however, Merrill's after-tax losses ballooned to about $14 billion and, on December 17, Bank of America's CEO, Ken Lewis, called Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke, informing them of his intention to exercise a Material Adverse Change clause ("the MAC clause") in the contract to get out of the deal.[3] Ultimately, however, Bank of America went ahead with the merger, which

[1] All excerpts of Federal Reserve documents referenced in this memorandum have been produced from in camera reviews by Committee staff at the Federal Reserve.
[2] Dan Fitzpatrick, Susanne Craig and Deborah Solomon, "In Merrill Deal, U.S. Played Hardball," *The Wall Street Journal*, (February 5, 2009).
[3] Document, *Analysis of Bank of America & Merrill Lynch Merger*, (December 21, 2008), Bates BOG-BAC-ML-COGR-00036 to BOG-BAC-ML-COGR-00076.

was consummated on January 1, 2009. In the end, Merrill Lynch's 4th quarter losses exceeded $15 billion.[4]

Then on April 23, 2009, New York State Attorney General Andrew Cuomo sent a letter to Members of Congress in which he alleged that Ken Lewis, under duress from the Treasury and the Federal Reserve, may have violated his fiduciary responsibility to Bank of America's shareholders in the interest of the larger U.S. financial system. These allegations were based on testimony received by Cuomo from Ken Lewis in connection to an investigation into bonuses awarded at Merrill Lynch in which Lewis seemed to admit that, under government pressure, he acceded to a merger with Merrill Lynch that, in the short term, was not in the best interests of his own shareholders.[5]

These revelations raise several important issues. First, if Ken Lewis folded to government pressure and agreed to a deal that put the interests of anyone other than his own shareholders first, he may be in violation of his fiduciary duties, both to reveal materially relevant information to them and to pursue their best interests. While the violation of a CEO's fiduciary duty to his or her shareholders is a serious matter, it remains one to be properly dealt with inside the existing legal system.

Second, and more important for this Committee, is whether or not officers of the federal government improperly exercised their power under the U.S. Constitution to compel a private corporation's management to violate its fiduciary duties, whether through non-disclosure of material information or through pushing for a merger that management felt to be no longer in the best interests of shareholders. Messrs. Paulson and Bernanke clearly applied enormous pressure on Ken Lewis not to back out of the deal, including threatening explicitly to fire him and his board. They saw Bank of America's merger with Merrill Lynch as critical for propping up a failing investment bank, which they believed to be in the best interests of the financial system as a whole. This Committee should be asking Messrs. Paulson and Bernanke on what grounds they took these actions. Unfortunately, they were not invited to appear at this hearing. At Ranking Member Issa's insistence, however, the Majority has promised to compel their testimony at a future date.

Until the relevant government officials are called to account for their actions, however, the Committee has had the benefit of reviewing internal Federal Reserve and Bank of America documents on this topic. The results of this review follow in the form of answers to some "key questions."

Key Question: Did the government overstep its authority in pressuring Bank of America not to back out of the Merrill Lynch merger?

The unequivocal answer is yes. While government regulators are properly concerned with the overall health of the economy and the financial system, in the case of the Bank of America merger with Merrill Lynch, government officials crossed the line by applying

[4] Letter, Andrew Cuomo, Attorney General of the State of New York, (April 23, 2009).
[5] Id.

inappropriate pressure on a private institution to go through with a business deal. This is extensively documented both in internal Federal Reserve emails and in the minutes of Bank of America's board meetings. When Bank of America's CEO Ken Lewis first called the government on December 17, 2008, to indicate that he was thinking about getting out of the Merrill deal by exercising the Material Adverse Change clause ("the MAC clause") in the contract, the Federal Reserve and the Treasury immediately began pressuring him not to pull out of the deal. Their pressure took two forms – both a stick and a carrot.

The stick was that both Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke threatened to fire Ken Lewis and the entire Bank of America Board of Directors if Bank of America pulled out of the Merrill deal. The government also demonstrated its intent to take adverse regulatory actions against Bank of America as well, although this may or may not have been explicitly threatened based on the emails reviewed by Committee staff.

These threats amounted to a gun placed to the head of Bank of America to go through with the merger, as seen in the below email from Jeffrey Lacker, an employee of the Richmond Federal Reserve:

> Just had a long talk with Ben [Bernanke]. Says that they think the MAC threat is irrelevant because its not credible. Also intends to make it even more clear that if they play that card and they need assistance, management is gone.[6]

This threat is confirmed by Bank of America's own Board meeting minutes, which state that:

> [T]he Treasury and Fed stated strongly that were the Corporation to invoke the material adverse change ("MAC") clause in the merger agreement with Merrill Lynch and fail to close the transaction, the Treasury and Fed would remove the Board and management of the Corporation.[7]

Furthermore, Federal Reserve emails reveal at least the intention, which may or may not have been communicated explicitly to Bank of America, that the bank's relationship with its federal regulators would be severely damaged if it failed to go through with the merger, a serious threat to a heavily-regulated institution like Bank of America:

> Spoke with Joe [Price, Bank of America Chief Financial Officer] and Amy [Brinkley, Bank of America Chief Risk Officer] finally about 30 minutes ago. They still feel comfortable that they would MAC lawsuit. Also feel they have good liquidity...Also feel that while it will have very broad market implications that the equity markets will react positively to them (not sure I totally agree).

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[6] Email, Jeffrey Lacker, Federal Reserve Bank of Richmond, (December 20, 2008), Bates BOG-BAC-ML-COGR-00020.

[7] Minutes of the Special Meeting of Board of Directors, Bank of America Corporation, (December 22, 2008).

> They said they want the transaction to go through but have to protect their shareholders and that is why they contacted us (**I did not get into the damage this will do to their relationship with regulators**) [emphasis added].[8]

In an email, Ben Bernanke also expressed his view that exercising the MAC clause would hurt Bank of America's relationship with its regulators:

> I think the threat to use the MAC is a bargaining chip, and we do not see it as a very likely scenario so that we can explain to [Bank of America] with some confidence why we think it would be a foolish move and why **the regulators will not condone it** [emphasis added].[9]

As for the carrot, both the Federal Reserve and the Treasury Department tried to persuade Ken Lewis that Bank of America's withdrawal from the Merrill Lynch merger would be bad for everyone involved. For example, in a December 19 meeting between Bernanke, Paulson, and Lewis, Paulson told Lewis that a dispute on the MAC clause now was not good for system, for Bank of America, or for Merrill Lynch and that any attempt to renegotiate the merger with shareholders would be "perilous."[10] Bernanke and Paulson tried to sweeten the deal by giving verbal promises of additional government capital and asset guarantees, and directed their staffs to begin planning this assistance package, to be timed with a joint January 20, 2009, announcement of both companies' losses.[11]

The argument that a Bank of America withdrawal would be very bad for Merrill Lynch and its shareholders is probably indisputable. The markets would surely have perceived it as a strong vote of no-confidence in Merrill Lynch. An internal Federal Reserve analysis of both companies, conducted by the investment management firm PIMCO, found that Merrill Lynch's, "deterioration has been substantially worse than" Bank of America's, "and all but ensures that the firm could not survive as a stand-alone entity without raising substantial new capital (and/or government support) that is unlikely to be available given the uncertainty about its prospects."[12]

However, there appears to be room for debate as to whether it would not have been in the best interests of Bank of America's shareholders to abandon the deal. While Bernanke, Paulson and others in the government argued that the markets would punish Bank of America for pulling out of the deal, at least one Federal Reserve Bank of New York employee also questioned the government's contention that a withdrawal from the Merrill Lynch merger would be disastrous for Bank of America and its shareholders. In response to an email containing draft "talking points" for the government's discussions with Bank of America, the New York Fed's Adam Ashcraft expressed his view that the statement,

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[8] Email, Mac Alfriend, Federal Reserve Bank of Richmond, (December 20, 2008), Bates BOG-BAC-ML-COGR-000118

[9] Staff notes on email, Ben Bernanke, Chairman, Federal Reserve Board of Governors, (December 21, 2008).

[10] Notes, Scott Alvarez, Federal Reserve Board of Governors, (December 19, 2008), Bates BOG-BAC-ML-COGR-00015 to BOG-BAC-ML-COGR-00017.

[11] Id.

[12] See note 3, supra.

"A collapse of the merger will have dire consequences for Merrill Lynch, and will likely have a severe adverse effect on Bank of America as well," was "a little over the top."[13] He went on to say:

> I think [sic] equally possible that the market looks at Merrill's 2008 [fourth quarter losses] and sees [Bank of America] making a smart move by walking away from a Black Hole into which large amounts of time, effort, and money would have been going. In other words, it is not clear that the market reaction to [Bank of America] is so clearly negative. It might be, but a little more balance here might be worthwhile.[14]

While it is true that Bank of America's own losses also accelerated rapidly in December, they remained about seven times smaller than Merrill's. PIMCO's analysis concluded that, as of December 21, Bank of America's after-tax quarterly net loss was about $1.4 billion, which "represents more than four times management's projected losses from just two weeks ago."[15] Mounting losses at Bank of America would make it even more desirable for the company to extricate itself from the Merrill Lynch merger.

Key Question: Did the U.S. Government seek to limit or control public disclosure of the mounting 4th Quarter 2008 losses at Merrill Lynch?

While none of the documents reviewed by Committee staff at the Federal Reserve show that government officials explicitly instructed Bank of America employees to not disclose the dramatically accelerating losses at Merrill Lynch, internal emails reveal at least the intent to influence disclosure decisions in order to allow the government to manage the situation in an orderly manner.

For example, although both Bernanke and Paulson gave verbal assurances to Ken Lewis of additional taxpayer capital injections and asset guarantees to sweeten the merger in exchange for Lewis' agreement to drop the MAC clause threat, the government refused to put this into writing. In an email, Jeffrey Lacker of the Federal Reserve Bank of Richmond said:

> Spoke with [Bernanke] and he confirmed [Lewis's] appeal for a letter committing to future support, which was denied. His sense is that [Lewis] is just generally anxious about the merger, not trying to shake anyone down."[16]

In his testimony to the New York Attorney General, Lewis asserted that this refusal by the government to provide any written commitment of support to Bank of America came

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[13] Email, Adam B. Ashcraft, Federal Reserve Bank of New York, (December 21, 2008), Bates BOG-BAC-ML-COGR-000120.
[14] Id.
[15] See note 3, supra.
[16] Email, Jeffrey Lacker, Federal Reserve Bank of Richmond, (December 23, 2008), Bates BOG-BAC-ML-COGR-000128.

from its desire to manage the public disclosure of the severity of losses at Merrill Lynch. Lewis described a conversation with Paulson on the subject of a written pledge of government support thus:

> Hank said two things: He said, "First, it would be so watered down, it wouldn't be as strong as what we were going to say to you verbally, and secondly, this would be a disclosable event and we do not want a disclosable event."[17]

In an email to Fed Chairman Ben Bernanke, Federal Reserve Governor Kevin Warsh wrote:

> It is also critical to understand [Bank of America's] view on disclosure requirements (e.g., 8-K), particularly whether they would need to discuss pro forma financials if and when transaction is consummated in first week of January. If their first disclosure is at time of January 19 [sic] earnings announcement, then we can better evaluate the prospects for a private capital raise by the company in the new year.[18]

Another email from Federal Reserve Bank of New York employee Arthur Angulo to New York Fed General Counsel Thomas Baxter also demonstrates the government's concern to control the flow of information to the public. In this email, Mr. Angulo says he will call Merrill Lynch's Chief Financial Officer Nelson Chai:

> I'll ask about: [Merrill Lynch's] current estimate of [4th Quarter] loss[es] v[ersus] market expectations and whether and when [Merrill Lynch] intends to file an 8-K. **If I get a sense that [Merrill Lynch] is leaning toward an early January filing, I'll try to steer him toward a later filing. If I get a sense that [Merrill Lynch] is committed to an early January filing, I'll ask for a follow-up discussion with appropriate securities counsel at [Merrill Lynch] to gain a better sense as to the amount of flexibility [Merrill Lynch] has in this regard** [emphasis added].[19]

This attempt to stage manage the situation was mooted when it became clear that Merrill Lynch had intended all along to defer responsibility to publicly disclose its mounting losses to Bank of America, as demonstrated in the following email from Merrill's Chief Financial Officer to Merrill CEO John Thain:

> Had a call with art angelo [sic] at fed, had a quick discussion on where we are quarter to date. His hope is that there is no disclosure prior to [Bank of America] quarterly announcement. We told him this was the current plan. He asked [sic]

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[17] Testimony to the New York State Attorney General, Kenneth Lewis, (February 26, 2009).

[18] Email, Kevin Warsh, Federal Reserve Board of Governors, (December 21, 2008), Bates BOG-BAC-ML-COGR-00026.

[19] Email, Arthur Angulo, Federal Reserve Bank of New York, (December 22, 2008), Bates BOG-BAC-ML-COGR-000127.

> this course changes [sic] and we planned on issuing an 8k on [Merrill Lynch] stand alone to alert him.[20]

While Merrill's existing public disclosure plan happened to conform to the government's wishes, this does not alter the fact that some within the Federal Reserve clearly intended to control the timing of public disclosure. The government's reason to do so is rational if one accepts the premise that the government's proper role in the crisis was to succeed in propping up failing financial institutions. An untimely disclosure of Merrill Lynch's huge 4th quarter losses would have started a run on the investment bank, greatly complicating the government's attempts to engineer a bailout. However, this does not answer the question of whether the government had already exceeded its authority in preserving the existing financial system at tremendous taxpayer expense.

Key Question: Was a merger with Bank of America the last hope for Merrill Lynch?

The answer is no. The ultimate position taken by Messrs. Bernanke and Paulson appears to have been that it was better to put taxpayers' money down the Merrill Lynch "Black Hole" if necessary to prevent Merrill from failing.

Internal Federal Reserve emails indicate that the government fully intended to prop up Merrill Lynch even if Bank of America pulled out of the deal. In response to an inquiry from the United Kingdom's Financial Services Authority one day prior to the shareholder vote on the merger, Federal Reserve Bank of Richmond employee Jennifer Burns wrote:

> We have had recent discussions with [Bank of America] and [Merrill Lynch] management who contend that they have the required shareholder support and are confident that the transaction will be approved with tomorrow [sic] vote. If approval is withheld, [Merrill Lynch] would continue to have access to the various facilities and programs currently in place in the US. Additionally, it is reasonable to expect that [Merrill Lynch] would be provided support necessary to preclude significant systemic disruption.[21]

That the government was committed to use taxpayer money to prop up Merrill come what may is reinforced by the Fed's contingency planning to provide additional backing to the troubled investment bank once Bank of America expressed its interest in backing out of the merger. In a document entitled "Contingency Actions re MER Should BAC Refuse to Consummate Acquisition," the Federal Reserve said:

> In the event that [Bank of America] were to abruptly announce that it does not intend to consummate its acquisition of [Merrill Lynch] on January 1, 2009, [Merrill Lynch] would face an immediate run. Emergency liquidity provision

[20] Email, Nelson Chai, Merrill Lynch, (December 22, 2008), Bates HOC-DPS-00002097.
[21] Email, Jennifer Burns, Federal Reserve Bank of Richmond, (December 4, 2008), Bates BOG-BAC-ML-COGR-000116.

> actions that could be taken to provide some time for the sale/disposition of [Merrill Lynch] businesses and assets include the following...[22]

The document goes on to list options including an expansion of Merrill's access to Federal Reserve lending and an emergency conversion to a bank holding company, which would give Merrill access to additional federal backing, including FDIC deposit guarantees.[23]

Given that Bernanke and Paulson were fundamentally committed to not let Merrill Lynch suffer the consequences of its own poor decisions, it is perhaps marginally comforting that they sought to make Bank of America's shareholders bear the losses before the taxpayers. This almost certainly explains the strong pressure they exerted on Ken Lewis to proceed with the deal despite his concerns for his own shareholders. However, the fundamental question remains unanswered; namely, on what grounds did the government decide to bail out Merrill Lynch, no matter the cost?

Key Question: Did Bank of America conduct sufficient "due diligence" of Merrill Lynch's financial health before deciding to pursue a merger with it?

The answer to this question is unclear but ultimately irrelevant, although the Committee Democrats are likely to spend a good amount of time trying to answer it anyway.

As mentioned above, the Federal Reserve hired PIMCO to conduct an analysis of both Bank of America and Merrill Lynch on a stand-alone basis, as well as of the putative merged company. That analysis found that:

> While the extent of the market disruptions that have occurred since mid-September were not necessarily predictable, [Bank of America] management's contention that the severity of [Merrill Lynch's] losses only came to light in recent days is problematic and implies substantial deficiencies in the due diligence carried out in advance of and subsequent to the acquisition.[24]

However, Bank of America relied in part on another group of outside experts, private equity company JC Flowers & Company, to perform a due diligence analysis of Merrill Lynch. JC Flowers found that the offered price was fair given a host of assumptions provided by Bank of America. Bank of America still felt comfortable with the deal in mid-September, when Lisa White of the Federal Reserve Bank of Richmond wrote to colleagues:

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[22] Document, "Contingency Actions re MER Should BAC Refuse to Consummate Acquisition," attached to an email, Arthur Angulo, Federal Reserve Bank of New York, (December 21, 2008), Bates BOG-BAC-ML-COGR-000123.
[23] Id.
[24] See note 3, supra.

> [Bank of America] management feels a much higher level of comfort with Merrill than it did with Lehman, specifically with the value of the franchise and the marks on the assets. While Amy [Brinkley, Chief Risk Officer] acknowledged that it may look to the outside world as if [Bank of America] is paying a bit of a premium for Merrill, [Bank of America's] estimates of Merrill's asset values indicate they are getting the firm at a 30-50% discount. Chris Flowers, the prominent private equity guru, has done extensive due diligence on Merrill over the past few months for potential equity investors, and I got the impression that [Bank of America] is at least partially relying upon this work.[25]

Clearly, Bank of America was wrong about the vulnerabilities of Merrill Lynch, as it turned out to have been wrong about its own vulnerabilities in the tumultuous economy of late 2008.[26] However, the question of whether its due diligence was adequate is a question better left to be settled between the companies' respective shareholders and management teams, in court if necessary. The Committee's time is probably not best spent trying to determine whether Bank of America's expert advisors were right when they said in September that the Merrill Lynch deal was a smart move, nor whether the Fed's own expert advisors were right when they said in December that the Merrill deal was not a smart move. Perhaps both sets of experts were right – what may have been a good deal in September might have become a bad deal by December due to unforeseen forces; we simply do not know. Therefore, it would be prudent to take an agnostic view of Ken Lewis' liability to his shareholders and leave it to the established legal procedures already in place and designed to handle such questions.

Key Question: Were the government's actions in forcing through the Bank of America merger with Merrill Lynch and bailing out failing financial institutions at taxpayer expense unconstitutional and inappropriate?

Trying to answer this question is very much an important public policy question that resides fully within the Committee's jurisdiction and responsibility, yet unfortunately this hearing is an imperfect forum in which to answer it because not all the key players have been invited to testify.

On October 13, 2008, Secretary Paulson and Chairman Bernanke essentially locked the CEOs of the nation's nine largest banks in a room in Washington and told them they had to sell the government shares in their companies in return for $125 billion in taxpayer money under the TARP.[27] Paulson's "talking points" for this meeting justified the mandatory capital infusion on the grounds that, "We don't believe it is tenable to opt out because doing so would leave you vulnerable and exposed." This was followed by a threat that, "If a capital infusion is not appealing, you should be aware that your regulator

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[25] Email, Lisa A. White, Federal Reserve Bank of Richmond, (September 14, 2008), Bates BOG-BAC-ML-COGR-00001.
[26] See note 3, supra.
[27] Elliot Blair Smith, "Bankers Told by Paulson to Accept U.S Aid or Be 'Vulnerable'," *Bloomberg.com*, (May 13, 2009).

will require it in any circumstance."[28] Given the fact that the TARP money forced on these nine banks in October 2008 was given to the Bush Administration by Congress explicitly to purchase "troubled assets," was it constitutional and appropriate for him to ignore the clear intent of Congress to initiate the largest government intrusion in the private sector since World War II? This question is the responsibility of the Oversight Committee, yet Paulson is not here to answer it.

In December 2008, Paulson and Fed Chairman Ben Bernanke put a gun to the head of Bank of America's CEO and Board of Directors in order to force through a merger with Merrill Lynch, even though Bank of America's CEO felt it was his duty to his shareholders to try his luck in the legal system and back out of the deal. They did so in the name of the financial system as a whole, without any transparency or consultation with the American people or the Congress. Was this an appropriate use of taxpayer money and government power? This question, too, is the responsibility of the Oversight Committee, yet Bernanke is not here either.

While Ken Lewis certainly had an integral role in the Bank of America-Merrill Lynch drama, his side of the story is not the only one. In order to perform its full duty, the Committee will need to go beyond today's hearing, which will only explore half the story, and ask these tough questions of the public officials who form the other side of the equation of taxpayer bailouts.

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[28] Document obtained by Judicial Watch, Inc., U.S. Department of the Treasury, "CEO Talking Points," electronic attachment to note 27, supra.