

STATE OF NORTH CAROLINA
COUNTY OF MECKLENBURG

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
CIVIL ACTION NO: 08-CVS-22632

**IRVING EHRENHAUS, On Behalf of
Himself and All Others Similarly Situated**

Plaintiff,

v.

JOHN D. BAKER, II, et al.,

Defendants

**BRIEF OF DEFENDANT WACHOVIA
CORPORATION AND OF INDIVIDUAL
DEFENDANTS OPPOSING PRELIMINARY
INJUNCTION**

The directors of Wachovia Corporation (the individual defendants in this action, herein the “directors”) had and have a duty to act in good faith and with due care and loyalty under G.S. § 55-8-30. A director must discharge these duties “[w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances.” *Id.* Plaintiff contends that the directors breached these duties on October 3, 2008 by approving the merger agreement between Wachovia and Wells Fargo & Company, and seeks injunctive relief. Plaintiff is not entitled to an injunction because he has no likelihood of success on the merits. Under the circumstances facing the Wachovia directors when they approved the Wells Fargo merger, they fulfilled their statutory duties and are entitled to the full deference accorded by the business judgment rule. Moreover, injunctive relief would provide no benefit to plaintiff or other shareholders because no option superior to a merger with Wells Fargo is available to Wachovia. Plaintiff’s notion that government funding might allow Wachovia to stay independent is pure speculation and has no factual basis.

In the three-week period prior to October 3, Wachovia experienced an acute liquidity crisis that, as prior briefs have explained, placed Wachovia on the brink of receivership. Lehman Brothers and Washington Mutual failed, and their stockholders received nothing. Without the Wells merger, Wachovia either had to pursue a sale of assets to Citigroup that would have left the remaining company on the verge of insolvency, or go into FDIC receivership and suffer a complete and certain loss of its shareholders' equity. During that period, financial market participants, depositors, and other counterparties had begun refusing to deal with Wachovia. In order to survive, Wachovia needed to afford assurance to the markets, regulators, depositors, and counterparties that the Wells merger was certain to happen, so Wachovia negotiated a merger agreement that afforded Wells no right to terminate based on material adverse changes and that paved a smooth road to consummation of the merger. The current value of the merger to Wachovia's shareholders exceeds \$11.8 billion. Wells Fargo's offer was conditioned upon the provisions of the merger agreement to which plaintiff objects – 39.9% of the vote on the merger (negotiated down from over 50% by Wachovia), and a mandatory shareholder vote. These provisions were part and parcel of an overall agreement intended to secure Wachovia's future and deliver value to Wachovia shareholders.

The merger agreement had the desired effect of providing assurance to third parties that allowed Wachovia to obtain access to capital and recover stability. As this Court is aware from prior filings, banking regulators approved the merger almost immediately, expediting their normal review procedures. No other suitor for Wachovia has emerged or is realistically imaginable – and if a superior alternative were to materialize, the new suitor would have access to the courts. A preliminary injunction is not proper, necessary, or appropriate here.

I. FACTS

While Wachovia's officers and directors had been carefully monitoring the troubled financial markets for months, and considering strategic alternatives, rapidly unfolding external events occurred in mid-September 2008 that quickly accelerated the challenges facing Wachovia. On September 15, Lehman Brothers announced that it was making a bankruptcy filing, and Bank of America announced that it was acquiring Merrill Lynch. On September 16, the U.S. government announced that it would provide substantial assistance to AIG in exchange for a 79.9% equity interest and a right to veto all dividends. Young Aff., ¶ 3.¹

The Wachovia board met at 6:00 p.m. on Tuesday, September 16 and considered the following options: (i) dispose of assets previously considered to be core; (ii) raise primary equity; (iii) combination of (i) and (ii); (iv) attract a strategic investor; (v) combine with another company; and (vi) exclusively pursue a strategy announced in July for preserving and protecting capital and liquidity by continuing to reduce risks and expenses and consider possible disposition of non-core assets. Recognizing that option (vi) was not viable, the board directed management to explore aggressively the other five options. Young Aff., ¶ 4. Management kept the board well and promptly informed of the events, efforts and developments that occurred both before and after September 16, and obtained guidance and direction from the board as appropriate on a timely basis. The board had nine formal meetings from Thursday, September 18 through

¹ Certain facts set forth herein are derived from two sections of the Preliminary S-4 (the "S-4") that Wachovia filed with the Securities and Exchange Commission on October 31, 2008: Background of the Merger (pp. 37-44) and Wachovia's Reasons for the Merger and Recommendation of the Wachovia Board (pp. 44-46). In her Affidavit filed herewith, Wachovia director Dona Davis Young confirms that these sections of the preliminary S-4 accurately summarize the information that was provided to the board of directors with respect to the matters at issue in this lawsuit. For facts outside the S-4, the source of the facts is noted in the text.

Monday, September 29 before meeting for a tenth time on October 2 to consider the Wells Fargo proposal. Young Aff., ¶ 5.

During the five-day period between Wednesday, September 17 and Sunday, September 21, Wachovia entered into confidentiality agreements with and conducted due diligence with two potential merger partners. By the evening of September 21, discussions with both potential partners had reached an impasse. One of the potential partners declined to proceed without federal assistance, which the government did not commit to provide. Neither of these parties have returned or made subsequent bids. Young Aff., ¶ 5; S-4 at 38-39.

Wachovia simultaneously attempted to raise capital, sell assets, or obtain a large investment by a strategic investor. Wachovia signed a confidentiality agreement with a potential investor on September 18, but discussions never progressed beyond the exploratory stages. Management engaged in preliminary conversations with other potential private investors during the September 19-21 period in preparation for a possible public offering or private placement during the week of September 22. Young Aff., ¶ 5; S-4 at 39. Wachovia also actively engaged in a process to find purchasers for certain businesses. *Id.*

During the week of September 22, the marketplace continued to deteriorate. On September 23, the breadth of the Federal Reserve's assistance to AIG was announced. Young Aff., ¶ 5; S-4 at 39. On Thursday, September 25, the Office of Thrift Supervision announced the seizure of Washington Mutual Bank and its placement into FDIC receivership. *Id.* Like the Lehman Brothers stockholders, Washington Mutual's stockholders received nothing for their equity. On the evening of Thursday, September 25, the tentative agreement in Congress regarding the federal bailout collapsed in talks at the White House.

These events resulted in significant pressure on Wachovia, as evidenced by the credit default swap market. Credit default swaps reflect the market perception of the underlying credit risk of a company. By September 26, the cost to purchase credit default swap protection on Wachovia had increased to 1500 basis points (15%), up from 106 basis points on January 2, 2008 and from 670 basis points on September 25, 2008. Young Aff., ¶ 5; S-4 at 50. The cost of procuring credit default swap protection on Bear Stearns had not reached 1500 basis points when Bear Stearns' merger with JP Morgan Chase & Co. was announced. *Id.* at 57; *see also id.* at 50 (comparison to other institutions). Employees from Wachovia's Treasury and Balance Sheet Management group informed the board on September 26 that Wachovia's liquidity position (cash available to meet current obligations) had declined alarmingly and that the Lehman bankruptcy, Washington Mutual's failure, and other recent negative events had now made it impossible for Wachovia to access its normal sources of liquidity. Young Aff., ¶ 6.

At the meeting on Friday, September 26, management advised the board that discussions had commenced with Citigroup and Wells Fargo regarding a possible merger. Young Aff., ¶ 5; S-4 at 40. Through the weekend, Wachovia actively explored merger options with both Citigroup and Wells Fargo, including sending top management to New York for due diligence and negotiations. Because of its liquidity position, management believed it likely that Wachovia had to announce a merger transaction by Monday morning, September 29. Young Aff., ¶ 5; S-4 at 40. On Sunday afternoon, September 28, Wells Fargo determined that it could not complete the due diligence it believed necessary and prudent within the compressed timeframe, and informed Wachovia that it would not make a proposal for a transaction without government assistance. Young Aff., ¶ 5; S-4 at 40.

Later that evening, the FDIC contacted Wachovia. Chairman Bair of the FDIC informed Wachovia that the federal government had determined that the Wachovia situation posed systemic risk to the banking system. She indicated that the FDIC intended to exercise its powers under Section 13 of the Federal Deposit Insurance Act to effect an “open bank assisted transaction” with another financial institution, which the FDIC would select through a bidding process to be conducted over the next several hours. Young Aff., ¶ 5; S-4 at 40.² A telephonic meeting of the board took place at approximately 9:00 p.m. on September 28. Management advised the board of the current situation and the FDIC’s position. Young Aff., ¶ 5; S-4 at 40-41.

At approximately 12:30 a.m. on Monday, September 29, Wachovia submitted its own bid, proposing that it receive FDIC assistance in the form of loss-sharing on a designated loan portfolio, grant the FDIC equity ownership in Wachovia, and raise approximately \$10 billion in capital in a public offering. Wachovia urged the FDIC to accept this proposal, and, based on the state of preparation for the capital raising transaction that Wachovia had considered the previous week, indicated that it was prepared to move quickly to implement it. Young Aff., ¶ 5; S-4 at 41.

At approximately 4:00 a.m. on Monday, September 29, Chairman Bair informed Wachovia of the FDIC’s decision not to accept Wachovia’s proposal and its further decision that Citigroup would acquire Wachovia's banking subsidiaries. Chairman Bair directed Wachovia to proceed to negotiate terms with Citigroup, with an announcement to occur before the start of business that day. Several hours earlier, Citigroup had delivered what was styled a draft agreement-in-principle to Wachovia, which reflected Citigroup’s proposal. Young Aff., ¶ 5; S-4 at 41. Citigroup proposed to acquire only a portion of Wachovia’s assets, leaving the Evergreen asset management business and

² As the defendants’ brief opposing expedition filed on October 28, 2008 explains, Section 13 authorizes the FDIC to effect an open bank assisted transaction only in extraordinarily exigent circumstances. The FDIC had never before invoked its Section 13 authority, and its decision to do so here illustrates the extreme gravity of Wachovia’s situation.

Wachovia's retail brokerage operations with Wachovia Corporation. The board met telephonically at 6:30 a.m. on Monday, September 29, and management advised the board of the events that had developed during the night. The board voted in favor of proceeding with Citigroup. Young Aff., ¶ 5; S-4 at 41.

Wachovia negotiated with Citigroup during the week of September 29, but Citigroup's insistence on separating Wachovia's businesses proved problematic. Young Aff., ¶ 5; S-4 at 42.³ On October 1, Citigroup insisted that the parties be prepared to execute the definitive agreements no later than Friday, October 3. *Id.* As of the evening of October 2, significant substantive areas of disagreement remained, as Citigroup took positions that were inconsistent with the non-binding agreement-in-principle. Young Aff., ¶ 8. Without the certainty of a transaction in hand, Wachovia's liquidity continued to deteriorate. The announcement of the proposed transaction between Wachovia and Citigroup on September 29 had not stemmed the erosion of the financial markets' confidence in Wachovia. Young Aff., ¶ 9.

At approximately 7:15 p.m. on October 2, Chairman Bair advised Wachovia that Wells Fargo would propose a merger transaction that night for the whole company, which would not require government assistance and which would result in Wachovia shareholders receiving the equivalent of \$7.00 of Wells Fargo common stock for each share of Wachovia common stock. She encouraged Wachovia to give serious consideration to that offer. Wells Fargo forwarded a signed merger agreement approved by its board shortly after 9:00 p.m. and indicated that its proposal would be disclosed publicly the following morning. The Wachovia board met to consider the Wells proposal at 11:00 p.m. that night. Young Aff., ¶ 7; S-4 at 42-43.

³ As the S-4 explains, Citigroup insisted that substantial liabilities be retained by Wachovia Corporation, and as a result Wachovia would at best have been left on the brink of insolvency, with little or no equity value for its shareholders. Young Aff., ¶ 5; S-4 at 43.

Despite diligent, persistent, and continuous efforts after the board meeting on September 16 to raise capital, sell assets, or identify a business combination with another entity, Wachovia had been unable to reach any definitive agreement with a third party that would allow Wachovia to resolve its liquidity issues and avoid FDIC receivership. Wachovia had not been successful in reducing the proposed Citigroup transaction to a definitive and binding agreement. The merger terms proposed by Wells Fargo were far superior to any terms that Citigroup had indicated (or subsequently indicated) it would be willing to accept. In addition, during the October 2-3 board meeting, the board was informed that negotiations with Citigroup had proven to be extremely difficult, with Citigroup insisting on terms that raised significant concerns about whether the surviving Wachovia entity would be solvent and viable, even if a transaction with Citigroup could be finalized. Young Aff., ¶ 8.

The Wells Fargo proposal presented a number of benefits to Wachovia that were far superior to the Citigroup proposal (even assuming it could have been finalized) and to receivership. The merger agreement did not have a “material adverse change” clause and provided Wachovia a clear, unimpeded path to consummation of a merger with Wells Fargo. This was very important because Wachovia was suffering a severe liquidity crisis. The board had been informed that Wachovia’s excess liquidity (*i.e.*, cash available to meet current obligations) had declined to alarming levels prior to October 3, 2008, including significant declines during the week of September 28, 2008, even after the proposed Citigroup transaction was announced on the morning of the 29th. Unless the financial markets, customers, and counterparties were confident that the Wells Fargo merger could be and was likely to be consummated, as of the night of October 2-3, it was likely that Wachovia would not be able to fund normal banking activities going forward, and thus would again face the very real prospect of FDIC receivership. Young Aff., ¶ 9.

At the October 2-3 meeting, the board was informed that Wachovia had obtained the best available merger terms. In return for the monetary and non-monetary benefits provided to Wachovia and its shareholders by the merger, Wells Fargo had initially proposed a Share Exchange Agreement pursuant to which it would be granted in excess of 50% of the voting power on the merger, but agreed to accept a reduction to 39.9%. The board was informed that these terms were intended by Wells Fargo to provide confirmation to the market that the merger could be closed and thereby prevent further deterioration in Wachovia's financial condition as a result of uncertainty. In return for the voting power granted to Wells Fargo, and the limits on the "fiduciary out provisions," Wachovia was able to obtain approximately \$11.8 billion in value and important non-monetary terms that were and are very valuable and attractive to Wachovia and its shareholders (*e.g.*, no material adverse change provision and a structure providing the assurance the merger could close that was necessary to reassure the markets, regulators, customers, and counterparties).⁴ The board was aware that the Merger Agreement did not include a break-up fee, a term often included to benefit the acquirer. One or more directors asked if further negotiation with Wells Fargo in an attempt to obtain more favorable terms would be prudent. The board's advisors uniformly advised against such negotiations under the circumstances, particularly in light of the time constraints faced by Wachovia. *Young Aff.*, ¶ 10.

Before approving the merger, the board discussed the urgent need for Wachovia to be able to obtain funding to sustain its operations pending a closing of the merger. The board knew that Wachovia needed to obtain significant immediate funding from Wells Fargo and also needed to

⁴ A material adverse change provision is a clause commonly found in merger agreements that gives the acquiring company the right to walk away from the deal in the event the target company experiences a significant adverse event or a material decline in value in the time period between signing and closing. The absence of such a clause in the Wells Fargo-Wachovia merger agreement was a significant concession by Wells in light of the difficulties that Wachovia faced at that time. *See Young Aff.*, ¶ 9.

provide substantial assurance to the financial markets and the Federal Reserve that the merger with Wells Fargo could be closed so that other sources of funding could be accessed as well. Absent such funding, it was extremely unlikely that Wachovia would be able to avoid receivership pending consummation of a merger with Wells Fargo. The company's advisors and Mr. Steel told the board they believed that unless a definitive agreement was signed by the end of the day Friday, October 3, the FDIC was prepared to place Wachovia's banking subsidiaries into receivership. Young Aff., ¶ 11. Receivership would have destroyed the value of Wachovia as a business franchise and completely wiped out its shareholder value.

Wachovia's financial advisors (Goldman Sachs and Perella Weinberg) informed Wachovia that the financial analysis they normally would perform in connection with a merger would not be meaningful for Wachovia because of the extraordinary circumstances faced by Wachovia and its severe liquidity crisis. These advisors indicated that extensive analysis was not required to confirm that the Wells Fargo merger proposal was fair to Wachovia's shareholders. These advisors also informed the board that no third parties were likely to appear and make a proposal superior to the Wells Fargo merger from the perspective of Wachovia and its shareholders. Young Aff., ¶ 13.

Relying on its advisors and informed by its own knowledge of the circumstances, the board approved the Wells Fargo merger. In approving the merger, the board was under significant time constraints imposed by the prospect of receivership; however, the board had thoroughly explored all options available for raising capital or entering into a business combination during the weeks preceding the meeting. Thus, the board was able fully and properly to consider the merger in the limited time available under the circumstances. Young Aff., ¶ 12.

On October 3, upon the announcement of the Wells Fargo merger, Wachovia's stock price jumped to \$7.05 from the prior day's close of \$3.91, and closed at the end of the day at \$6.21.

