Bank mergers: Bank of America-Merrill Lynch vs. Wells Fargo-Wachovia acquisitions

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ABSTRACT

This case explores the two recent acquisitions and their responses to offers. While the managements at Bank of America and Merrill Lynch fail to exercise fiduciary prudence in their merger, the managements at Wells Fargo and Wachovia exercise fiduciary duty in their merger. This case also compares the performance of the two banks, Bank of America and Wells Fargo, in terms of how corporate governance had an impact on their stock performance after their respective acquisitions. Wells Fargo's effort in adhering to proper corporate governance, such as, no irregularities in executive compensation during and after merger, conservative credit practices, transparency of information, and proper due diligence in Wells Fargo - Wachovia merger, are relatively quite ethical and transparent. This case further suggest that Wells Fargo's effective governance leads to better Wells Fargo's stock performance than those of Bank of America and Philadelphia Banking Index, a benchmark used in the banking industry.

Keywords*:* Corporate governance, bank acquisition, agency problem, stock performance

Introduction

This case examines the actions taken by the management and board of directors ("the agents") of two large U.S. financial institutions in regards to their handling of recent acquisitions and responses to offers. Particular attention is paid in this case to how these corporations responded to the U.S. federal government's interjection into the examined acquisitions. The agents at Bank of America (BAC) and Merrill Lynch (MER) failed to exercise duty of care in their merger, whereas, the agents at Wells Fargo (WFC) and Wachovia (WB) exercised duty of care in their merger. This case also compares the performance of the two companies BAC and WFC, after their respective acquisitions to show how corporate governance had an impact on market's perception of their stock.

Corporate governance is defined as "the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled." Corporate governance aims to reduce or eliminate the agent-principle problem inherent in a corporation, thus helping to achieve the goal of any corporation, that is, maximization of shareholders' wealth. One aspect of corporate governance deals with the responsibilities of management and board of directors of a corporation to its shareholders. Among these responsibilities, "the duty of due care requires that they act with the care that a reasonably prudent person in a similar position would exercise under similar circumstances, and that they perform their duties in a manner that they be in the best interest of the corporation."(Craig, 2004).

Top management prefers to manage a large firm because of the additional compensation and prestige it brings. Jensen (1986) suggests the agency conflict in acquisitions due to this additional pay through a bad merger because most CEOs hold only a small fraction of their firm's stock. Harford and Li (2006) indicate that boards typically increase the CEO pay along with firm size, even if the size comes at the cost of poorly performing acquisitions. In contrast to the conflicts-of-interest argument, Roll (1986) proposes the hubris hypothesis and asserts that overconfident managers believe that they are making the right decision for their shareholders, but irrationally overestimate their abilities.

Bank of America – Merrill Lynch Deal

The chain of events that culminated in Merrill Lynch's collapse materialized over October 2007 when MER posted a quarterly loss of $2.4 billion for Q3 2007 and had written off of $8.4 Billion in assets. Merrill reported a net loss of $8.6 Billion for the year 2007. The write-down was triggered by significant failure in MER's subprime mortgage backed securities. To this point, MER had been the world's largest underwriter for collateralized debt obligations (CDO). The majority of the CDOs were subprime mortgage backed securities. For the period of 2006-2007, Merrill was lead underwriter on CDO deals with a dollar value of $93 billion and they were ill prepared to handle the shock of a major revenue driver turning into a loss center. In fact, MER reported a profit of $2.1 Billion for the second quarter of 2007. The sudden plunge of MER into losses in third quarter after a very profitable second quarter was due to MER's bad accounting practices. MER was not reporting the actual values of its bad investments. MER was able to do this by converting how particular investments were accounted for on its balance sheet (http://ethisphere.com/what-went-wrong-ethically-in-the-economic-collapse/) As MER's unethical accounting practices were revealed, it was forced to ultimately report its dire financial

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position. It reported quarterly losses of $9.83 billion in January 08 and $1.97 Billion loss in April 2008 (http://en.wikipedia.org/wiki/Merrill_Lynch).

On September 15th 2008, BAC announced that it had tendered an offer for MER. BAC offered to buy MER for $50 billion in an all stock transaction, which equates to about $29 a share, a 70% premium at that time (http://www.efinancialnews.com/story/06-02-2009/in-merrill-deal-us-played-hardball). At the time of the announcement, BAC's CEO stated that BAC was "Acquiring one of the premier wealth-management, capital-markets, and advisory companies (MER.) (This deal) is a great opportunity for our shareholders" (http://en.wikipedia.org/wiki/Merrill_Lynch).

BAC board failed to perform it fiduciary duties to its shareholders in its merger with MER in several dimensions including (1) Board's prioritization of retaining its position at the expense of the shareholders' value (Agency problem); (2) BAC's failure to conduct proper "due diligence" prior to the acquisition of MER; (3) BAC's failure to maintain transparency regarding MER's actual losses; and (4) Unethical executive compensation (http://en.wikipedia.org/wiki/Merrill_Lynch).

By December 2008, Merrill's had posted a $15 billion loss and BAC began to rethink its position about the merits of completing its MER acquisition. BAC's CEO went so far as to inform the US Treasury Secretary and the Federal Reserve Board on December 17th that BAC wanted to get out of the deal invoking Material Adverse Change clause (Cuomo, 2009). Ultimately, BAC's board agreed to consummate the merger after the federal government explicitly threatened to remove the board in its entirety if BAC did not do so. Specifically, US Treasury Secretary Henry Paulson told the BAC board, "We would remove the board and management if you called it" (the execution of the Material Adverse clause) (Cuomo, 2009). The BAC board approved the merger deal due to increased pressure from Federal Reserve and Treasury. Instead of making a decision towards shareholder value maximization, BAC executives prioritized their career violating their fiduciary duties and succumbed to the government's pressure (http://en.wikipedia.org/wiki/Merrill_Lynch).

BAC hired JC Flowers and Company to determine the fair price for MER. JC Flowers determined a fair price based on the assumptions provided by BAC, which were wrong to begin with. Specifically, the expected losses of MER were grossly underestimated. In December 2008, PIMCO was hired by the Federal Reserve to conduct an analysis on the buyout of MER by BAC. The analysis done by PIMCO found that MER would not have chance as a standalone entity. The vast difference in BAC's estimation of MER's losses and BAC's contention that MER's losses came to light only later were cited by PIMCO raising concerns about the due diligence carried out by BAC before and after the acquisition of MER (www.online.wsj.com/public/resources/documents/RepublicanMemobofa0610.pdf).

Aside from the aforementioned processes, there were other significant red flags about MER that should have indicated the BAC that they were acquiring a potential poison pill in MER. BAC's board should have proceeded with extreme caution when contemplating acquiring MER given MER's checkered ethical history. Specifically, there are a few incidents in MER's past that should have given the BAC board pause. One, MER in 1998 agreed to pay for a $400 million out of court settlement with Orange County for its improper role in the contribution to the County's bankruptcy. Two, it was public knowledge that MER was embroiled in the financial irregularities perpetrated by Enron. These irregularities would ultimately lead to Enron's demise. MER's involvement in this episode would cost its shareholders $80 million to settle civil lawsuits brought against the corporation. In this instance, more troubling than the

monetary cost to the firm was the fact that two MER executives were convicted of federal crimes and jailed (http://ethisphere.com/what-went-wrong-ethically-in-the-economic-collapse/).

The BAC board had fiduciary duty to its shareholders to reveal financial information about MER before the shareholders' vote on the merger deal. But, BAC board and management chose not to disseminate the totality of MER's losses to the BAC shareholders prior to deal's official closure. MER silently booked additional losses that amounted to billions in a week's period after the shareholders' vote on the merger. MER's losses for the fourth quarter of 2008 were $7 billion worse than they had been projected prior to the merger vote (Cuomo, 2009). These additional losses were not disclosed to the shareholders, even though BAC official had known about them. This non-disclosure of proper information can be attributed not only to the unethical behavior of BAC but also to MER's management.

MER's unethical practices and BAC board's inability to curtail them have had negative impact for BAC's shareholders since the acquisition. Specifically, BAC did not prevent MER's chairman John Thain from distributing a $10 million bonus to the MER board members for agreeing to the BAC acquisition although it was clear MER was on the brink of insolvency at the time of acquisition and that MER had no other suitors. Further, the BAC board did not keep Thain from rushing through $4 billion of MER employee bonus payments in the period immediately preceding the deal's formal closure (http://www.bloomberg.com/apps/news?pid=20601110&sid=ahDtf3JPsFSw). To put gravity of the situation into context, BAC had posted multi-billion dollar losses for Q4 2008 and Q1 2009 and implemented severe job cuts.

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Wells Fargo – Wachovia Deal

The Wells Fargo and Wachovia board of directors demonstrated due care in their merger. Before launching into our discussion of how we reached such a conclusion, it is important to delineate the competing offers presented to the WB board from Citigroup(CITI) and Wells Fargo (WFC).

As shown in Exhibit 1, CITI offered the WB board $2.16 billion for WB's retail banking arm (Dash and Sorkin, 2008). At the time of offer, WB was trading at $2 a share in the immediate aftermath of the offer's announcement. WB's stock had slide to this low level from its previous day's close of $10 (http://money.cnn.com/2008/09/29/news/companies/wachovia_citigroup/index.htm).

In effect, CITI was offering $1 per share to the WB shareholder for the retail banking division. Further, CITI's offer included the provision that CITI would absorb WB's senior and subordinated debt. WB's debt totaled $53 billion at the time of the announced agreement. WB would continue its operations as an exclusively non-banking entity. The reconstituted WB would be composed of wealth management, retail brokerage, and asset management components.

The federal government put pressure on the WB board to agree to be acquired by CITI. At the time of the CITI's offer FDIC chairman Sheila Bair said, "This action was necessary to maintain confidence in the banking industry given current financial market conditions." (FDIC press release, 2008). The federal government had in large part underwritten CITI's offer. CITI would absorb up to $42 billion of losses and the FDIC would absorb losses beyond that. CITI also granted the FDIC $12 billion in preferred stock and warrants for bearing this risk (FDIC press release, 2008).

On October 3, 2008, WFC agreed to pay $15.4 billion to buy WB in its entirety. WFC's offer called for each share of WB common stock to be exchanged for 0.1991 shares of WFC common stock. This is equivalent to a value of $7 per WB's share. WFC also would assume WB's preferred stock and debt. WFC's offer was independent of Federal government's financing and support. WFC's offer was financially far better for WB's shareholders than that of CITI's offer.

Exhibit 1: Comparison of Citigroup's vs. Wells Fargo's Deal

	Citigroup	Wells Fargo
Share Price	$1	$7
Debt Assumption	Yes	Yes
FDIC Backstop	Yes, after the first $42 billion.	No
FDIC Fees	$12 billion	None

CITI never signed a definitive merger agreement with WB, and was relying instead on a two-page term sheet, preventing WB from negotiating a deal with any other party. WB's deal with WFC appeared to be in breach of that agreement. CITI and WB were close to finalizing the details of a definitive agreement. CITI's offer would have been subject to a vote by WB's shareholders, who would not have approved it considering a better offer from WFC. WB's board prioritized shareholder wealth maximization from Well's offer to any potential legal concerns from rejecting CITI's offer.

WB's board did exercise proper due care as they chose the best option available for their shareholders including the following reasons: (1) WB's decision to accept WFC'S offer maximized WB's shareholder value; (2) WB's board recognized that its fiduciary duty are simply to its share holders; (3) WB's board recognized it was beyond its mandate to consider the health of the entire U.S financial system at the expense of its own shareholders; to this end WB successfully thwarted FDIC's pressures to accept CITI's lower offer. 96% of WB's shareholders who voted approved WFC's acquisition offer. This result validates the actions taken by the WB board (http://blogs.wsj.com/deals/2008/10/03/can-citigroup-kill-the-wells-fargo-wachovia-deal/).

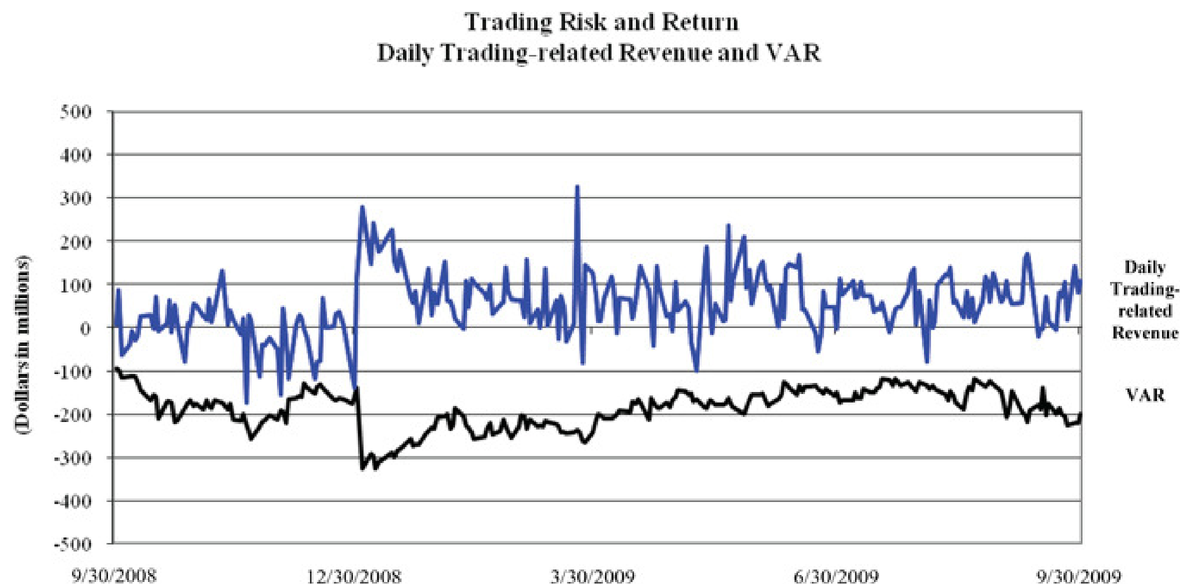
Apart from WB's prudent decision to go with WFC, we analyzed WFC's decision in this merger proposal and if they adhered to the fiduciary duty to their shareholders. We found that WFC did proper due diligence before acquiring WB. WFC found, by acquiring WB, it could enter new markets and increase its deposits to $787Billion from $339Billion and it also estimated that there would be an annual cost savings of $5Billion (https://www.wellsfargo.com/downloads/pdf/press/WFC_WACHOVIA_100308.pdf). WFC was profitable and it used the Internal Revenue Service rule change that was passed in the last week of September 2008 to temporarily lift a limit on losses that a bank can write off from its taxes after acquiring a troubled bank (http://www.minnpost.com/danhaugen/2008/10/03/3773/six_days_behind_the_scenes_in_the_wells_fargo-wachovia_deal). The decision made by WFC based on its analysis seems to be in the best interests of its shareholders, when it is seen with in the light of the performance of the

combined WFC-WB entity in recent quarters. It is worth mentioning that WFC-WB had losses only for Q4 of 2008 and has been profitable since then. WFC also gave a press release on Oct 9 2008, showing its strategic reason behind its decision on acquiring WB (https://www.wellsfargo.com/press/2008/20081009_merger_proceed). No irregularities were found in executive compensation during and after WFC-WB merger. WFC also created an allowance of credit losses of $21.7Billion as a de-risking measure and created $5.6Billion of credit reserve build to adhere to the conservative credit reserve practices, by the end of year 2008 (https://www.wellsfargo.com/pdf/press/4q08pr.pdf). De-risking measures, conservative credit practices and transparency of information along with proper due diligence in merger are appreciable on WFC's part in adhering to proper corporate governance.

Post-Acquisition Stock Performance

BAC after buying MER posted a loss of about $2.4 billion in for the quarter ending December 2008. BAC also lost about $1 billion for the third quarter of 2009. For the period, BAC reported that its personnel costs and operating costs increased to $16.3 billion from $11.7 billion previous year, mainly due to MER acquisition (http://newsroom.bankofamerica.com/index.php?s=43&item=8552). MER continues to be a loss making center for BAC as mentioned BAC in its 10Q of Q3 09 -"net loss increased as higher gains on the sale of debt securities and higher equity investment income were more than offset by the negative credit valuation adjustment on certain Merrill Lynch structured notes."

Figure 1. Trading Risk and Return



Source: Bank of America's 10Q for 2009

In Figure 1, it is shown that BAC's Value added Risk (VAR) increased after the acquisition of MER and is yet to return to its pre-acquisition levels. VAR is defined as a threshold value such that the probability that the mark-to-market loss on the portfolio over the

given time horizon exceeds this value (assuming normal markets and no trading in the portfolio) is the given probability level. For the quarter ending December 2008, WFC posted a loss of $2.55 Billion after the acquisition of WB. Even though the losses reported by the two companies, BAC and WFC, after their respective acquisitions were comparable, their share performance have been markedly different.

On September 2, 2008, BAC was trading at $32.63 and reached a low of 3.14 as of March 6, 2009, a 90% decline compared to about 77% decline in share price of WFC during the same period. While both the BAC and WFC stocks have rallied along with the entire market since March 2009 BAC still underperforms WFC. BAC currently is trading about 50% below its September 2008 level where as, WFC is already at its September 2008 levels.

From the Figure 2, it is clear that WFC outperformed both BAC and Philadelphia Banking Index (BKX: A benchmark index used in the banking industry to track the performance of banks). This mediocre stock performance of BAC compared to WFC shows how market reacts when company forgoes corporate governance under the pressure of the government.

Figure 2. **Post-Acquisition Stock Performance**

Source:www.finance.yahoo.com

Summary

This case suggests that the agents at Bank of America and Merrill Lynch failed to exercise fiduciary prudence in their merger, while the agents at Wells Fargo and Wachovia exercised fiduciary responsibility in their merger. This case also compares the performance of the two companies Bank of America and Wells Fargo, after their respective acquisitions to show how corporate governance had an impact on their stock performance. No irregularities in executive compensation during and after merger, conservative credit practices, transparency of information, and proper due diligence in Wells Fargo - Wachovia merger are considerable on Wells Fargo's part in adhering to proper corporate governance. This case further suggests that

Wells Fargo’s effective governance leads to better stock performance than Bank of America and Philadelphia Banking Index.

Discussion Questions

1. How to instill the importance that corporate responsibility should increase with the size of a corporation?
2. How much does corporate responsibility aid in company’s stock performance?
3. What are the ways to handle situations where bigger firms cannot be allowed to fail as it would cause a domino effect?
4. How to protect the shareholders’ value during a merger?
5. Are more regulations better for the banking industry?
6. How to regulate government’s role itself to avoid arm-twisting a corporation making them not to act in the best interests of the shareholders?
7. What risk avoiding measures can be taken to prevent bigger banks from a financial debacle?
8. How to isolate an individual institution’s failure from causing a systemic financial breakdown?

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