IN THE UNITED STATES COURT OF FEDERAL CLAIMS

FRANK P. SLATTERY, JR., ***et al.*****,** **Plaintiffs,** **v.** **THE UNITED STATES,** **Defendant.**	**Civil Action No. 93-280 C** **(Chief Judge Smith)**

PLAINTIFFS' POST-TRIAL MEMORANDUM

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Table of Contents

Table of Contents

Page

Table of Contents

Page

Table of Contents

Page

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PLAINTIFFS' POST-TRIAL MEMORANDUM

Like the financial institutions involved in the *Winstar* cases, Meritor Savings Bank's ("Meritor") predecessor, Philadelphia Saving Fund Society ("PSFS"), agreed with federal banking authorities — in this case, the Federal Deposit Insurance Corporation ("FDIC") — to acquire a failing thrift.[1] The agreement saved the FDIC Bank Insurance Fund over $800 million. At the heart of the agreement was a promise by the United States that PSFS could book the $800 million of negative net worth (that it had assumed on the government's behalf) as supervisory goodwill to be amortized over a fifteen-year period. As the Supreme Court affirmed in *Winstar*, this promise can only be rationally understood as a commitment by the government to treat this "supervisory goodwill" as fully qualifying regulatory capital. On any other reading, PSFS could have been seized the moment the transaction was consummated. The government, however, disregarded this promise and thereby caused the demise of what was once the largest and oldest savings bank in the country.

At trial, Plaintiff Frank P. Slattery offered overwhelming — and mostly unrebutted — evidence establishing the principal elements of Plaintiffs' claim. Specifically, the facts adduced at trial establish, by much more than the requisite preponderance of the evidence, that: (1) FDIC

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1 In this Brief, Plaintiffs use the terms "PSFS," "Meritor" and "the Bank" interchangeably.

entered into a binding contract with PSFS on April 3, 1982, which required FDIC to permit PSFS to treat supervisory goodwill resulting from PSFS's acquisition of Western Savings Fund Society ("Western") as a regulatory capital asset for 15 years, with a concomitant requirement that PSFS amortize the goodwill over 15 years on a straight-line basis; (2) the Bank's right to treat the Western goodwill as a regulatory capital asset was unqualified, *i.e.*, the goodwill had to be treated as an asset for <u>all</u> regulatory capital purposes and not, as the United States now asserts, for some purposes but not others; (3) FDIC repeatedly disregarded its contractual obligations by failing to treat PSFS's goodwill as an asset for purposes of determining the Bank's capital adequacy; (4) FDIC's failure to treat PSFS's supervisory goodwill as regulatory capital for all purposes caused FDIC to impose on Meritor the 1988 MOU, the 1991 Written Agreement, and further caused it to commence insurance revocation proceedings, prompting the Pennsylvania Department of Banking to seize Meritor on December 11, 1992.

Plaintiffs address each of these propositions in turn below.

I. FDIC AND PSFS ENTERED INTO A BINDING CONTRACT ON APRIL 3, 1982 WHICH REQUIRED FDIC TO PERMIT PSFS TO TREAT THE SUPERVISORY GOODWILL ARISING FROM THE WESTERN MERGER AS A REGULATORY CAPITAL ASSET TO BE AMORTIZED OVER 15 YEARS.

On April 3, 1982, FDIC and PSFS executed a Merger Assistance Agreement ("MAA") (PX 21). In doing so, FDIC warranted that:

> The Board of Directors of the FDIC has duly authorized the execution of this Agreement and has taken all action necessary for the FDIC to enter into and perform this Agreement. This Agreement constitutes a valid and binding obligation of the FDIC, enforceable in accordance with its terms.

PX 21 at § 4.2. Under the terms of the Agreement, FDIC also furnished to the Bank an FDIC Board of Directors resolution "authorizing the FDIC to enter into and perform this Agreement," *id.* at § 4.3, and an Opinion of the FDIC General Counsel finding that FDIC "has the legal power and authority to perform all acts contemplated hereunder." *Id.* at § 4.4; *see also* PX 19 & PX 23.

The financial terms of the Agreement were essentially threefold. First, FDIC and PSFS were to exchange several notes and a sum of cash. Second, FDIC agreed to provide limited income protection, and indemnity against losses, on a defined subset of Western's outstanding troubled loans. *See* MAA (PX 21) at 6-18; *see also* Response to Second Request for Admissions (Exh. 4 to Memorandum in Support of Plaintiffs' Motion for Partial Summary Judgment "Pl. SJ Mem.") at 11.

The third major component of the 1982 Agreement was a Memorandum of Understanding ("the 1982 MOU") that addressed regulatory capital issues. *See* PX 22. By April, 1982, the market value of Western's liabilities exceeded the market value of its assets by over $1 billion. *See* Tr. 92:12-96:9 (Nocella); Memorandum from Anthony J. Walsh to Robert F. Miailovich (Sept. 10, 1982) at 2-3 (PX 33). Absent specific regulatory forbearance on capital adequacy, the merged institution would have been insolvent and subject to seizure immediately upon consummation of the acquisition. Tr. 103:1-19 (Nocella); Tr. 907:18-24 (High); Tr. 272:19-23 & 274:18-275:5 (Cooke); Tr. 2730:10-20 (Gough). Accordingly, the 1982 MOU, which was executed simultaneously with the MAA (*see* PX 21 & PX 22) and expressly made a part thereof,[2] clarified the methods by which FDIC would assess the Bank's regulatory capital. The MOU stated in relevant part:

> Regarding the use by the Bank [PSFS] of certain accounting methods, the FDIC would not object to the following:
>
> * * * *

[2] *See* Response to Second Request for Admissions (Exh. 4 to Pl. SJ Mem.) at 11, 12 (The 1982 MAA is a binding contract in which the 1982 MOU is incorporated by reference).

> 3. *The difference between the liabilities assumed and the total of the market value of the Western assets, less reserves, may be treated as goodwill and amortized on a straight-line basis up to fifteen (15) years.*

PX 22 (emphasis added).

Official FDIC documents, and admissions made by FDIC in this litigation, establish that the 1982 MOU is a binding contract incorporated into the MAA, and that FDIC was fully authorized to enter into the 1982 MOU and to make the commitments there made. *See* Response to Second Request for Admissions (Exh. 4 to Pl. SJ Mem.) at 11, 12; Letter to PSFS from Thomas A. Brooks, General Counsel of FDIC (April 3, 1982) (PX 23) ("The Merger Assistance Agreement and any other agreement and notes necessary to the consummation of the transaction . . . will constitute the valid and binding obligations of the FDIC enforceable in accordance with their terms"); MAA (PX 21) at § 4.2 ("The Board of Directors of the FDIC has duly authorized the execution of this Agreement and has taken all action necessary for FDIC to enter into and perform this Agreement."). In light of these admissions, and in contrast to some of the *Winstar* cases, the questions of *whether* a contract exists and *whether* the FDIC official executing the contract had authority are *not* disputed.

The only issues that remain, therefore, are: What does the contract mean, and was it breached? Plaintiffs demonstrate below that *all* of the witnesses — both government and PSFS witnesses — who participated in the negotiation and drafting of the contract agree that, under the Agreement, the Bank's supervisory goodwill was to be counted as regulatory capital for *all* regulatory purposes. Thus, the mantra of *other* FDIC officials that the agency was free to disregard Meritor's supervisory goodwill as regulatory capital when assessing the Bank's capital adequacy not only should be rejected, but is evidence of breach.

As shown below, Plaintiffs also demonstrate that FDIC examiners and decision-making officials looked upon goodwill with disdain, and consequently never did accord the Bank's goodwill the treatment the agency had promised. Thus, while the Bank honored its obligations and assumed hundreds of millions of dollars of Western's red ink, all to the great benefit of FDIC, the FDIC in turn never did accord PSFS, and later Meritor, the benefit of its contract. Rather, the supervisory goodwill resulting from the Western transaction remained an anchor pulling the Bank into the abyss, or perhaps more bluntly, a noose that just got tighter and tighter.

II. THE 1982 AGREEMENT REQUIRED FDIC TO TREAT PSFS' SUPERVISORY GOODWILL AS A REGULATORY CAPITAL ASSET AS GOOD AS CASH FOR ALL REGULATORY PURPOSES; THUS, THE CONTRACT REQUIRED FDIC TO TREAT THE GOODWILL AS GOOD AS CASH IN EVALUATING THE ADEQUACY OF THE BANK'S CAPITAL.

A. The Scope of the FDIC-PSFS Contract Is Controlled by *Winstar*

The 1982 MOU required FDIC to treat Meritor's supervisory goodwill as regulatory capital for all regulatory purposes, to be amortized over 15 years on a straight-line basis. Indeed, this issue has been definitively resolved by *Winstar*. As noted above, the 1982 MOU, which was incorporated into the MAA, provides:

> 3. The difference between the liabilities assumed and the total of the market value of the Western assets, less reserves, *may be treated as goodwill and amortized on a straight-line basis up to fifteen (15) years.*

PX 22 (emphasis added). The MOU is signed by Robert P. Gough, Deputy Director of the Division of Supervision, and Anthony J. Nocella, Executive Vice President - Finance of PSFS. These are the same individuals who executed the Merger Assistance Agreement on the same day. *See* PX 21 at 21.

This Court, an *in banc* panel of the Federal Circuit, and the Supreme Court all reviewed essentially the identical contract language in the three contracts addressed in the *Winstar* trilogy and found that this language required the government to treat the institutions' supervisory goodwill as regulatory capital. In the first of the three contracts, Winstar and the government executed an assistance agreement that incorporated, among other things, a forbearance letter, which stated in relevant part:

> For purposes of reporting to the Board, the value of any intangible assets resulting from accounting for the merger *in accordance with the purchase method may be amortized by [Winstar] over a period not to exceed 35 years by the straight-line method.*

Winstar Corp. v. United States, 64 F.3d 1531, 1544 (Fed. Cir. 1995) (*in banc*) (emphasis added). The Statesman assistance agreement likewise contained an integration clause which, the courts found, incorporated certain Federal Home Loan Bank Board resolutions. Bank Board Resolution 88-169, which approved the Statesman merger plan, provided:

> The value of an unidentifiable intangible asset resulting from accounting for the Acquisition and the Mergers *in accordance with the purchase method of accounting may be amortized by [Statesman] over a period not in excess of twenty-five (25) years by the straight-line method* . . .

Id. (emphasis added). Like Winstar and Statesman, Glendale Federal entered into an assistance agreement with the government that, in turn, contained an integration clause. *Id.* at 1540. Bank Board Resolution 81-710 approved the merger and further allowed Glendale to furnish an accounting opinion which:

> (a) indicates the justification under generally accepted accounting principles for the use of the purchase method of accounting for its merger with Broward, (b) specifically describes, as of the Effective Date, any goodwill or discount of assets arising from the merger to be recorded on Glendale's books, and (c) substantiates the reasonableness of amounts attributed to goodwill and the discount of assets and the resulting amortization periods and methods. . . . . Glendale shall submit a stipulation that any goodwill arising from this transaction shall be amortized in accordance with [Bank Board] Memorandum R-31b. . . .

Id. at 1540-41. Glendale furnished a response from its accountants:

> Pursuant to the provisions of the Agreement of Merger between [Glendale] and Broward . . . and the Supervisory Action Agreement between [Glendale] and the Federal Savings and Loan Insurance Corporation (FSLIC) . . . $18,000,000 of the resultant goodwill is associated with the savings deposit base and will be amortized on a straight line basis over 12 years . . . . The remaining goodwill of $716,666,000 will be amortized on a straight line basis over 40 years . . .

Id. at 1541. In each of these contracts, the Federal Circuit found that the government "had an express contractual obligation to permit [the institution] to count the supervisory goodwill generated as a result of its merger . . . as a capital asset for regulatory purposes." Id. at 1540, 1543, 1544. The Supreme Court, reviewing each of these contracts, affirmed the Federal Circuit's findings. *United States v. Winstar Corp*, 586 U.S. 839, 116 S.Ct. 2432, 2448-51 (1996). The PSFS contract language essentially tracks the language found in the *Winstar* trilogy and must be accorded the same meaning. As this Court observed: "Defendant should be held liable in all cases in which similar language defined the government's contractual obligation to permit amortization of goodwill over a 25 year-or-more time period. . . . It is not a responsible posture to reargue points lost overwhelmingly before all three levels of our federal judicial system." *California Fed. Bank*, 39 Fed. Cl. at 767.

Not only is the contractual language essentially identical to that considered by this Court, the Federal Circuit and the Supreme Court, but the circumstances giving rise to the goodwill agreements in the present action and in *Winstar* are strikingly similar. *See* 116 S.Ct. at 2448-51. In each instance, the government executed the agreements to avoid expending millions of dollars to pay off insured depositors of a troubled bank. *Compare* MAA (Exh. 21) at 1-2 (finding that Western "is in an unsafe or unsound condition, . . . many of the assets acquired by [PSFS] from Western have a market value of less than the carrying value on the books of Western, . . . many of the assets acquired by [PSFS] from Western are earning a return less than the cost of the liabilities the Bank assumed from Western," and that the merger "will reduce the risk or avert a threatened loss to the FDIC") with the assistance agreements in *Winstar*, 64 F.3d at 1543. In this case, FDIC has admitted that the liabilities of Western exceeded its assets, marked to market, by $696 million at the time of the merger, *see* Defendant's Response to Plaintiffs' Second Set of Admissions at 1, and that absent the merger, the agency "would have terminated Western's deposit insurance and . . . the State of Pennsylvania would have appointed a receiver to liquidate the institution." Id. FDIC's concern that Western's failure would cost the insurance fund some $700 million, *see* id. at 7, served as a powerful incentive for the agency to enter into the goodwill contract at issue.[3] FDIC has reaped the benefit of its contract: Not only did it successfully avoid having to resolve Western in 1982, but even the seizure of Meritor a decade later cost FDIC not even a single dollar, a rarity in FDIC's experience. Tr. 4277:22-4278:9 (Hartheimer).

PSFS, for its part, never would (or even *could)* have merged with Western and entered into the MAA and 1982 MOU unless FDIC was contractually bound to treat the Bank's supervisory goodwill as regulatory capital for all regulatory purposes. Like the *Winstar* cases addressed by the Supreme Court, PSFS would have had a *negative* capital position[4] and would have been subject to regulatory sanction the day the transaction was consummated unless FDIC had committed itself to treat the Bank's supervisory goodwill as capital. Tr. 103:1-19 (Nocella); Tr. 907:18-24 (High); Tr. 272:19-23 & 274:18-275:5 (Cooke); Tr. 2730:10-20 (Gough); *Winstar*, 116 S.Ct. at 2449 ("[I]t is not disputed that if supervisory goodwill had not been available for purposes of meeting regulatory capital requirements, the merged thrift would have been subject

3 After accounting for the costs of the assistance agreement, FDIC estimated that PSFS's acquisition of Western saved the FDIC insurance fund over $575 million. *See* FDIC News Release (PX 24) at 1.

4 PSFS, as of June 30, 1982 had an adjusted tangible equity capital ratio of negative 3.59%. *See* Memorandum to File from Michael J. Zamorski (PX 55) at 1.

to regulatory noncompliance and penalties from the moment of its creation") (citations omitted). Without the regulatory forbearance contained in the 1982 MOU, the merger would have transformed PSFS from a healthy into an unhealthy institution, which no rational bank management could have permitted. *See Winstar*, 64 F.3d at 1542 ("Prior to the merger, Glendale was a healthy, fully capitalized thrift. . . . [A]fter merging with Broward [a troubled thrift] Glendale's regulatory net worth would have been negative $460 million if supervisory goodwill had not been counted as a capital asset")[5]; *Winstar*, 116 S.Ct. at 2449 ("[u]nder the circumstances" it would have been "madness" for the parties not to have settled the regulatory treatment of these transactions as a condition precedent of their mergers) (citations omitted).

Nor is it any answer that FDIC could have treated PSFS's goodwill as regulatory capital for purposes of satisfying minimum capital requirements, but *not* for purposes of determining the Bank's capital adequacy. Not only were there no formal, regulatory capital minima at the time, Tr. 86:11-14 (Nocella); Defendant's Response to Third Request for Admissions at 3; *see also id*. at 5, but even if they had existed, such a perverse reading of the agreement would have benefited PSFS not a bit. Rather than terminating PSFS's insurance or otherwise taking regulatory action against the Bank based upon the Bank's failure to satisfy some regulatory capital requirement, FDIC could have justified any adverse regulatory action merely because PSFS no longer had "adequate capital" — whatever that is — given the type or quality of capital it now had. If that were the agreement, PSFS would have had no more protection than the government claimed the

5 The tangible net worth of the acquired institution was a negative $6.7 million, and the new Winstar thrift would have been out of compliance with regulatory capital standards from its very inception, without including goodwill in the relevant calculations. . . . Absent those forebearances [goodwill and capital credits], Statesman's thrift would have remained insolvent by almost $9 million despite the cash infusions provided by the parties to the transaction.

Winstar, 116 S.Ct. at 2450-51.

Winstar banks had in the absence of a contract there, a proposition soundly rejected by the Supreme Court. The government's argument has never squared with the reality of the circumstances, and should be rejected.

B. The Representatives of Both FDIC and PSFS Who Negotiated the Terms of the 1982 MOU Are in Agreement That FDIC Agreed to Treat the Western Goodwill as an Asset for All Regulatory Capital Purposes

In rejecting the parties' respective motions for summary judgment on the contract interpretation question, this Court (implicitly) invited the parties to offer parole evidence regarding the parties' intent. The parties' intent at the time of contracting, of course, is a touchstone of a contract's meaning. *Winstar*, 64 F.3d at 1539. Here, the negotiators for *both* FDIC and PSFS agree that paragraph (3) of the 1982 MOU was intended — as Slattery has maintained and as common sense dictates — to allow the Bank to count its supervisory goodwill as an asset for all regulatory capital purposes.

1. FDIC Chairman Bill Isaac Explained That FDIC Relied On The Offer Of Supervisory Goodwill as an Indispensable Measure To Save The Entire Savings Association Industry

President Carter appointed Chairman Isaac to the three-member FDIC Board in 1978. Tr. 1503:20-22 (Isaac). Both of Kentucky's senators, the Kentucky governor, and others had recommended Mr. Isaac for the position. Mr. Isaac was 33 years old at the time he was nominated, and 34 by the time he was confirmed by the United States Senate. Tr. 1503:23-1504:3 (Isaac). In 1984, President Reagan named Mr. Isaac Chairman of the FDIC. Tr. 1504:14-16 (Isaac). He remained as Chairman until the end of 1985. Id. at 1504:17-19. Bob Gough, a government witness who served as Assistant and then Deputy Director in the FDIC Division of Banking Supervision under Isaac, Tr. 2693:22-2694:12 (Gough), considered Isaac a man of integrity and one of the best FDIC directors. Tr. 2785:21-2786:5.

Chairman Isaac testified that the condition of the savings bank industry in 1980 and 1981 was desperate:

> The savings bank industry was in very, very difficult times at that point. And the industry as a whole, you know – looking at the collective balance sheet of the industry – my memory is it was insolvent on a mark to market basis, if you wrote down their assets to market value based on the current interest rate climate. I believe the industry as a whole had an insolvency of approximately $100 billion. So it was a huge problem for the FDIC. We had an $11 billion deposit insurance fund and potentially a hundred billion dollar insolvency was looking at us.

Tr. 1508:7-16. Mr. Isaac testified that in or about 1979 or 1980 "the entire industry was threatened by the very high interest rates" at the time and that he "was very concerned about the savings bank industry." Tr. 1508:20-1509:4. Mr. Isaac went to the then-chairman of the agency, Irv Sprague, who agreed that the agency had to prepare to deal with the problem. Tr. 1508:17-1509:13. Mr. Sprague asked Mr. Isaac to head up a task force, which was comprised of the heads of all the major divisions of the agency and many of the deputies from around the FDIC. Tr. 1509:13-21. The task force worked for nine months and produced voluminous reports containing its proposals. Tr. 1509:22-1510:15.

According to Isaac, the task force agreed that given the $11 billion insurance fund and the $100 billion insolvency, it was advisable to avoid resolving institutions unless their capital was fully depleted. Tr. 1510:6-25. Simply, "it was better. . . to deal with problems later rather than sooner." Id. "Our belief was that the longer we waited, the better off we would be, as long as they weren't adding risk, because time was money to us." Tr. 1511:20-22. Isaac concluded, as did the task force, that it was better to merge, rather than liquidate, the banks when they reached zero capital.

> We didn't want to have to liquidate them, because if we liquidated them, paid off the insured depositors and liquidated the assets, we were going to be facing enormous losses, because you would only

> be able to sell the assets at a mark to market basis, and we felt certain that interest rates would not remain at 21 percent forever, and that we would be better off dealing with those asset sales and the like in a lower rate climate. And a lot of the savings banks, if you gave them time and interest rates came down, they would actually recover and be able to rebuild their capital and their earnings. So we decided that we would merge those that we had to deal with into stronger institutions, and try to sell the franchise and get some value out of it and not have to liquidate the assets.

Tr. 1512:3-17. Isaac then outlined three policy decisions taken by the agency to promote such mergers. First, the agency agreed to enter into asset maintenance agreements with the acquirers, which agreements "basically w[ere] [used] to subsidize [the] portfolio" acquired. Tr. 1516:19-20. The FDIC used an average cost of funds to the industry and an average yield on government securities as a means by which to subsidize the acquirer's balance sheet to encourage the acquirer to restructure its balance sheets. Tr. 1516:21-1517:10. The FDIC "didn't want them to have to hang on to those [bad] assets" and thus encouraged their sale. Tr. 1516:21-23

Second, FDIC also provided acquirers with notes, or otherwise loaned them money to assist them with the acquired negative net worth of the acquired institution. Tr. 1517:25-1518:1.

Third, and most relevant here, FDIC made a policy decision to accord the acquiring institution the right to treat the resulting supervisory goodwill as a regulatory capital asset to be amortized over 15 years. On this, Chairman Isaac had much to say, and was quite clear:

> We also agreed, because they were booking, they were agreeing to acquire this institution, and the assets being mark to market were worth less than the liabilities, and, therefore, there was a goodwill factor in there, and we allowed them to write the goodwill off over a period of 15 years rather than – we allowed them to book the goodwill and make it part of their assets and their capital structure and to write it off on a straight-line basis over 15 years. The FSLIC, in contrast, allowed people to book goodwill and write it off over a 40-year period. And we disagreed with that policy. We thought it was a very dangerous policy.

Tr. 1517:11-22. Chairman Isaac additionally testified:

> [W]e were urged to adopt [the goodwill policy] by a lot of people, including the administration, and a lot of people in the Congress, we were urged to adopt the FSLIC model of allowing goodwill to be booked. Supervisory goodwill and regulatory accounting and the like. We resisted all that, and we did come up with a 15-year amortization on a straight-line basis on the goodwill. I don't think we refer to it as supervisory goodwill, just goodwill.

Tr. 1518:6-14.

> I know that's what the task force recommended. I know that that's what the [FDIC] board understood we were doing, and whether it was actually brought to a board meeting and on what date, I can't tell you, but I do know that all the senior staff of the FDIC was involved in developing that recommendation, through this task force that I headed, and the Chairman of the agency certainly knew, before I became Chairman, certainly knew what we were doing every step of the way, as did the controller of the currency, and when I became Chairman, I certainly knew what we were doing.

Tr.1518:23-1519:7. Nor was FDIC's goodwill policy merely something the agency stumbled into. To the contrary, Chairman Isaac carefully explained the distinctions between the FSLIC policy and the FDIC policy, the latter being, in Chairman Isaac's view, far more prudent than the former. Tr. 1519:12-1521:2 (FDIC relied on shorter amortization schedule; FDIC never merged two weak institutions; FDIC closely monitored industry). But, as Chairman Isaac testified, "[w]e never had a situation comparable to this in the history of the FDIC. . . . [W]hat we needed to do was to get through this period, and eventually, rates would come down and a lot of these institutions would get a lot stronger. This is a very different problem than we were used to dealing with." Tr. 1522:1-1523:4. The agency recognized the risk in allowing goodwill to be amortized over a prolonged period of time, but:

> [the agency's] hope was that interest rates would come down, and the assets would go back up in value, and that's why we were relatively comfortable doing it. *It was basically another device to buy time and to afford the FDIC the opportunity to not put cash we didn't have into the deal. We could have filled up that hole with cash, but we would have not done very many deals because we*

> *would have been out of cash*. And we were faced with a $100 billion insolvency, and we had $11 billion. So you try to make the $11 billion go as far as you can.

Tr. 1525:25-1526:9 (emphasis added); *cf.* Tr. 5460:7-24 (Brumbaugh) ("Both the FSLIC and the FDIC faced the same kind of problem . . . . In the FSLIC's case and in the FDIC case insofar as they were dealing with mutual savings banks at the time, most if not all of these institutions were insolvent on a mark-to-market basis, and if either of the insurance agencies had closed all the insolvent thrift institutions in the traditional fashion with cash assistance, it probably would have drained the resources of both of the insurance funds. As it turned out, . . . the FSLIC was declared insolvent by the GAO in 1986, I believe — it might have been the beginning of 1987, and the FDIC was declared insolvent in 1991."); *see generally* Tr. 5460-5464 (Brumbaugh).

Chairman Isaac then summarized his understanding of the FDIC-PSFS agreement.[6] In so doing, he bluntly acknowledged that the offer of treating supervisory goodwill as a regulatory capital asset was an essential term of the agreement, without which PSFS never could have done the deal, and further acknowledged, candidly, the extraordinary benefit received by the FDIC:

> I mean, you had – you had a deal that you were trying to do with PSFS, PSFS had no incentive to take on this troubled institution, and we wouldn't have wanted them to take it on unless we had done something to make – a number of things to make the transaction economically viable for them.
>
> If we had said that you got to take these assets over as they are, they would have – with no help from the FDIC, they wouldn't have done the deal. Okay? So we tried to come up with an economic package that made this thing viable to them.

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[6] Not only did Chairman Isaac set FDIC policy, but he was also integrally involved in the PSFS deal. Tr. 97:6-11 (Nocella) (Isaac offered the 15-year amortization period); Tr. 271:12-20 (Cooke) (Isaac spoke with Cooke several times, by phone or in person); Tr. 1540:13-25 (Isaac) (same); Tr. 2781:14-21 (Gough) (Gough spoke with Isaac at least as often as he spoke with Fritts regarding negotiations with PSFS); Tr. 89:18-20 (Nocella) (Isaac called at 2:00 a.m. to make final call regarding goodwill); *see also* PSFS On-Line Extra, "Anatomy of an Acquisition" (PX 26) as CSL112 0133-34.

> One thing we did is, we gave them the income maintenance agreement to cover that portfolio going forward. That was very important. I think we also gave them some – we loaned them some money, as I recall. I know we did to a number of these institutions.
>
> And third, we said to them, we will count the goodwill over a 15-year period, it can be amortized over a straight-line basis, we will count that as part of your assets and capital structure.
>
> *If we hadn't done that, if we hadn't agreed to that latter thing, and made them charge off the goodwill immediately, they couldn't have done the deal because their capital ratio would have been way too low and they would have done great damage to their franchise. We wouldn't have allowed them as a regulator to do it, had the balance sheet looked like that.*
>
> *So it was making an exception to our practice to allow them to write this off over a 15-year period because we thought it would save us a lot of money, and it did. We got out after a very big problem relatively cheaply*.

Tr. 1527:2-1528:7 (emphasis added).

Chairman Isaac noted that FDIC permitted only institutions that had "relatively strong management," "relatively strong capital, and relatively strong earnings" to do these deals. Tr. 1514:22-1515:14. In his view, PSFS in 1982 was a "solid" institution "compared to [its] peers." Tr. 1515:18-24. He explained that some of the banks that were permitted to acquire its weaker sisters actually were losing money because "even the better ones" were losing money in 1982. Tr. 1515:5-7. But he underscored that only the best institutions were permitted to take on the significant negative net worth of the troubled institutions. In this regard, Chairman Isaac characterized the Chief Executive Officer of PSFS at the time, M. Todd Cooke, as "a leader of the industry" and "a very well respected person in the industry." Tr. 1541:5-7. *Accord*, Tr. 2696:1-2 (Gough) (acquirers had to be capable and viable); Tr. 2703:20-2704:12 (Gough); Tr. 3169:18-3170:14 (Lutz); Tr. 3106:8-11 (Lutz); Cf. Tr. 76:9-15 (Nocella) (capital ratio was 6 plus percent and acceptable to FDIC); Tr. 2939:9-2940:7 (Fritts) (PSFS bid was only viable bid, and only bid that satisfied FDIC's least cost test); Tr. 2788:5-24 (Gough) (PSFS bid was in class by itself).

Thus, the circumstances of the deal could not be more plain: (1) PSFS was a strong bank with strong management that never would have gone forward without FDIC guarantees that the resulting goodwill would be treated as regulatory capital; (2) FDIC was desperate to go forward with the deal to save itself hundreds of millions of dollars that it would otherwise have had to expend to pay off the insured depositors of Western, at a time when the industry was insolvent by more than $100 billion and the insurance fund was just $11 billion.

2. Chairman Isaac Acknowledged that the FDIC Intended the Western Goodwill to be Treated as Cash for all Regulatory Capital Purposes

Faced with substantial evidence that FDIC in fact disregarded the Bank's supervisory goodwill when determining both the Bank's capital adequacy and FDIC's regulatory response, the United States has constructed a defense that parses the language of the contract as providing that the Bank could treat the Western goodwill as regulatory capital for some purposes but not for others. Never mind that there is no evidence that such distinctions were ever discussed with PSFS negotiators at the time the contract was negotiated, and put aside that no responsible management would have or could have risked pursuing the acquisition with only the façade of protection such an agreement would have accorded. Instead, the government pursues this theory still, even though it remains just that — a theory — because each of the principal negotiators for both FDIC and the Bank agrees that such distinctions were *not* and *never* were part of the contract.

In response to a question posed by the Court, Chairman Isaac was emphatic in concluding that PSFS's supervisory goodwill:

> was part of the capital structure of the bank for all purposes. For all the purposes that were relevant to the FDIC, we would count it as part of the capital structure of the bank.

Tr. 1530:10-14 (emphasis added). The Court and the witness then engaged in a dialogue of their own, in which Chairman Isaac forthrightly testified that the goodwill was to be treated as better capital than other assets because regulators could not write it down or classify it according to risk:

> The Court: So it would be counted as any other asset?
>
> The Witness: That's correct. You wouldn't discount the goodwill. You wouldn't go in and say, well, that's a bad asset, we're not going to count it.
>
> The Court: I guess in one sense the goodwill would be a better asset on the books than other assets, in that it would have no interest rate risk or no credit risk?
>
> The Witness: True enough.

Tr. 1531:1-9. And then when asked whether the FDIC would discount the goodwill for purposes of determining the quality of assets, Chairman Isaac was again unequivocal:

> It doesn't get discounted. It is what it is. As was noted, it – a lot of assets, you can come in and say, well, they are not worth what they are on the books for. The goodwill is clearly what it is.

Tr.1532:7-14. As many other witnesses subsequently testified, Chairman Isaac explained that the agency historically was hostile toward the use of goodwill as a regulatory capital asset:

> The agency is, after all, the insurer of banks, and when a bank fails, the agency is called upon to liquidate the bank. So the FDIC examiners approach an institution on – with the mentality that this is potentially a failing bank, and – what am I going to be able to liquidate the assets for if it fails? And so that's why the FDIC tends to want real hard values so that it can – it wants to assign very hard values to hard assets because they – they want to be able to know that when they close the bank that they are going to be able to realize that value for sure. And goodwill is a little elusive, in different economic environments, you may or may not be able to get that goodwill when you sell an asset. And when things are

> booming, frequently you can, and when things are in the dumpster, you can't. So goodwill is more elusive. The flaw in applying that thinking here is that we knew that if we marked these assets to market we were going to lose a lot of money, and we didn't want to mark them to market. We wanted to deal with these institutions, if we had to, at a much later date, when interest rates were much lower and these assets had come up in value. And it wasn't a matter of what could we sell them for, can sell them for – for a premium in the marketplace; we just knew that when rates came down, the value of these assets automatically would go up. The hard tangible value of them would automatically go up when interest rates came down. And so applying the old thinking to this problem wasn't going to work. That's why we allowed this limited use of goodwill here.

Id. 1534:5-1535:9. Chairman Isaac made clear that he and others recognized that supervisory goodwill was a nonearning asset, but that this fact would not be used against PSFS. Instead, the policy was to factor the goodwill out of the analysis of the bank's earnings, so that if the Bank were earning $50 million less than its peers due to amortization, its earnings should be viewed as equal to its peers. Tr. 1546:7-18. Both Chairman Isaac and others have testified that the contract was intended to afford significant protection to the bank, assuring that the regulators would not treat the bank less well merely because it had agreed to take on the Western problem and the resulting supervisory goodwill. *See also* Tr. 87:13-88:7 (Nocella) (purpose of agreement was to put PSFS's capital in same condition after as before the merger); Tr. 88:9-17 (Nocella) (purpose of agreement was to ensure that merger did not harm the bank).

Chairman Isaac's testimony should be accorded special weight not only because he was Chairman of the FDIC at the time, but because of the attention he personally devoted to these deals. "It was," he testified, "the most important business before the agency at the time, all of these deals. [The problems facing the industry] were very threatening, life-threatening to the agency." Tr. 1539:5-8.

3. The PSFS Negotiators Have All Testified That The Supervisory Goodwill Was to be Treated as Capital for All Regulatory Capital Purposes

Not only does Chairman Isaac view the agreement through the prism that supervisory goodwill was to be treated as capital for all regulatory capital purposes, but that view is in accord with each and every bank representative involved in the negotiations.

M. Todd Cooke

Mr. Cooke, a World War II signal corps veteran and a graduate from Princeton and MIT, served as an officer of PSFS and Meritor from 1966 through 1987. Tr. 260:9-261:7 & 263:4-7 (Cooke). He became Chairman and Chief Executive Officer in 1979 and remained in that position until 1985. Tr. 264:20-24 (Cooke).

Mr. Cooke reaffirmed that PSFS would not have gone forward with the Western acquisition if the Bank had not been permitted to treat the resulting supervisory goodwill as regulatory capital for all regulatory capital purposes. He understood, and so testified, that the merged institution would otherwise have had a negative net worth "the day that ink was dry on the paper." Tr. 274:18-275:5. Mr. Cooke recalled nothing in the contract that allowed FDIC to treat goodwill as an asset for some regulatory purposes and not others. "Any such reservations or shadings" were "not reflected" nor "incorporated in the contract into which we entered with the FDIC." Tr. 277:1-16. He affirmatively stated that he does not recall FDIC ever reserving for itself the right to look at the goodwill differently than other assets in determining the adequacy of the bank's capital, Tr. 277:17-21, nor would PSFS have gone through with the deal had FDIC ever insisted on such a reservation. Tr. 277:22-278:2. "[F]or our purposes and the purposes of the agreement, [the supervisory goodwill] was as good as cash." Tr. 304:17-23.

Robert S. Ryan

Mr. Ryan, a Korean War veteran and a graduate of Princeton College and Harvard Law School, was a partner of the Philadelphia law firm of Drinker, Biddle & Wreath from 1956 until 1992. Tr. 322:4-323:13 (Ryan). It was in that capacity that Mr. Ryan served as the primary outside counsel for PSFS. Indeed, Mr. Ryan was the primary outside counsel providing the Bank with advice in connection with PSFS's acquisition of Western. Tr. 328:10-19 (Ryan).

Mr. Ryan's testimony is in perfect harmony with that of Chairman Isaac. Mr. Ryan testified that PSFS's acquisition of Western left a "hole" of approximately $800 million. Tr. 331:7-10. The "larger elements of the deal" were largely intended to fill that $800 million hole. Tr. 331:13-14. Mr. Ryan explained that there existed "an income hole because you're taking over assets that were earning way below the cost of money." Tr. 331:20-21. That hole "had to be filled[,] [a]nd that's what the income maintenance agreement was designed to do." Tr. 332:1-3. Mr. Ryan continued:

> The other thing is, you have the obvious problem of the – of the question of capital. We were doing purchase accounting, which would free the assets for sale, that would allow you to sell assets. You were doing purchase accounting, and that left you with a big hunk of goodwill, and there had to be an arrangement as to what - how the FDIC would treat the goodwill. Otherwise, the bank is insolvent the day after the transaction. And that was to be done by allowing PSFS to treat the goodwill as an asset, and it drops down to capital, then, if it's allowed to be treated as an asset.

Tr. 332:4-14. Like Chairman Isaac, Ryan vigorously disputes that the FDIC reserved unto itself the right to discard goodwill in determining the capital adequacy of the Bank:

> No, it would have been a crazy concept. I mean, that puts us immediately subject to supervision, instantly, for having done the transaction. And goodwill is goodwill, and that's what we were worried about. The reason for getting something in writing on it was to assure that the FDIC would treat the goodwill as an asset and wouldn't subtract it out on their regulatory considerations.

*   *   *   *

> The transaction could not have gone ahead without that. Nobody in their right mind is going to enter into a transaction where the regulator says you can put [it] in your capital ratios, but remember, two months from now, they can come down and say, you know, I don't like the goodwill in your capital assets, so I'm going to start treating you as though you don't have enough capital.

Tr. 333:6-21; *see also* Tr. 333:22-334:14 (rejecting distinction now urged by the government, finding that such a reading of the contract "would put PSFS in a position where it's subject to supervisory control for having entered into the transaction"). Mr. Ryan unhesitatingly rejected the suggestion that the agency was free to treat goodwill as a lesser type of capital:

> My recollection is very strong on the general proposition. The whole reason for that clause in the MOU is because of the apprehension that the FDIC might view the goodwill as something other than a good asset, and would not give it credence in capital. And the whole function of it was to do that, yes, and that was, I think, perfectly, clearly understood by the people at the time, that that goodwill was supposed to be treated as an asset.

Tr. 341:19-342:2; *see also* Tr. 368:3-8 ("The goodwill was to be counted as an asset and amortized over 15 years, not 13 years or until some examiner thought that he was worried about the goodwill; it was to be treated as an asset and amortized over — over 15 years. Otherwise, we would have been idiots to have entered into the transaction."); Tr. 362:7-11 ("I knew the goodwill was an asset that might well be looked at as a bad asset, a poor asset, and we were negotiating to get them to agree that they would treat it like an asset, as it had to do, or we disappeared and went under the day after the transaction").

<u>Anthony J. Nocella</u>

Anthony Nocella, a graduate of LaSalle University and the Wharton Graduate School of Banking, was an officer of PSFS and Meritor from 1974 through about 1987. Tr. 73:1-74:23 (Nocella). He served as Chief Financial Officer of the Bank and was a principal negotiator of the

1982 goodwill contract. Tr. 80-83 (Nocella). Mr. Nocella testified that the parties agreed that goodwill would be treated as "an asset that would be amortized over 15 years." Tr. 83:5-9.[7]

Like each of the other witnesses, Mr. Nocella reaffirmed under oath that there was no discussion during the 1982 negotiations supporting the government's current position that goodwill would be treated as regulatory capital only for purposes of satisfying minimum capital regulations. According to Mr. Nocella, "there was no discussions of that nature at all." Tr. 86:1-9. He explained:

> There was a discussion that it would be included in capital, but at the time, there was just no such thing as capital ratios, anything of the kind. It just didn't exist.

Tr. 86:11-14. Mr. Nocella again affirmed:

> There were no discussions of that nature relative to capital adequacy. What it was is, we knew we had six and a half percent capital and we wanted to walk out of the room with more than six and half percent capital.

Tr. 88:3-7. When asked as to his understanding as to how the goodwill would be treated as compared to other assets on the institution's books after the deal, Mr. Nocella was emphatic:

> There was no differentiation. There was no discussion. It was an asset to be amortized over 15 years, and that's what it was. That was a point of negotiation for half a dozen hours.

Tr. at 89:10-16.

4. The Government's Only Testifying Witness Regarding the Interpretation of the 1982 MOU Concurred That the Supervisory Goodwill Created as a Result of the Western Acquisition Was to be Treated as an Asset for Purposes of Determining the Bank's Capital Adequacy.

Rather than creating a conflict among the witnesses, Mr. Gough's testimony — while at times internally contradictory — generally reinforces the testimony of Chairman Isaac and the

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[7] Mr. Nocella testified that the MOU did not specifically state that goodwill would be treated as an asset (only "as goodwill") because goodwill is already an asset, so the dollar amount is

bank officials. First, he reaffirmed Chairman Isaac's testimony that FDIC traditionally treated goodwill with hostility. Indeed, Mr. Gough testified that he "never brought a merger application to the board which had any goodwill in it . . . [because] its future value could not be determined and should be written-off immediately." Tr. 2702:16-21. He explained, however, much like Chairman Isaac did, that the early 1980s presented a unique and profound problem to the agency. Tr. 2696:7-8. "It was clearly apparent to the FDIC it was only a matter of time before these institutions died." Tr. 2698:6-7. *See also generally* Tr. 2697-99 ("And we had a series of institutions listed that were listed by their, I guess you might call it a death date, they were only going to last so long if these interest rates continued, and some plan had to be developed to survive, to allow them to survive at a cost that would be cheaper than liquidating.").

Mr. Gough also freely touted Chairman Isaac's role in forming the FDIC policy. According to Mr. Gough, Chairman Isaac, "as head of the FDIC, . . . had final say on anything." Tr. 2718:19-20. "He was very involved in the whole [negotiating] process." Tr. 2719:14-15. Mr. Isaac was very active in the early part of the deal, was always informed as the deal progressed, and always had ultimate authority on the PSFS deal. Tr. 2781:14-21 & Tr. 2782:5-7.

Mr. Gough also lauded PSFS management:

> We weren't going to turn the institution over to any management team that we thought incompetent. We had to have a high confidence level in the management, that they could work through any potential problems they might see. We would then assume an interest rate scenario that was comparable to what existed at the time, and given that, and the type of assistance that was given, and the other reinvestment possibilities they had, that this management team could keep this institution going for the foreseeable future. On a profitable basis.

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already included in capital. Tr. 84:18-85:1.

Tr. 2723:13-25; *see also* Tr. 2818:17-2819:2. In fact, there were some potential acquirers that FDIC would *not* allow to bid on a failing bank, given the condition of their own institution. Tr. 2717:8-14. With respect to the PSFS deal, Mr. Gough testified:

> What we're saying, in fact, is we still are not crazy about goodwill, we're not going to require you to get rid of it immediately, we're going to allow you to carry it on your books for 15 years but you have to amortize it; *i.e.*, you have an expense every year to amortize that asset down to zero over 15 years, and that's clearly what we said.

Tr. 2735:6-19. In Mr. Gough's view, treatment of supervisory goodwill in this manner "allowed what [PSFS was] acquiring to be reflected as the same capital as when [it] acquired it." Tr. 2739:4-7. The agreed-upon treatment of supervisory goodwill was necessary because, without it, PSFS's "capital account . . . after the merger or after the transaction was completed, would have been in such a state as to raise supervisory concerns," Tr. 2730:3-6, possibly leading to seizure of the institution. Tr. 2730:14-20. Significantly, Mr. Gough concluded that FDIC accomplished its goal with respect to the PSFS-Western merger:

> We would have a merged institution that was viable for the foreseeable future rather than having to liquidate a $1.2 billion institution at a cost of almost $700 million. The FDIC was looking at this as the most efficient way to solve the mutual savings bank problem. *I think looking back on it, history will say it worked.*

Tr. 2760:5-10 (emphasis added). Indeed, the deal should look satisfying to Mr. Gough and the government as it allowed FDIC to escape any payout to any depositor of either Western or Meritor. Tr. 4277:22-4278:9 (Hartheimer).

Perhaps most significantly, Mr. Gough testified that Western goodwill had to be treated as an asset <u>both</u> for purposes of determining compliance with minimum capital requirements, Tr. Tr. 2731:25-2732:5 (goodwill would be considered in the calculation of regulatory capital), and for purposes of determining whether the bank was solvent. Tr. 2790:4-20 ("It would count toward solvency"); Tr. 2806:23-2807:4 (same); cf. Tr. 2940:8-16 (Fritts) (insolvency in 1982 meant zero capital). Mr. Gough explained:

> Q. Mr. Gough, just a few questions. We had touched on how goodwill was applied or interpreted by the Regulators. I believe you testified they would be considered for solvency purposes or a solvency analysis, *and for regulatory capital adequacy purposes*; is that correct?
>
> A. I think so, yes.
>
> Q. And you said, that viability was a different animal – I'm not using your words, but a different – correct?
>
> A. A different analysis, yes.
>
> Q. But viability would look at the capital of an institution, wouldn't it?
>
> A. It's one of the factors that we would certainly look at in looking at an institution.
>
> Q. And in making that analysis on viability and looking at capital you would include the goodwill; correct?
>
> A. In PSFS's case, yes.

Tr. 2806:23-2807:16 (emphasis added). Mr. Gough went even further, explaining that FDIC was required to predicate its decision-making on the assumption that the Bank's Western goodwill was real or legitimate capital. For example, he hypothesized that if Meritor had wished to expand, or otherwise sought regulatory approval for some contemplated action, the agency could not withhold that approval on the basis that much of the Bank's capital consisted of supervisory goodwill. Tr. 2800:15-2802:4.

Mr. Gough's testimony closes the loop as to all participants in a negotiation surrounding the FDIC–PSFS 1982 contract. In each case, the witness has affirmed under oath that the supervisory goodwill created out of the Western acquisition was to be treated as capital for purposes not only of determining capital compliance, but also for purposes of determining capital adequacy. *See* Tr. 86:17-87:5, Tr. 89:2-6 & Tr. 125:4-6 (Nocella); Tr. 1530:5-25 & Tr. 1531:1-9 (Isaac); Tr. 106:5-25 & Tr. 103:23-104:6 (Nocella); Tr. 367:24-368:8, Tr. 377:9-379:4, Tr. 362:4-11, Tr. 360:22-361:4, Tr. 334:9-14 & Tr. 341:16-342:2 (Ryan); Tr. 277:1-278:2 (Cooke). In fact, Chairman Isaac and Messrs. Cooke and Ryan testified that the goodwill was an alternative to, and was to be treated as good as, cash. Tr. 1525:1-1526:9 (Isaac); Tr. 304:17-23 (Cooke); Tr. 338:14-22 (Ryan). And Examiner Robert Valinote, who was specifically tasked to monitor the condition of PSFS following the Western transaction on behalf of the FDIC's Washington Office, affirmed his understanding that there had been an "upper level determination in the FDIC" that the intangible capital of the institution was to be viewed "the same as" the Bank's tangible capital for purposes of determining capital adequacy. Tr. 2836:17-2838:1 & Tr. 2890:4-17 (Valinote); *see also* Tr. 3128:10-19 (Lutz) (reading 12 C.F.R. 325.5(b) (1985) as requiring that supervisory goodwill "continue to be counted as capital for purposes of determining capital adequacy"); Tr. 4653:7-4655:23 (Hammer) (obtained assurances from FDIC Director of Research Paul Horvitz regarding treatment of goodwill; believed goodwill could be treated as an asset for all regulatory purposes; left Chase Manhattan Bank "to go to PSFS because I figured it had plenty of time to turn around and had plenty of capital").

5. At the end of the day, Plaintiffs' interpretation of the 1982 MOU is the only reading of the 1982 Agreement that makes any sense.

Of course, after 120 hours of testimony and the admission of literally hundreds of documents, there is no evidence that anyone involved in the 1982 MOU ever articulated at the time that all that FDIC was committing itself to was that the Bank could treat goodwill as an asset only for purposes of calculating their capital ratios. As Mr. Cooke suggested, FDIC would have had no one with whom to negotiate had that position been articulated at the time. Tr. 277:22-278:2 .

The absurdity of the government's contract construction is revealed by testimony of one of its most ardent defenders. Former FDIC Regional Director, Paul Fritts, readily acknowledged that tangible capital, or "pure equity," was all that mattered ever. Tr. 2953:11-17 & Tr. 2955:1-2956:6. Mr. Fritts went so far as to agree that ratios, standing alone, were meaningless. Tr. 2952:14-21, Tr. 2966:15-21 & Tr. 2955:1-2956:6; *accord* Tr. 908:12-16 (High); Tr. 2046:8-12, Tr. 2065:10-15, Tr. 2075:14-17 & Tr. 2077:7-2078:10 (Mancusi). If, as Mr. Fritts has testified, capital ratios are meaningless, then the government's stilted reading of the 1982 contract afforded PSFS absolutely nothing. After all, under the government's reading of the contract, the Bank could satisfy minimum capital requirements with the Western goodwill yet leave the institution exposed to severe adverse regulatory action, including termination of insurance or loss of charter, because of the type or quality of capital that goodwill provided. As the government so frequently has reminded the Bank and this Court, goodwill provides no cushion in the event of losses; it is a nonearning asset; it is in fact a drag on earnings. Why, one must ask, would such respected management as Mr. Cooke and his team agree to risk the oldest savings association in the country and go from a positive net worth of more than 3% to a net worth of *negative* 3.6%, leaving the Bank exposed to the whims of the FDIC? The answer, of course, is that they did nothing of the kind. The government's *post hoc* reading of the contract is, at the end of the day, not supported by the evidence, fails to conform with the reality of the circumstances existing at the time, and ascribes to the respected PSFS management team a "madness" that the Supreme Court failed to impute to the management of the plaintiffs in *Winstar*. The result here should be no different.

III. THE UNITED STATES BREACHED THE PARTIES' 1982 CONTRACT

A. FDIC Began to Disregard the 1982 Contract Almost Before The Ink Was Dry

The testimony of some FDIC regulators that the goodwill contract, in their view, permitted the agency to disregard PSFS's, and later Meritor's, supervisory goodwill when determining its capital adequacy is itself evidence of breach. That is, if FDIC, or those at FDIC who regulated Meritor after the 1982 transaction, considered themselves free to discard the Bank's supervisory goodwill for whatever purposes, one would not reasonably expect the same individuals to treat the Bank's supervisory goodwill in a manner broader than that which they thought was required of them. This is especially so given the agency's historical, well-established hostility to goodwill. Tr. 1519:19-21 & 1532:18-1535:9 (Isaac); 2702:4-21 & 2735:9-20 (Gough); 3117:23-3118:15 & 3173:19-3174:7 (Lutz); 4970:23-4971:6 (Ketcha); Tr. 5467:19-5468:4 & Tr. 5467:19-5468:4 (Brumbaugh).

As shown below, once it is established that the agency was bound to treat the Bank's goodwill as regulatory capital for *all* regulatory capital purposes, the evidence becomes overwhelming, and indeed, basically undisputed, that FDIC breached — breached immediately and breached often — the 1982 contract.

1983 In his November 30, 1983 Report of Examination, the FDIC Examiner-in-Charge, Edward R. Albertson, observed that "[t]angible net worth is widely used as an investment guide to determine adequacy of capital." He thus performed the calculation, noting that "[i]f intangible assets are deducted from equity capital, the bank's adjusted capital ratio on a tangible net worth basis would be only 0.39%." *See* FDIC Report of Examination as of November 30, 1983 (PX 42 at 1-a-1). Ironically, the institution's tangible net worth was 60 percent *higher* immediately prior to its seizure in December, 1992. *See* Memorandum to Paul G. Fritts from Nicholas J. Ketcha Jr.

(PX 491) at 2) ("Bank calculations for 9-30-92 show . . . a tangible shareholders' equity to total assets of 0.61%").

It is not surprising that Mr. Albertson focused on the bank's tangible capital. At trial, he acknowledged that he has considered PSFS's goodwill as "fluff" that he would therefore "immediately deduct" when analyzing its capital account. Tr. 796:23-797:22 & Tr. 827:19-828:19. Mr. Albertson was the Examiner-in-Charge of three examinations of Meritor, in 1983, 1987 and 1988; and he participated in approximately six examinations of the Bank. Tr. 784:17-25 (Albertson). He noted that FDIC always deducted "fluff" such as goodwill when assessing a bank's capital, Tr. at 797:2-22 & 824:9-19, and further admitted that — notwithstanding the 1982 MOU — he and his fellow examiners treated Meritor's goodwill no differently than the goodwill on the books of any other institution. Tr. 828:14-18 ("I mean, it just wasn't an asset as we're used to. I mean, you look at your capital account and you immediately deduct, in your mind, an intangible capital as you would at any other company."); *see also* Tr. 3177:2-3179:1 (Lutz). In fact, Mr. Albertson has testified that, in his view, "the major problem" at Meritor was "the fact that bank management had been treating the supervisory goodwill as something other than garden variety goodwill." Tr. 822:11-23.

1984 The following summer, FDIC denied Meritor's application to retire 2 million shares of common stock. The entire basis for FDIC's decision was the "adverse effect the proposed retirement of common stock would have on the bank's already low *tangible equity capital position*." *See* FDIC Order (July 27, 1984) (PX 51) (emphasis added). The Bank strenuously protested this decision, and still more strenuously protested its basis, arguing that FDIC was ignoring the 1982 agreement and in effect punishing PSFS for having helped the government by taking over Western. *See* Letter from Anthony J. Nocella to Kenneth L. Walker

(PX 60). FDIC yielded on the latter point, eventually agreeing to reaffirm the 1982 agreement (*see* Letter from A. David Meadows to Anthony J. Nocella (Exh. 62)), but still refused to allow the stock repurchase to go forward. *See generally* Tr. 230:25-231:8 (Nocella); 284:13-22 (Cooke).

While understandably declining to second-guess FDIC's denial of PSFS's request on the merits, Chairman Isaac nonetheless found that the basis upon which the agency denied the request was inconsistent with the 1982 MOU:

> Well, I don't think it would be appropriate to say we're going to reject this based on the fact that you don't have sufficient tangible capital, because that's not the measure we agreed to in the MOU. We agreed that we would look at capital, including this goodwill.

Tr. 1547:12-17. Mr. Gough similarly agreed that the FDIC action, to the extent it was predicated on the Bank's low tangible capital, was not "consistent with the 1982 MOU." Tr. 2799:17-19.

While Chairman Isaac and Mr. Gough acknowledge that FDIC action predicated upon the Bank's "low tangible capital" is inconsistent with the 1982 MOU, FDIC's practice of discarding the Bank's supervisory goodwill was now well under way, and would not stop until Meritor's doors were padlocked almost a decade later.

1985 In the December 13, 1985 Report of Examination as of June 30, 1985, Examiner-in-Charge Joseph Modla opined:

> In regard to the grandfathered intangible, management maintains that the value of that asset is supported by a number of items including the value of core deposits and branch offices acquired in the Western merger and the value of the FDIC income maintenance and loss protection agreements also relating to that merger. While there may be some value to that intangible, no current documentation is available to support it. For many years, the Corporation's policy has been to exclude intangibles when determining a bank's equity capital. . . . In view of the size of the Western goodwill, approximately $625 million, management has been asked to prepare a valuation for review by the FDIC Regional Office.

*   *   *   *

> It is evident that a capital enhancement program is necessary to ensure a realistic level of protection for this institution.

See PX 68 at 1-1. Shortly before this examination, FDIC had for the first time promulgated regulations setting forth minimum capital ratios. *See* 50 Fed. Reg. (DX 444) at 11128-38. Under the new regulatory regime, insured institutions were required to maintain a 5.5% primary capital ratio and a 6.0% total capital ratio. Id. at 11136. In his Report of Examination, Mr. Modla noted that the Bank's primary and total capital ratios — if goodwill were included — were 6.85% and 7.04%. Consequently, Mr. Modla was recommending "a capital enhancement program" for an institution whose primary capital ratio was *135 basis points above the required minimum*.

Again, Chairman Isaac weighed in at trial, testifying that "[t]his language strikes me as bizarre." Tr. 1553:2.

> Just totally ignores that we entered into a contract to agree to count the goodwill at face value, and there is — no examiner has any business trying to ask them to re-evaluate the goodwill.

Tr. 1553:4-7.

1986 As a result of the 1985 examination report, and the concerns Mr. Modla raised about the institution's capital position, FDIC recommended for the first time that the Bank enter into a Memorandum of Understanding requiring the Bank to maintain a heightened level of capital. *See* Letter to PSFS Board of Directors from FDIC New York Regional Office Director Edward T. Lutz (Jan. 27, 1986) (PX 79). In the letter that accompanied the 1985 Modla Report of Examination, Regional Director Lutz acknowledged that FDIC had "serious concerns relative to some of Examiner Modla's findings, especially the bank's equity situation." Id. Mr. Lutz there concluded that "[n]ecessary strategies to assure proper administration of bank capital is an integral part of the Memorandum of Understanding we wish to enter into with you." Id.

In a January 22, 1986 confidential memorandum to the file, Mr. Lutz confirmed the link between Meritor's <u>tangible</u> capital and FDIC's desire for a Memorandum of Understanding that included heightened capital ratio provisions:

> While the inclusion of [the goodwill and Notes] in equity is in accordance with regulatory parameters and agreements, further growth and subsequent depositor protection cannot be realistically supported by such equity accounts. . . .
>
> On December 13, 1985 . . . a proposed Memorandum of Understanding [was] presented to the directorate . . . . The Memorandum includes development of a written plan to maintain a 6.5 percent primary capital ratio. . . .
>
> *   *   *   *
>
> The capital program will be subject to ongoing discussions and is considered the primary basis for our entering into a Memorandum of Understanding.

Confidential Memorandum to DBS Files (Jan. 22, 1986) (PX 77) at 1-2.

Mr. Lutz grounded his decision-making on the erroneous assumption that the Bank could not leverage its goodwill, and that the institution instead could grow based solely on its tangible capital cushion. *See* discussion *infra* at __; Tr. 3197:24-3198:22 & 3281:6-25 (Lutz). Mr. Lutz's after-the-fact reading of the 1982 MOU not only fails to comport with the Bank's understanding of the agreement, but also fails to comport with Chairman Isaac's understanding of the agreement.

> I would say if they [FDIC regulators] are not counting the goodwill as a legitimate part of the capital structure, then they should, and that, if their analysis does not include it, they are violating the agreement. But I don't know what they did here, and I would hate to, based on reading a sentence, make a judgment about it.

Tr. 1557:18-24 (Isaac); *see also* Tr. 1559:20-22 (Isaac) (PSFS's supervisory goodwill "was part of their capital structure, and they can — it counts as any other capital does [under the 1982 MOU], which means you can leverage it.").

The 1986 draft MOU did not mention the Bank's supervisory goodwill at all. *See* PX 78; *see also* Tr. 3143:10-14 (Lutz) (source document of MOU is the 1985 Report of Examination, which contained discussion of FDIC's traditional view that intangibles are ordinarily excluded in assessing capital adequacy). While no Memorandum of Understanding was executed in 1986, the language of the 1986 draft MOU (and an MOU drafted by FDIC in 1987) is "very similar to the language that was ultimately used in 1988," compare PX 78, PX 91 & PX 172, and represents the "pulling out" of a gun that eventually goes off — in 1988. Tr. 5487:13-22 (Brumbaugh). "The problem" FDIC sought to resolve, as reflected in the language of the draft MOU's, "was how to raise tangible capital in order to provide protection to the FDIC fund . . . ." Id. To be certain, the documents and testimony discussed above exemplify a constant feature in FDIC's supervision of Meritor: Bank examination reports focus on the Bank's tangible capital, and regulatory action is subsequently proposed to require the Bank to meet heightened capital ratios and, in effect, replace some or all of its supervisory goodwill with tangible capital.

1987 FDIC's practice of internally discounting the Bank's supervisory goodwill continued unabated. In the Confidential Supervisory Section of the Report of Examination that was commenced as of September 30, 1986, and completed February 26, 1987, Examiner-In-Charge Modla wrote:

> Growth in this bank is governed by funding availability and capital constraints. Thus, while the bank has been able to maintain capital in excess of regulatory minimum levels, ... while presently in excess of 7 percent, the bank's primary and total capital ratios are deceptive. By agreement with the Corporation, the bank is including $277 million of note issues that normally cannot be included as primary capital in other banks and, in addition, $559 million of goodwill from the Western Savings Bank merger is not deducted from the bank's capital structure. Deduction of that goodwill reduces the bank's total capital ratio to 4.01 percent.

PX 88 at A-1. Chairman Isaac was asked whether this language was consistent with the 1982 MOU. Chairman Isaac testified:

> I am very troubled by the language that the capital ratios are deceptive. Nobody was deceiving anybody. It was agreed to by the FDIC's senior people and the board of directors that they would treat the capital account in a certain fashion, and they were treating it that way, and that's not deceiving of anyone, so I don't appreciate that characterization of it. I think it's incorrect. Call it what you might, but it's not deceptive and *it is not consistent with the agreement we entered into*, a contract we entered into, to call it deceptive.

Tr. 1562:17-1563:2 (emphasis added).

Chairman Isaac put it best when he testified that, from his perspective as the individual tasked with proposing and implementing a strategy to deal with the savings bank crisis, as the principal architect of the policy as it related to supervisory goodwill, and as Chairman of the FDIC who authorized the 1982 FDIC-PSFS agreement: "*There [was] to be no distinction between goodwill capital and nongoodwill capital under the agreement.*" Tr. 1567:25-1568:2 (emphasis added). But, as shown above and as reflected in dozens of other FDIC documents, the agency routinely discarded, discounted or otherwise mentally eliminated the Bank's goodwill when assessing its financial condition and in making regulatory decisions concerning the future of the Bank.

The fact is that the examiners who reported on Meritor's condition during the 1982-92 period, and who proposed the actions that led to Meritor's demise, did not believe — regardless of the 1982 agreement — that the "capital adequacy" issue should be analyzed at Meritor differently from the analysis applied to other banks that had no goodwill agreement. Tr. 796:23-797:22, Tr. 817:5-22, Tr. 824:9-19 & Tr. 827:19-828:19 (Albertson); Modla Report of Examination as of June 30, 1985 (PX 68) at 1; Modla draft of Report of Examination as of September 30, 1986 (PX 94) at CSL012 2349-50; Valinote Quarterly Report re Meritor (1/14/88)

(PX 126) at 5; Tr. 3392:9-19, Tr. 3347:14-3348:4, Tr. 3358:17-3361:5, Tr. 3354:25-3355:17, Tr. 3404:16-3405:25 & 3421:2-16 (Shull); Tr. 1169:8-13, Tr. 1174:1-17 & Tr.1382:16-18 (Fitzgerald); Tr. 996:21-997:14 & Tr. 1011:14-1012:10 (High). At least one reason for this is easily seen: The Regional Office responsible for Meritor made absolutely no effort to instruct the field examiners as to the promises that FDIC had made in 1982. The testimony of the three Regional Directors during this period is particularly telling.

Paul G. Fritts, the first Regional Director tasked with supervising PSFS after it acquired Western (and later the Executive Director for Supervision and Resolutions, who in December, 1992, recommended to the FDIC Board of Directors that the agency initiate insurance revocation proceedings against Meritor), testified that he actually instructed his examiners to ignore Meritor's supervisory goodwill when assessing the bank's capital adequacy:

> I had discussions with them [FDIC examiners assigned to PSFS] saying we're going to look, notwithstanding this [1982] agreement or what it means that we didn't negotiate, the regional office, we've got to determine what the adequacy of the capital position of PSFS is. And my understanding of the agreement [1982 MOU] was that it's only for ratio compliance purposes.
>
> * * * *
>
> I can recall discussions, several, that I had with examiners and the bank to the point that this did not — this agreement, and I don't recall the agreement. I don't recall this document, but the general agreement to permit goodwill to be counted in the capital ratio, that did not follow that it was going to be counted to determine whether PSFS was adequately capitalized or not.

Tr. 2964:4-11 & Tr. 2965:22-2966:14. Mr. Fritts testified that he explained this point to FDIC bank examiners, including the "examiner in charge over there several times." Tr. 2966:7-11.

Ed Lutz, Regional Director from 1984 through 1987, acknowledged that he never corrected the examiners when they made statements in their reports concerning the bank's goodwill that were inconsistent with his understanding of the 1982 MOU. Tr. 3181:17-3183:3.

Mr. Ketcha, Regional Director from 1988 through 1992, does not remember that he himself ever even looked at the 1982 MOU prior to his deposition in this matter. Tr. 4948:19-4949:4. Nor could he point to any briefing or documents which supplied him with an understanding of the terms and conditions of that agreement. Tr. 4951:8-12. Nevertheless, he formed the opinion that the 1982 goodwill agreement "did not restrict the FDIC's supervisory authority in any way," and that the agency was free to assess Meritor's capital adequacy in terms of capital ratios that excluded goodwill. Tr. 5058:16-5059:8; 5092:5-5093:4; 5116:5-5117:15; 5148:24-5150:11; 5156:11-5160:16; JX 3 (Ketcha Dep.) at 78-81, 182-84, 189, 322-23, 451-54. When an examiner was brought in from another region to examine Meritor in 1991, Mr. Ketcha made no effort to educate the new examiner on the goodwill agreement. JX 3 (Ketcha Dep.) at 485.

The examiners' accounts are consistent, and the experience of the 1991 examiner from out-of-region — William Shull — is striking. Mr. Shull learned about the goodwill agreement when he was on-site at Meritor and called the Regional Office to ask about its requirements. The Regional Office actually refused to tell him anything, or even to send him a copy of the agreement, saying instead that he should just examine the Bank from his own independent perspective. Tr. 3328:10-3330:10; 3392:9-15; 3396:20-3397:4; 3399:4-18; JX 9 (Shull Dep.) at 257-62, 372. Mr. Albertson, who served as Examiner-in-Charge in 1983, 1987, and 1988, testified similarly that no one in the Regional Office offered any guidance as to what if any commitments FDIC had made in 1982. Mr. Albertson knew that there was an agreement regarding goodwill (which he and other examiners apparently believed was reflected only in a "letter"), but as far as he was aware, the agreement left FDIC free to treat Meritor's goodwill just as they treated goodwill at other banks — as "fluff" to be disregarded. Tr. 824:9-19; Tr. 826:2-18 (Albertson).

Dennis Fitzgerald was Examiner-in-Charge in 1992, and wrote the exam report upon which Meritor's seizure was based. He had also participated in FDIC's examinations of Meritor in 1983, 1987, 1988, and 1990. Over the course of these five exams, Mr. Fitzgerald logged a total of 1,671 hours of on-site examination work at Meritor, but at no time during the entire decade does he recall anyone in the Regional Office discussing with him what commitments, if any, the FDIC had made with respect to the supervisory goodwill. Tr. 1165:8-1167:4. It should come as no great surprise, then, that Mr. Fitzgerald, like the other examiners who reported on Meritor, treated the Bank's goodwill just as they treated goodwill at other banks, i.e., as virtually worthless. Tr. 1174:1-4 (personally viewed goodwill as "worthless"); Tr. 1169:8-13 (treated Bank's goodwill just like he would any other bank, except that it counted in calculating capital ratios); Tr. 996:21-997:14 (High) (Fitzgerald stated on numerous occasions that goodwill was worthless, should not be counted as capital, and repeatedly expressed concern about the Bank's tangible capital levels). As Mr. Hammer testified: "The examiner in the field, he doesn't care what these fellows up in Washington do. . . . He didn't care what those guys wrote. What did he care? He's doing his job." Tr. 4674:23 -4675:6.

B. FDIC Breached The 1982 MOU By Imposing On Meritor The 1988 MOU, Which Imposed Significantly Higher Capital Requirements On The Bank

At FDIC's insistence, on July 21, 1988, Meritor's Board of Directors executed an MOU with FDIC and the Pennsylvania Department of Banking ("PDB"). *See* 1988 MOU (PX 172). That MOU required, *inter alia*, the Bank to "use its best efforts to increase its ratio of primary capital to total assets to not less than 6.50 percent by December 31, 1988." Id. at ¶ 1. At the time, FDIC regulations required banks to maintain only a 5.50 percent primary capital ratio. *See* 50 Fed. Reg. 11128-38 (DX 444). Most significantly, the 1988 MOU required Meritor to inject $200 million in "tangible equity capital funds" by March 31, 1989, if the Bank could not reach the 6.50% primary capital ratio by December 31, 1988. *See* 1988 MOU (Exh. 172) at ¶ 1. Purportedly reaffirming the government's obligations under the MAA and 1982 MOU, the 1988 MOU provided that the calculation of primary capital under the MOU would ". . . include . . . the unamortized balance of goodwill accounts acquired in connection with the merger of Western Savings Bank. . . ." *Id.* [8]

1. FDIC documents establish that the agency imposed the capital requirements in the 1988 MOU because the agency assessed the institution's capital adequacy on a tangible rather than total capital basis

As noted above, Chairman Isaac concluded that numerous FDIC-prepared documents reflected an analysis of the Bank's capital structure in a manner inconsistent with the 1982 contract in that the agency repeatedly evaluated the bank's capital *without* goodwill. The agency's decision to discount Meritor's supervisory goodwill, however, was *not* confined to the dozen or so documents reviewed by Chairman Isaac. As this Court will recall, plaintiff's expert, Michael Mancusi, both in his Report (PX 543), and in his testimony, Tr. 2043:16-2208:8, reviewed dozens of additional FDIC documents and concluded therefrom that the agency's "real concern is tangible capital." Tr. 2051:16-24 & Tr. 2052:12-20 (regarding PX 117) ("in their composite rating, they are excluding goodwill from their assessments of total capital adequacy"); Tr. 2053:25-2054:1 (regarding PX 144) ("They are focused entirely on the tangible capital in their assessments of capital adequacy."); Tr. 2057:10-18 (regarding PX 42) ("Here again, the FDIC is focused on tangible capital versus total capital and the inclusion of goodwill, they are excluding the goodwill."); Tr. 2059:6-15 (regarding PX 68) ("I think in the case of the entire reading that you did, the FDIC is excluding goodwill or the examiner is excluding the goodwill

[8] The terms of the 1988 MOU were negotiated to some extent, but the principal negotiators for the bank and FDIC agree that Meritor had no real choice but to execute the 1988 MOU or face more severe regulatory action. *See* Tr. 1206: 4-10; Tr. 1224: 21-1226: 19 (Slattery); Tr. 3233: 1 – 3234: 8 (Lutz); Tr. 836:9 – 837: 9 (Albertson).

from his assessment as to capital adequacy. . . . I also think in the second part of what you read, he has said that he chose to ignore the requirement of the 1982 memorandum of understanding to include goodwill as part of the capital analysis.”).

While Plaintiffs here do not seek to repeat Mr. Mancusi’s testimony or detail his Report, there are more than a dozen FDIC-prepared documents in the months leading up to the MOU about which Mr. Mancusi has testified that reflect an unyielding hostility and lack of acceptance toward the Bank’s contracted-for supervisory goodwill and the FDIC’s concomitant failure to treat that goodwill as a real or legitimate asset. These documents constitute powerful evidence that the agency drew distinctions between the Bank’s goodwill and nongoodwill capital, a distinction it was prohibited from making under the 1982 MOU. They further establish that FDIC’s failure to treat the Western goodwill as real or legitimate capital was the driving force behind FDIC’s decision to impose the heightened capital requirements.

For example, in the April 6, 1987 Draft Comments and Conclusions for Report of Examination as of September 30, 1986 (PX 94), FDIC examiner Joseph S. Modla unabashedly discounted Meritor’s supervisory goodwill in his regulatory capital calculations and in his assessment of Meritor’s capital adequacy:

> Also by agreement, the remaining $559 million of Western goodwill is not deducted from bank capital. These agreements have substantially benefited the bank in conforming to FDIC capital standards. *However, in a practical sense, the strength of the bank’s present capital structure must be subjected to serious question because of its composition and the Western goodwill*. Bank management continues to maintain that the Western goodwill has substantial value. Executive Vice President Nocella stated that the acquired Western market share is presently worth $810 million based on calculations provided by an investment banking firm. *Once again, it must be pointed out that the corporation’s policy has been to exclude intangibles such as goodwill when determining a bank’s equity capital. Goodwill is not an earning asset of the*

> *bank and, in a time of need, provides no support since it cannot be marketed as a separate entity*.

PX 94 at CSL012 2349-50 (emphasis added). This commentary was deleted from the final Report of Examination, with comparable comments restricted to the confidential section of the Report that was not to be shared with Meritor. *Compare* PX 94 at CSL012 2349-50 with DX 6 at 1-1-1 and PX 88 at A-1.[9]

Later that same year, Senior Banking Analyst George M. Herger made clear FDIC's connection between true "capital adequacy" and "tangible" capital:

> Capital adequacy, for regulatory purposes, meets numerical minimums. However, when reduced for allowable goodwill and subordinated debt from the Western assisted merger, tangible net worth becomes markedly weak and very much so in light of deteriorated asset quality, rate sensitivity, and weak earnings.
>
> * * * *
>
> Regulatory capital consists of the normal components, plus . . . $277 million in capital notes issued by Western prior to 4-3-82 and approximately $390 million in FDIC allowable goodwill. As of 12-31-86, the regulatory capital ratios were 6.53% primary and 6.70% total capital. However, tangible 9-30-87 primary capital per call report data amounted to 1.92% of average assets and reserves less intangibles with total tangible capital at 2.88%. . . . Capital adequacy appears very marginal for regulatory purposes, the low level of tangible net worth must be seen as cause for concern and the component rating of "4" at the recent FDIC examination was warranted. . . . considering the low level of tangible net worth, the volume of subquality assets is cause for concern.

Memorandum to Regional Director Edward T. Lutz from George M. Herger (Dec. 1, 1987) at 2, 4 (PX 117). At the time, the minimum acceptable primary capital ratio was 5.50%; Meritor thus

[9] In fact, as a result of Examiner-in-Charge Modla's examination report, FDIC again considered in 1987 imposing a Memorandum of Understanding on Meritor which would require the Bank to meet heightened capital ratio requirements. See Draft Memorandum of Understanding (March 19, 1987) (PX 91).

stood 113 basis points <u>above</u> the minimum at the same time FDIC expressed its "concern" about Meritor's "very marginal capital." *See id*.; 50 Fed. Reg. at 11128-38.

FDIC's focus on tangible capital continued into the 1987 examination. *See* FDIC Report of Examination as of December 31, 1987 (March 17, 1988) at 1-1 (PX 119). The report of this examination is important because, as the decisionmakers at FDIC acknowledge, it formed the basis for the MOU that the bank would be forced to sign the following year. *See* Tr. 3143::10-19 (Lutz) (the source document for the MOU is the examination report. They sort of run hand in hand, because the corrective program arose out of the examination report"); Tr. 3219:8-14 (Lutz) (MOU "driven by the 1987 exam report"); Tr. 808:6-8 (Albertson). Regarding capital, Examiner-in-Charge Albertson, a contributor to the first draft, Tr. 807:7-10, and the examiner who had characterized supervisory goodwill as "fluff," noted:

> Primary capital includes approximately $241 million in notes which are allowed as a result of management's agreement with the FDIC in connection with the Western Savings Bank merger. Also by agreement, the remaining $488 million of Western goodwill is not deducted from bank capital. Without these agreements, which substantially benefit the bank, the primary capital ratio would be calculated at 1.68%.

PX 119 at 1-1, 1-2. At trial, Mr. Albertson acknowledged that Meritor's lack of tangible capital as of the examination date was "one of the factors," and, indeed, a "very significant" factor, in leading FDIC to impose the 1988 MOU. Tr. 807:14-808:5. His trial testimony, in fact, makes clear just how little examiners in the field understood how the policymakers in Washington interpreted the PSFS-FDIC 1982 contract. While anathema to Chairman Isaac's view of the contract, Mr. Albertson testified that he did not count the Bank's supervisory goodwill in determining the safety and soundness of the institution, nor did he treat the Bank's goodwill any differently than he would treat any other bank's intangible assets:

> Q. And because it doesn't protect the [insurance] fund and doesn't absorb losses, you deducted it [goodwill] from the capital account of Meritor when you examined that account, didn't you?
>
> A. I think I addressed this question before. I included it in all the capital ratios and in the schedules. I allowed it for regulatory purposes, *and then I examined the bank on a safety and soundness basis, at which point, I use the tangible capital ratio*.

Tr. 881:20-882:3 (emphasis added).

> Q. Line 9. "Questions: Did you disagree with PSFS's position regarding the letter [1982 MOU] because you interpreted the letter differently or because, in your view, goodwill simply isn't as good as gold?[10]
>
> "Answer: Well, no, I disagree with it because of the condition of the bank, and the deteriorating bank, if you're relying on something such as the letter, an intangible source of capital, that's not good for the health of any bank."
>
> Then you go down "How can you rely on capital? What's the worth? I mean, it just wasn't an asset we were used to. I mean, you look at your capital account and you immediately deduct in your mind intangible capital as you would any other company." Is that your testimony?
>
> A. Yes, that's what I said there.
>
> Q. Isn't it true that the so-called letter agreement really didn't affect the way you [analyzed] Meritor's condition at all; isn't that true?
>
> A. That's not true.
>
> Q. Why don't you look at page 28 of your deposition.
>
> A. Yes.
>
> Q. And line 20, "how did the existence of a letter affect the way in which you analyzed Meritor's condition? Answers, I don't think it affected it at all." That was your testimony, was it not?
>
> A. Yes.

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[10] Mr. Albertson subsequently explained that "good as gold" meant tangible capital. Tr. 847:5-7.

Tr. 882:18-883:18.

> Q. Now, we've talked also about the fact that you didn't treat the goodwill on Meritor's books any differently than goodwill on other institution's books. The examiners that you worked with on Meritor followed the same view, did they not?
>
> A. I can't speak for every examiner.
>
> Q. I will let you look at page 33 of your deposition.
>
> A. Yes.
>
> Q. Page 32, line 25. "Were there different views as to how to treat the goodwill?
>
> "Answer: There might have been. I think everybody looked at it generally the same way – well, I can't speak for other people. As far as I know, we all knew it was there. We accepted it and we worked with it. There may have been – as an examiner we are not always kept abreast of regional office discussions from the bank, but as far as examiners talking with the view of examiners which are more or less on the same level, I was always going to be treated this way, and that's it.
>
> "Question: And by 'this way,' you mean you're going to treat the goodwill the same way you treat goodwill on the books of other banks?
>
> "Answer: Yes."
>
> That's your testimony under oath at that time?
>
> A. Yes.

Tr. 825:18-826:18. Mr. Albertson, at least at deposition, and under oath, also affirmed his belief that FDIC never would have required the Bank to raise $200 million as set forth in the 1988 MOU but for the fact that most of its capital consisted of supervisory goodwill.

> Q. Line 16. It says "According to Exhibit 17, the bank's supervisory goodwill at the time was approximately $488 million. Would it be safe to conclude that the corporation probably would not have – the corporation, "meaning the FDIC," probably would not have asked for the 200 million tangible equity infusion instead of the supervisory goodwill, the bank had 488 million in tangible capital? "Answer: Well, that would make sense, you know, if you

add up the figures, and whether there's other considerations for the 200, but just on the addition and subtraction, that would make sense."

Do you see that?

A. Yes.

Q. That was your testimony under oath, was it not?

A. Yes.

Q. And isn't it your belief or wasn't it your belief at the time that the FDIC included these capital provisions to compensate for the quantity of the supervisory goodwill on Meritor's books?

A. You're asking me – you're reading a question or asking me a question?

Q. I was asking you a question. Isn't it your belief the FDIC included the capital provisions in the MOU to compensate for the goodwill on its books?

A. They may have – without the goodwill, they may have asked for more capital, tangible.

Q. Why don't you look at page 28 of your deposition.

"Question: Is it your sense that the corporation, that is the FDIC, included the capital provisions of this MOU in part to compensate for the quantity of supervisory goodwill that Meritor had on its books?

"Answer: Do I have any specific knowledge of that? No, would I guess – if I were guessing, I would say yes."

Is that your testimony?

A. This is page 28?

Q. Yes, 128.

A. Oh, 128, sorry.

Q. Do you see that, lines 3 through 9, page 128? That was your testimony, was it not? Yes?

A. "In part to compensate for the quantity of supervisory goodwill," yes.

> Q. And in terms of signing or not signing the MOU, wasn't the alternative for the institution to not signing it a cease and desist order?
>
> A. We always hoped it wouldn't come to that. That is one of the alternatives.

Tr. 834:16-836:13; *see also* Tr. 817:5-22 (Q. So you didn't analyze Meritor's capital differently from the way in which you analyzed the capital of any other bank you examined? A. Differently? I don't think we did. I can't think of any reason why we would do it differently."); Tr. 801:25-802:3 (agrees that "tangible capital excluding goodwill is a more meaningful view of a bank's capital adequacy."); Tr. 814:10-815:9 (purpose of capital plan was to force bank to augment its tangible capital); Tr. 812:16-17 (critical of Bank's leveraging of the goodwill).

No level of intellectual gymnastics can harmonize the understandings reached by those who actually negotiated the 1982 contract, including Chairman Isaac, with either the documents generated by FDIC or the testimony of the authors of those who prepared the documents. In light of the documentary evidence, and the testimonial evidence regarding these documents, FDIC cannot reasonably dispute that the 1988 MOU was intended to compel Meritor to augment or replace some of its supervisory goodwill with tangible capital. Most critical, of course, is the Report of Examination on which the MOU was based and the testimony of the Examiner who drafted the report and recommended the MOU. Mr. Albertson acknowledged that "the capital inadequacy" that led him to propose the capital-directed supervisory action "was inadequacy of *tangible* capital." *See* Tr. 814: 10 – 815:9 & 821:2-9; Report of Examination as of December 31, 1987 (PX 199) at 1-2; 3/21/88 Confidential Summary (PX 135) at 6 (emphasis added). Mr. Lutz, Regional Director at the time, concurred that lack of tangible capital was at least one of the reasons the MOU was imposed. Tr. 3248:9-Tr. 3249:3 (Lutz), and the contemporaneous FDIC documents similarly show that the lack of tangible capital had been the primary motivation for

FDIC's proposing capital-demanding MOU's in 1985 and 1986 as well as in 1987-88. *See* Report of Examination as of June 30, 1985 (PX 68) at 1; Confidential Memo to DBS Files (PX 77).

In each of these instances, and in many more, *see* PX 543 (Mancusi Report) at 12-15 & Exh. B attached thereto; *see also* Tr. 2031-2062 (Mancusi)[11], FDIC analyzed the Bank's capital adequacy on a tangible capital basis, drew negative inferences, and concluded that regulatory measures were necessary. In each case, of course, FDIC failed to treat Meritor's goodwill as promised, and instead drew an impermissible distinction between the Bank's goodwill capital and its nongoodwill capital. That, of course, is inconsistent with the parties' agreement. Tr. 1567:25-1568:2 (Isaac).

2. Testimony of Former Regional Director Paul Fritts and Examiner Ed Albertson Fit Together To Explain How and Why The Breach Occurred

While Chairman Isaac, his task force and the FDIC Board of Directors adopted a policy pursuant to which FDIC accorded PSFS the right to treat supervisory goodwill as a regulatory capital asset for all regulatory purposes, Paul Fritts, the FDIC Regional Director supervising the Bank immediately after the PSFS-Western merger, nonetheless essentially instructed his examiners to ignore the agreement:

> I had discussions with them saying we're going to look, notwithstanding this agreement or what it means that we didn't negotiate, the regional office, we've got to determine what the

[11] In a January 14, 1988 Quarterly Report, Examiner Valinote again acknowledged the linkage between the MOU and Meritor's *tangible* capital position:

> [I]n its leveraging of *real and fictitious capital* [management] has . . . exposed this institution to excessive interest rate and credit risk. . . . It is for this reason that formal regulatory action should be considered and, therefore, strongly recommended. [Emphasis added.]

PX 126 at 5 (emphasis added).

> adequacy of the capital position of PSFS is. And my understanding of the agreement was that it's only for ratio compliance purposes.

Tr. 2964:4-11; *see also* 2963:15-2966:14. Mr. Fritts himself concedes that he did not partake in the negotiations over the 1982 MOU, nor did he even see the MOU prior to its execution. Tr. 2942:8-9 & Tr. 3014:1-4. But he nonetheless had strong opinions about the advisability of treating the Bank's goodwill as regulatory capital, as he repeatedly affirmed that the agreement did not affect his or his examiners' assessment of the Bank's capital adequacy. *See* Tr. 2999:5-8 ("1982 MOU did not impact at all the FDIC's qualitative analysis of Meritor's capital adequacy"); Tr. 2969:25-2971:10 (goodwill contributes nothing to capital adequacy); Tr. 2988:12-23 (goodwill ordinarily discarded in determining heightened capital requirements because "goodwill is not worth much"); Tr. 2998:11-18 (generally, the more goodwill a bank has "the less well off it is"); Tr. 2974:6-10 (PSFS not permitted to use the goodwill to grow).

Mr. Fritts was perhaps most emphatic in declaring that the Bank's goodwill was worthless after it had sold the assets acquired from Western. *See* Tr. 2974:16-2975:3 (goodwill is worthless after acquired assets are sold); Tr. 3007:22-3008:15 (same); Tr. 2968:12-23 (goodwill only had value if Bank is "just slightly undercapitalized" and Bank "is still holding [acquired] assets"; "vast majority" of regulators looked at supervisory goodwill the same way); Tr. 2955:1-2956:6 ("We only looked at those other things [intangibles] as a marginal add-on"); Tr. 2973:24-2974:5 (goodwill "really had no value" after acquired assets are sold "because it couldn't absorb losses or protect the insurance fund"); Tr. 3064:2-6 (goodwill "would definitely be a negative" after the acquired assets were sold). In so stating, Mr. Fritts adopted a view that was diametrically opposed to the view of those who negotiated the 1982 MOU. *See* Tr. 1543:9-13 (Isaac) (contract "doesn't say anything like that"); Tr. 104:17-105:5 (Nocella) (could sell acquired assets without writing down goodwill); Tr. 340:16-341:6 (Ryan) (same).

Given Mr. Fritts' hostility to goodwill and his insistence that goodwill would never affect his examiners' analysis of a bank's capital adequacy, it is only to be expected that his examiners would follow suit. The FDIC Examination and Quarterly Visitation Reports concerning PSFS reflect as much. *See* FDIC Report of Examination as of November 30, 1983 (PX 42) at 1-a-1; FDIC Report of Examination as of June 30, 1985 (PX 68) at 1-1, 1-2; Confidential Supervisory Section of the FDIC Report of Examination as of September 30, 1986 (PX 88) at A-1; Modla Draft of Report of Examination as of September 30, 1986 (PX 94) at CSL012 2349-50; Valinote Quarterly Report re Meritor (1/14/88) (PX 126) at 5; FDIC Report of Examination as of December 31, 1987 (PX 119) at 1-1, 1-2. Of course, Examiner Albertson, the Examiner-in-Charge for the 1987 examination and a principal player in the first draft of the 1988 MOU, deferred and subscribed to his former boss's view that goodwill is fluff, cannot absorb losses or protect the insurance fund, and thus may not be taken into consideration in evaluating the Bank's capital adequacy.[12] In light of this mindset, it was almost to be expected that sooner or later FDIC would begin to panic over the relatively low tangible net worth of Meritor, especially given the duration of the national economic downturn — the high interest rates and the real estate depression — and the inevitable resulting losses the industry began to suffer. Thus, while the Bank had been assured in 1982 that the agreed-upon treatment of the Western goodwill would accord it time to absorb the Western debt and further provide it with a capital cushion that would provide some measure of protection in times of distress, FDIC's historic hostility to goodwill prevailed over the contract FDIC executed. Albertson, relying on Meritor's low

[12] Mr. Albertson may well have been advised to speak with someone in the FDIC's Washington office regarding the scope of the 1982 agreement, but he never did. Tr. 792:3-13.

tangible net worth, recommended and subsequently drafted the 1988 MOU that set into motion a chain reaction that eventually led to Meritor's seizure four years later.[13]

3. Testimony by Frank Slattery and Former Regional Director Ed Lutz Supports a Finding That the 1988 MOU Was Imposed Upon Meritor Because FDIC Failed to Treat Meritor's Supervisory Goodwill as Real Capital.

Frank Slattery is a veteran of the U.S. Army Artillery during the Korean War, and a graduate of Princeton in 1959 and the University of Pennsylvania Law School in 1964. Tr. 1196:18-20. He has served as general counsel and corporate counsel to a number of companies, including Berman Leasing Company, Big Word Company, and Eltra Corporation, where he primarily worked on mergers and acquisitions. Tr. 1197:6-17. He subsequently became the general counsel of Lease Financing Corporation ("LFC"), and later its president. Tr. 1197:18-21. As president, he caused LFC to invest in Meritor in 1987, initially investing a modest amount, but subsequently gaining an equity share of as much as 5.5 percent. Tr. 1199:16-24; Tr. 1201:16-19.

In March of 1988, approximately six months after LFC's initial investment, Mr. Slattery joined Meritor's Board of Directors. Tr. 1202:5. Mr. Slattery had previously served on the Board of Directors of Provident National Bank for approximately five years. Tr. 1202:8-12. At Mr. Slattery's first Board meeting in March of 1988, several FDIC regulators were present.

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[13] Mr. Hammer may have said it best:

> I worked for the FDIC for two years. They had one thing in mind, in my view - you have plenty of FDIC people here. They had to protect their insurance fund. That's number one on their list. That's number 1, 2, 3, then they worry about 4, 5, 6. That's their job. That's what we worried about when I was there. Now, tangible capital gives you a buffer against the insurance fund, regulatory capital doesn't.

Tr. 4673:25-4674:7.

Slattery recalls that the regulators' presentation to the Board "was something less than a glowing report," and reflected FDIC's view that "there were very definite problems" at Meritor. Tr. 1203:13-1204:3. Mr. Slattery then engaged in his own due diligence, spending much of his time shuffling between meetings with Mr. Lutz, the Regional Director, and members of Meritor's Board, to determine the condition of Meritor. Tr. 1204-05.

Within about a month from his appointment to the Board, Mr. Slattery was selected as the negotiator for the Bank with the regulators. Tr. 1204:13-14. In this capacity, Mr. Slattery had a number of meetings with Mr. Lutz, all in Mr. Lutz's New York office. Tr. 1205:2-5. In the first meeting, Mr. Slattery was joined by Meritor's Chief Financial Officer, Harold Connell. At that time, Mr. Lutz raised the issue of the Bank agreeing to an MOU, a term Slattery had never heard until that meeting. Tr. 1205:7-21. Mr. Slattery's recollections of his meetings with Mr. Lutz are contained in the transcript at pages 1206-1218 and 1223-1232. As reflected in the excerpts below, Mr. Slattery testified that Mr. Lutz pointedly explained to him that supervisory goodwill was not real capital, and that regulators cannot equate the two for purposes of either assessing the financial health of the Bank or determining the appropriate regulatory treatment of the Bank:

> But in the course of those first several meetings, Mr. Lutz told me that he wanted the bank to sign this MOU. He told me that the conditions of the MOU were flexible, and that he would work with us, but that *the capital requirement that he had in the MOU was not negotiable, or if it was negotiable, in very narrow grounds*, but that most other things in it could be negotiated. But he told me that what he wanted first and foremost was to have management regard the regulators as though what the regulators were saying was of some value, and he wanted the board to particularly get involved, to be certain that he had the hearts and minds of the board and of the management.

Tr. 1206:4-16 (emphasis added).

> So a great deal of what I did in the early meetings was ask Mr. Lutz really what was on his mind, why he was as concerned about a bank that he had analyzed versus a bank that I had analyzed

> within the last 60 days, and he saw it quite differently than I. And he went into a discussion of what the role of a regulator is, why the regulators often come up with findings that they share some with the bank, some not with the bank, and he taught me a lot about regulators. . . . In the course of the conversation, Mr. Lutz raised the issue about capital, *and he said we have a very great concern about the capital structure of this bank. And I said why? And he said, well, you have a great deal of supervisory goodwill. And I said, yes, I know, I had seen that. And he said that goodwill is different than other capital. It's different than the capital that you typically would look at because it's nothing more than a bookkeeping entry*.
>
> And I said, but, you know, where did it come from? I had read the footnote in Meritor's annual report which stated some of this. And so we had a long discussion about this, either in the second or third meeting, and I think it was the second meeting. And *so he talked* abo*ut the 1982 agreement, and he talked about what flowed from that, but the net result was he said you can't expect a regulator to put value on that equivalent to what other capital is. And I said, well, why not? I said, the government entered into this contract, didn't they? Yes, he said, but that was at a time when we were trying to assist other banks, and he said you got good value for it*.

Tr. 1207:6-1208:16 (emphasis added).

> Well, I went back a series of times, each time to talk about the MOU, and A, whether we ought to sign it, and B, what should be in it.
>
> And in the course of that, I talked to him several times about that. *He reiterated his claim that you could not expect supervisory goodwill to be regarded by regulators as the same as other capital*.

Tr. 1210:7-13 (emphasis added).

> Well, when *Mr. Lutz told me that the goodwill portion of the capital would never be given much weight by the regulators,* that made an impression on me. And that's why I went back to management, to the old Board members who had been there, and to our lawyers to find out what was meant by this, because I, frankly, hadn't focused on that when I first heard about it.
>
> As time went by, I came to believe that Mr. Lutz, and I assumed the agency that he represented, felt that way, that this was not –

> that this capital was not the same as other capital and the institution had a much different opinion.

Tr. 1216:1-12 (emphasis added). Mr. Slattery also testified that he spoke with Mr. Lutz about what, if anything, would happen to Meritor if Meritor's Board of Directors declined to sign the agreement.

> In the first set of meetings, Mr. Lutz explain[sic] to me what the authority of the regulators was and what they could do, and among other things he went through MOU, cease and desist, 8(a), all of that, because frankly I didn't' know it. . . . When we had [the MOU] almost in its final form, there was a directors meeting or there was a finance committee meeting, I don't remember which it was, and I was asked what if we don't sign this? And I said I think they can do most anything they want to do if you don't sign it, and they expect us to sign it. The Board or the finance committee asked me to go back specifically to Mr. Lutz and to frame it as narrowly as I could, which I did do, and I believe I called Mr. Lutz on the phone, but it is possible I went to see him because it was a pretty important thing, and I was going back and forth once or twice a week to see Mr. Lutz.
>
> And I said if we stop now and we just tell you we're going to do all of these things and we don't sign the MOU, what would you do? He said, well, I don't know if you're seriously asking me that or if you are just doing a pro forma thing. I said I am seriously asking you that. He said, Frank, that would be a breach of faith. We would – could go as far as taking the bank the way it stands. And I said, well, I know a little bit about capital now, we have six point something percent. He said, no, you have 1.5 percent. If we want to, we could take the bank now. I went back and told the Board that.

Tr. 1225:2-1226:6. Mr. Slattery explained that Mr. Lutz's reference to the 1.5 percent figure was to Meritor's tangible capital levels, excluding goodwill. Tr. 1226:8-10. Mr. Slattery subsequently took the information back to the Meritor Board, which proceeded to execute the MOU.

Significantly, Mr. Lutz had an opportunity to respond to Mr. Slattery's testimony, but refuted only a narrow aspect of it. Mr. Lutz, for example, did not hide his disdain for supervisory goodwill. He testified that he made no distinction between GAAP goodwill and supervisory goodwill in analyzing the Bank, notwithstanding the 1982 Agreement that FDIC do just that in the case of Meritor. Tr. 3178:21-3179:1. Mr. Lutz further reaffirmed his view that the Western goodwill was not cash, not a loan, not security, and could not "earn the Bank a dime." Tr. 3179:2-5; *see also* Tr. 3179:22-3181:1 ("I'm a little slow. I don't get how it contributes to capital. I'm not getting it.") Mr. Lutz further acknowledged his concern that Meritor was leveraging, but should *not* have been leveraging, its supervisory goodwill. Tr. 3197:24-3198:1. Indeed, this is reflected in PX 77, a confidential memorandum over Mr. Lutz's name. That document states, in relevant part:

> Present equity capital concerns enhanced by management's seemingly insatiable desire for bank growth and a recent interstate acquisitions since last examination suggest policies detrimental to future capital strength prospects. . . . While the inclusion of [the Western goodwill] in equity is in accordance with regulatory parameters and agreements, *further growth and subsequent depositor protection cannot be realistically supported by such equity accounts.*

PX 77 at CSL012 0364. Lutz reaffirmed that this language reflected his views at the time. Tr. 3197:6-12. Mr. Lutz then conceded that he would not have hesitated to share his thoughts regarding the Western goodwill with Mr. Slattery:

> Q. Okay. And conversation with Frank Slattery, you had several of them concerning the 1988 MOU?
>
> A. Sure.
>
> Q. But you don't recall the specifics?
>
> A. No.
>
> Q. But you would agree that in conversations you had with Meritor, you would have regularly discussed the capital adequacy of the institution?
>
> A Sure.

> Q. In fact, almost every time you met with them, you would discuss that; right?
>
> A. I think that's fair to say, yes.
>
> Q. And so in your conversation with Mr. Slattery concerning the 1988 MOU, you would have talked to him about capital adequacy; correct?
>
> A. I'm sure we did.
>
> Q. And in that context, issues such as goodwill would have come up; right?
>
> A. Perhaps.
>
> Q. And it most likely would have come up as to your view of the goodwill, whatever that might be?
>
> A. No, not necessarily.
>
> Q. But if you were discussing the value of goodwill, you would have shared with Mr. Slattery and/or Mr. Nocella, if it came up, the views you have expressed [here] to the Court under oath, wouldn't you?
>
> A. Absolutely.
>
> Q. Such as that it is essentially a nonearning asset, it's two impacts, it's a drain on earnings and it doesn't earn any interest?
>
> A. That's correct.
>
> Q. And that it doesn't earn you a dime, it's not an investment security, it's not cash, it's not a mortgage-backed security, it's not a loan, you would have shared all of that with him, as well?
>
> A. I would have said that.

Tr. 3226:16-3228:1. Mr. Lutz also has testified that he views tangible capital as an important remedy for whatever ills a bank may have, but that supervisory goodwill cannot cure anything. According to Mr. Lutz:

> [Capital] lays a foundation if you will, for at least, in part, putting the institution into position - you know, if there are embedded losses in the loan portfolio, you are in a position to be able to absorb those losses with the addition of additional capital. It provides, you know, it's free funds coming to the institution, presumably that, you know, will help at least if there are nonearning assets that need to be carried. Those new funds help to carry those nonearning assets. So, yeah, I mean, it certainly is a component of a corrective program to try to get the institution's, whatever, difficulties — whatever difficulties recommended.
>
> * * * *
>
> Q. All right. Now, in terms of what you may or may not have said to Mr. Slattery, Mr. Nocella, would you agree that in terms of the following answers here on page 79 and 80 [of your deposition], that you would have shared this position with them, question, "am I correct that capital is a value to the institution in part because it can absorb operating or loan losses.
> "Answer: Yes.
> "Question: Am I correct that capital is a value to an institution in part because it can be invested to produce positive earnings.
> "Answer: Correct.
> "Question: Is supervisory goodwill a value to an institution in either of those respects?
> "Answer: You shifted from, you were talking about capital and you were talking about supervisory goodwill."
> What's the interface between the two? You have to explain that to me.
>
> A. Where are we?
>
> Q. You would have told them that as well?
>
> A. I did.
>
> Q. "Interface" means connection, doesn't it?
>
> A. Yes, it does.

Tr. 3229:8-3231:20; *see also* Tr. 3160:22-3161:9 (acknowledging that the purpose of the $200 million requirement was to enhance the "buffer against potential losses"). Mr. Lutz's views of goodwill, opinions that he acknowledges he would have freely shared with Mr. Slattery, comport well with Mr. Slattery's recollection of his discussions with Mr. Lutz. Mr. Lutz's testimony thus bolsters, rather than undercuts, Mr. Slattery's testimony. And, of course, of most significance, is that Mr. Lutz does not dispute that these discussions occurred.

In fact, Mr. Lutz disputes very little of Mr. Slattery's recollection of their conversations. To the contrary, the only matter that Mr. Lutz affirmatively disputes is Mr. Slattery's recollection that Mr. Lutz represented that FDIC would seize Meritor if Meritor did not agree to the MOU. "The fact of the matter is, I can't deliver on saying I'm going to seize your institution because I'm not, as FDIC, not empowered to seize an institution." Tr. 3165:8-10. At the same time, Mr. Lutz readily concedes that he may have advised Mr. Slattery that failure to execute the MOU would have resulted in more severe regulatory action against the Bank. *See* Tr. 3232:11-12 ("Would we have taken more aggressive supervisory action? Did I say that? I don't remember."); Tr. 3233:1-9 ("Do you recall whether in the context of discussing the MOU that was under negotiation with the bank in 1988, you ever made the point to the bank management that if the bank didn't agree with a MOU, the FDIC could take more severe supervisory action? Answer, It's possible I said that."); Tr. 3234:2-8 ("Q. And is it possible that you told Slattery that a cease and desist order could follow if they did not sign? A. I simply said it's possible. I said, 'something more severe.' Something more severe could include a cease and desist order. Q. Could it have included a notice to 8(a)? A. Could have.")

There is very little difference between whether Mr. Lutz actually threatened seizure, or words that indicated that seizure could result. Rather, Mr. Slattery's sworn testimony that Mr. Lutz had threatened the institution with more severe regulatory action, whatever that action might be, is again bolstered by Mr. Lutz's own testimony. Consequently, the Court is faced with credible, sworn testimony by Mr. Slattery that is almost entirely unrebutted by the only FDIC witness who would have been in a position to rebut it if Mr. Slattery's statements under oath were false.

Nor is Mr. Slattery's testimony the only evidence of Bank officials hearing from Mr. Lutz that, in his opinion, goodwill simply does not count when he analyzes the Bank. In October, 1987, Mr. Nocella prepared a memorandum to the file documenting one such conversation he had with Mr. Lutz:

> Ed Lutz stated he felt that because of our tangible capital level, we should go under forebearance. He asked me to ascertain the financial costs of this from a capital markets standpoint. He would like us to lower our gap more quickly, e.g. to $2 bil. by 12/31/88. He would like a formal business plan and capital plan which is part of the forebearance agreement because we have changed strategies over the last few years. He would like to see top management hiring and incentives and raises also stopped as part of the expense cut. He felt that paying the dividend was all right especially because of our many Philadelphia retail customers/shareholders. *He felt that the goodwill write-off was not raised at the meeting but will be a "mental" calculation when calculating capital adequacy*. I stated that writing off goodwill for GAAP doesn't strengthen or weaken the institution, but a forebearance agreement might weaken the institution. I told him I'll get back to him tomorrow.

PX 110 (emphasis added); *see also* Tr. 145:23-146:6 & Tr. 149:11-150:6 (Nocella) (same); Tr. 137:6-25 & 232:14-18 (Nocella) (Lutz stated that goodwill should not be treated as an asset, he did not consider it a component of capital, and that he "didn't care" about the 1982 MOU); Tr. 825:11-17 (Albertson) (no reason to believe that Mr. Lutz didn't consider goodwill fluff).

Based on what Mr. Lutz has *not* denied, as well testimony from others reaffirming Mr. Lutz's hostility toward goodwill, Mr. Slattery's testimony is not only credible, but compelling, and should be accepted.[14]

[14] Mr. Slattery was not alone in understanding that the 1988 MOU was driven by FDIC's obsesssion with tangible capital and its failure to treat Meritor's goodwill as real capital. *See* Tr. 2152:16-2153:5 (Hillas); Tr. 405:8-15 (McCarron); Tr. 571:13-574:1 & Tr. 558:20-559:20 (McCarron); Tr. 385:6-11; Tr. 381:8-382:9 & Tr. 357:7-14 (Ryan).

4. Common Sense Supports a Finding that FDIC's imposition of the 1988 MOU Breached the 1982 MOU.

Meritor enjoyed positive earnings in 1983, 1984, 1985, and 1986. Meritor 1986 Annual Report (PX 6) at CSL012 0743; Tr. 920:25 - 921:9 (High). Its losses in 1987, which were almost entirely a paper loss of $330 million due to the expedited write off of a large portion of the goodwill, Meritor 1987 Annual Report (PX 7) at 2, cannot be the basis for FDIC's decision to impose the MOU given that the agency sought the MOU beginning in 1986. Confidential Memo to DBS Files, 1/22/86 (PX 77) at CSL012 0364; Draft MOU (PX 78); Letter from Lutz to Meritor Board (PX 79) at 2. Reduced to its essence, PSFS maintained capital levels more than 100 basis points in excess of the regulatory mimima, yet was not only required to increase its capital levels, but ultimately, to sell two-thirds of its franchise to comply with the onerous terms of the MOU. Accepted at "face value," as Chairman Isaac described FDIC's commitment with respect to supervisory goodwill, and drawing "no distinction" between Meritor's goodwill capital and nongoodwill capital, Meritor's capital levels were most assuredly at healthy levels and therefore could not justify the draconian capital requirements contained in the 1988 MOU.

And common sense again is the answer to the government's mantra that FDIC sought tangible capital to enhance Meritor's earnings and/or its capital adequacy, not just to provide a cushion against losses. Raising capital ratios and forcing the Bank to sell off its best assets would do neither, as FDIC most assuredly understood. After all, the sale of the better assets would necessarily increase the classified assets as a percentage of the Bank's total assets, and would further dampen prospects of enhancing earnings. Michael Piracci, the Assistant Regional Director at the time, testified that he understood that the eventual branch sale would harm the Bank's earning capacity, and that he generally believed that the Bank was "selling something that was really critical to the institution." JX 7 (Piracci Dep.) at 143. Internal FDIC memoranda reflect similar misgivings. DX 1390 (Valinote states in a memorandum to Ketcha: "management's dismantling activities may result in increased exposure for the FDIC insurance fund. Asset origination capacity will be virtually non-existent, depositor confidence will be substantially eroded, employee morale drained, and higher risk asset portfolio retained."); PX 241 (Examiner Francisco writes: "asset quality profile of the bank would be worse post merger because of the sale of higher earning and better quality assets to Mellon."); cf. PX 96 at 4 (Hammer advises in May, 1987 that higher ratios would be impediment to "steady, less volatile earnings").

Nor can it be lost that FDIC not only required Meritor to use its best efforts to obtain a 6.5 percent capital ratio in only a matter of months, but it required Meritor to raise $200 million of tangible capital by March 1989 if the Bank did not achieve the 6.5 percent primary capital ratio by year end 1988. Mr. Mancusi, a regulator for the Office of the Comptroller of the Currency from 1967 through 1985, including stints as Deputy Regional Administrator and as Regional Administrator (the functional equivalent of the Assistant Regional Director and Regional Director in the FDIC) and who served subsequently as Deputy Controller of the OCC, and who in such capacity served for a period of time on the FDIC Board of Directors, testified that in his almost twenty years of regulatory experience, he is aware of only a couple of instances in which institutions were required to raise a sum certain of capital on behalf of the institution. Tr. 1984:1-1999:19; Tr. 2037:19-2038:20.

Significantly, the only circumstances in which regulators ordered banks to raise a sum certain (in contrast to the more common requirement of enhanced ratio requirements) was only after the regulators "had made a determination that if we were to examine the bank again, they would be capital insolvent because of the loan losses that we believe existed in their loan portfolio." Tr. 2038:3-6. Indeed, Mr. Mancusi *never* imposed a requirement that a bank raise a sum certain where he did not reach the conclusion that the bank would be tangibly insolvent at the time of the next examination. Tr. 2038:7-20. The $200 million requirement here, of course, "left the bank with limited options," Tr. 2039:6-15, and caused the Bank to sell all of its suburban branches. But who really benefited from imposition of this requirement? As Mr. Mancusi testified, "it raised for Meritor and for the deposit insurance fund tangible capital in front of the deposit insurance fund." Tr. 2039:18-22. Mr. Mancusi concluded that, based on the documents in the record, together with FDIC's decision to impose a sum certain on the bank, that FDIC's failure to treat supervisory goodwill as a regulatory capital asset "was a substantial factor in their determination" to impose the heightened capital requirements." Tr. 2060:13-2062:17.

Dr. Brumbaugh was even more emphatic. He observed that FDIC, from the first examination after the 1982 MOU onward, repeatedly referred to the need to raise additional tangible capital. "There would have *obviously* been concern on the part of the FDIC, from its perspective, that potentially they might have greater losses, if there's a problem with the institution. But for the institution, that's not [their] problem." Tr. 5467:2-16. As FDIC's problems deepened, so did its concern about the Bank's supervisory goodwill:

> Beginning in 1988 and perhaps a little earlier was the apex and the public perception of the apex of the savings and loan crisis and thrift institution crisis, and it was really the beginning of the public perception of the seriousness of the overall banking crisis. Now, it was at about this time that I began my scholarly work which ultimately led to the work that I did for the House subcommittee in evaluating the condition of the commercial banking industry and the condition of the Federal Deposit Insurance Corporation. And that led to the report that we did in 1990.
>
> As I said earlier, the Federal Savings and Loan Insurance Corporation was declared insolvent in 1986. By 1988, it was clear that the FDIC was beginning to face some of the same problems. The realization was acknowledged in late 1990, and the insolvency

> of the fund was made official in 1991, and this is the period of time in which that was beginning.
>
> * * * *
>
> The problem that the FDIC faced at the time was how to deal with the potential insolvency and resolution of institutions. To the extent that the institutions had adequate market value and/or tangible capital, which was generally used as a proxy, the likelihood of the FDIC suffering losses was less. In a situation like we have in Meritor in 1988, to the extent that the institution was allowed, as it should have been under the 1982 agreement, to count goodwill as an intangible asset in the calculation of tangible capital requirements and, therefore, the FDIC basing actions on it after that, it would mean that if there was a potential deterioration and the need to resolve the institution, the FDIC could suffer greater losses because the institution could remain open and operating longer, and if there was an ultimate resolution, the potential for higher costs would exist, therefore, depleting a fund which was at this point in time known to be under extreme strain.

Tr. 5491:8-5492-25. Dr. Brumbaugh concluded that, based on the documentary evidence, the circumstances existing in the industry and in the agency, FDIC imposed the capital requirements contained in the 1988 MOU to enhance the capital cushion protecting the insurance fund because, in its view, the Bank's supervisory goodwill did not. Tr. 5493:20-5495:10; Tr. 5452:9-5453:16. That conclusion, of course, is overwhelmingly supported by the documents and testimony in the record.

IV. THE 1988 MOU COMPELLED THE BANK TO CARRY OUT A RADICAL DOWNSIZING THAT CONSTRICTED EARNINGS, FORFEITED PROFITABLE LINES OF BUSINESS, SACRIFICED LOW-COST FUNDING AND BETTER EARNING ASSETS, AND INFLATED OPERATING COSTS

Finally signed and executed in August, 1988, the Memorandum of Understanding obligated Meritor to increase its primary capital ratio to 6.5 percent and, if that were not accomplished within four months, also to raise $200 million in tangible capital by the end of the first quarter, 1989. PX 172. As soon as Meritor had satisfied these demands, FDIC immediately imposed still higher capital requirements: 8.5% primary capital and 10.5% risk-based capital.

The MOU, and the Written Agreement that replaced it in 1991, created for Meritor an unrelenting capital crisis that would continue without respite until the day the Bank was taken by FDIC in December, 1992.

A. FDIC Cannot Justify Its Breaches Of The 1982 Agreement By Pointing To Financial Problems That FDIC Itself Created

Because capital could not be raised in the markets, satisfying FDIC's extraordinary capital demands drove the Bank progressively to liquidate its best assets and most valuable deposits. For Meritor's managers, the entire four year period was a break-neck scramble to catch up with the regulators' increasingly aggressive capital targets. For the institution — the oldest and largest thrift in the Nation — it was a massive four-year blood-letting.

The history and predictable consequences of that blood-letting are material to this suit.

That the blood-letting was caused by FDIC's thirst for tangible capital, in disregard of the 1982 agreement, is of course the key fact: we have shown that the first of the government's major breaches, the 1988 MOU, was inspired by tangible capital, and we will show below that the same is true of the 1991 Written Agreement and the 1992 seizure. But the economic consequences of the government's capital campaign against Meritor are also important, for this reason: The government will argue that FDIC caused both the 1991 Written Agreement, and the 1992 seizure, in response to Meritor's general financial condition, not its capital account. The evidence overwhelmingly refutes this argument, but it is an inescapable fact that Meritor's condition in 1991-92 was indeed poor. In large part, that was FDIC's own doing. Consider the sheer magnitude of the liquidation that the government compelled. In less than five years the Bank shrank from $19 billion to $3.5 billion in total assets;[15] the total workforce was cut from 5,187 to

[15] PX 7 at 1; PX 530 at Exh. 7.

917;[16] and 118 of 145 branch offices were sold.[17] As Dr. Brumbaugh put it, "[t]hat kind of shrinkage is unbelievable." Tr. 5506:20-21 (Brumbaugh).

The record shows that the magnitude and severity of Meritor's shrinkage was directly and foreseeably caused by FDIC's capital demands — demands that were made in derogation of the 1982 goodwill agreement. The record also shows that the seriousness of Meritor's financial woes in 1991 and 1992 — including in particular its weak earnings and relatively high percentage of non-performing assets — were a direct and foreseeable result of the Bank's radical downsizing. To the extent, therefore, that the government attempts to rationalize its further breaches of the goodwill agreement in 1991 and 1992 by pointing to those financial problems, it is pointing to problems that, in large measure, FDIC itself wrongfully created.

The predictable consequences of Meritor's downsizing also sheds clear light on FDIC's motive in imposing the 1988 MOU. Because the only possible way for Meritor to satisfy FDIC's demand for $200 million was to sell a large portion of its branch network and its better assets, predictably compromising the Bank's earning capacity and predictably denigrating the quality of its asset portfolio, any suggestion that the purpose of the 1988 MOU was to improve the Bank's earnings or assets is untenable. The 1988 MOU accomplished one and only one purpose: enhanced protection for the FDIC.

B. It Was Not Possible for Meritor to Satisfy the Capital Dictates of the 1988 MOU By Selling Stock

There are only three ways to raise capital ratios: Sell stock, retain earnings, or downsize. Like almost every other bank in the country at the time, Meritor was in no position to retain earnings. And even for the most profitable bank in the country, raising capital through retained

16 PX 8 at 3; DX 766 at 2.

17 PX 7 at 3; PX 11 at CSL 056 0519.

earnings to 6.5% within a matter of months would have been inconceivable. The remaining options, therefore, were to sell stock or to liquidate.

But that in fact left only one option, because satisfying the MOU through a stock sale was impossible. Roger Hillas, with a lifetime of experience in bank stocks, concluded that a stock sale was simply not possible. Tr. 740:21-741:2, 624:1-21 & 707:11-21 (Hillas). Mike High, CFO of Meritor, agreed. Tr. 936:16-19. Both Bankers Trust and Roger Hillas reported to the Bank that a stock sale was impossible. Tr. 409:7-22 (McCarron); Tr. 1243:24-1245:19 (Slattery). Meritor's Board of Directors, which included several savvy and highly experienced investors, agreed with Bankers Trust and Mr. Hillas that efforts to sell stock would be futile. Tr. 1245:20-1246:16 (Slattery); Tr. 625:12-627:17 (Hillas). Plaintiffs' expert Dr. Brumbaugh concurred that at this time "there was no possibility that the institution could raise capital by an acquisition, a merger, or raising capital in the capital markets given the condition of the thrift institution and the banking industry in general at that time[.]" Tr. 5494:24-5495:3 (Brumbaugh).[18]

The key players at FDIC did not disagree. Examiner Valinote, who was intimately familiar with the Bank and its economic environment from his regular quarterly examination reports, testified that in his view a stock sale was not feasible. Tr. 2909:15-2910:21 (Valinote). FDIC examiner Albertson, who authored the exam report upon which the 1988 MOU was based, acknowledged that the markets at the time would not permit a stock sale by Meritor. Tr. 816:7-9 (Albertson). Regional Director Lutz admitted that he himself made no effort to analyze whether

[18] In addition to his almost unequalled level of expertise in the study of thrift institutions during this period, Dr. Brumbaugh was himself President and Chief Executive Officer of a Thrift in 1987. Tr. 5495:14-20 (Brumbaugh). In that capacity, he too sought to access the capital markets (*id.*), making him uniquely qualified to opine on these issues.

it would be possible for Meritor to satisfy the MOU through a stock sale. Tr. 3260:6-3261:11 (Lutz).

The MOU effectively compelled Meritor to raise capital (and its capital ratios) by liquidating itself. Indeed, at one point FDIC Examiner Valinote questioned, in an internal FDIC memorandum, whether it was appropriate for FDIC to force Meritor to liquidate itself rather than for FDIC to seize the bank and conduct the liquidation itself. Tr. 2899:3-2901:13 (Valinote); DX 1390. From this point forward the Bank's efforts to satisfy FDIC's ever-increasing capital demands, by self-liquidation, would be the all-consuming business of bank management. Tr. 1450:22-1451:7 (Slattery). FDIC's demands made it very difficult for the Bank to "do business on a regular basis." Tr. 439:13-440:1 (McCarron).

C. Even Prior To The Sale Of Meritor's Suburban Branch Network To Mellon, Meritor Liquidated Extensive Earning Assets In Its Drive To Comply With The Capital Dictates Of The 1988 MOU

Roger Hillas and Jack McCarron joined the Bank at virtually the same moment that Meritor signed the 1988 MOU. From that moment forward the energies of senior management were primarily directed at satisfying the MOU's capital requirements. The capital demands made by FDIC, in the MOU and elsewhere, put the Bank in an almost continuous life-threatening scramble. Every asset and liability on the books of the Bank was reviewed for its liquidation potential. Tr. 623:22-624:21 (Hillas); Tr. 404:8-405:1 & 529:15-19 (McCarron). In 1988 alone Meritor liquidated $1.8 billion worth of assets. Tr. 933:3-7 (High). Meritor Credit Corporation (a highly profitable $1.4 billion operation that housed all of the Bank's consumer credit assets) — Tr. 439:13-22 (McCarron); PX 11 at 34 — was the first to be sold, and would never have been sold but for FDIC's capital demands. Tr. 623:22-624:21 & Tr. 648:7-13 (Hillas); Tr. 942:12-13 & Tr. 930:1-9 (High). The credit card portfolio held by Meritor Credit Corporation was sold separately, for $88.7 million, and this too represented the sale of profitable business lines for the sake of raising capital. Tr. 930:24-931:12 & Tr. 948:2-8 (High); PX 11 at 34.

A massive liquidation of mortgage-backed securities ($1.5 billion in 1989 alone) was primarily driven by the need to reduce assets to increase the Bank's capital ratios. Tr. 931:20-23 & Tr. 939:6-940:16 (High). Also to enhance its capital position, Meritor sold its Mid-western and West Coast mortgage banking subsidiaries. Tr. 928:23-929:2 & Tr. 942:10-12 (High); PX 8 at 8; PX 201. Meritor Mortgage West, by itself, had a servicing portfolio of $3.3 billion. PX 11 at 34.

Meritor's mortgage banking operation had been profitable. Tr. 977:20-978:10 (High). The West Coast operation posted over $8 million in revenues in only the first quarter of 1989. PX 11 at 34. The subsidiaries Meritor had acquired in the mid-1980s were, generally, profitable. Tr. 919:1-3 (High). But in at least some ways, Meritor was denied the opportunity to take full advantage of the diversification strategy that it had implemented in the mid-1980s. Before the diversified entity could be consolidated and made efficient, the Bank was forced to liquidate its new business lines. Tr. 919:24-920:21 (High). As a result the Bank had the worst of both worlds in that it absorbed the increased operating costs of expansion and yet was denied, to a significant extent, the benefits of that expansion that would have accrued. *Id.*

In 1989 the Bank sold eight branches on the periphery of Philadelphia, for a total of $225 million, to improve capital ratios. Tr. 930:15-23 & 945:15-946:4 (High). These branches were sold at a premium ($9 million, net of expenses — PX 11 at 34), as was the Bank's student loan portfolio, which was sold for $368 million. Tr. 932:3-18 & Tr. 943:19-944:12 (High). Student loans were both guaranteed and profitable. There was no reason to sell them except for FDIC's capital demands. *Id.*

The consequences of rapid downsizing such as Meritor was compelled to undertake were predictable. The sale of mortgages directly reduces earnings, and the sale of deposits and assets to increase capital is self-destructive, both of earnings and asset quality, unless the proceeds are fully re-leveraged. Tr. 167:2-171:1 (Nocella). Even Regional Director Lutz admitted that he thought the Bank's downsizing might be injurious. Tr. 3152:16-3153:15 (Lutz); Tr. 1258:22-1259:18 (Slattery); PX 216. And, in addition to the fact that the sale of earning assets and liabilities predictably decreases earnings and compromises the quality of a bank's asset portfolio, rapid downsizing — as FDIC examiners themselves acknowledged — is almost certain to produce serious overhead problems. Tr. 3826:13-20 (Francisco).

D. In Violation Of The 1982 Agreement, And Without Regard For The Consequences For The Bank, FDIC Compelled Meritor To Sell Two-Thirds Of Its Branch Network, And Its Better Assets, In Order To Improve The Tangible Buffer For FDIC Insurance Fund

By year end 1988, Meritor had succeeded in raising its primary capital ratio to over 6%, well in excess of regulatory requirements. But it had failed to reach the 6.5% ratio required by the MOU, and at the end of March 1989, Meritor had also failed to inject $200 million in tangible capital. The new Regional Director, Nicholas Ketcha, made it abundantly clear that dire consequences would result if Meritor did not raise the $200 million promptly.

1. FDIC Repeatedly Threatened Meritor With Severe Regulatory Sanction If The Bank Did Not Raise $200 Million In Tangible Capital Immediately

In official communications to the Bank commencing in April, 1989, Mr. Ketcha stated that absent the $200 million infusion FDIC would make a finding that the Bank was operating in an unsafe and unsound condition, and take appropriate action. PX 191; PX 200; PX 212. Under Section 8 of the FDI Act, an "unsafe and unsound" finding could support either a Cease and Desist Order or withdrawal of insurance. It was perfectly clear to Meritor management that a regulatory gun had been put to the Bank's head. Tr. 410:7-22 & Tr. 416:13-419:8 (McCarron);

Tr. 949:20-950:10 & Tr. 952:24-954:1 (High); Tr. 1251:12-24, Tr. 1253:19-1254:22 & Tr. 1255:4-18 (Slattery).

Mr. Ketcha was equally adamant in his personal meetings with bank managers. On one occasion Mr. Slattery recounted to Mr. Ketcha the substance of conversations Slattery had had with Mr. Ketcha's predecessor, Ed Lutz. Slattery recounted that Mr. Lutz had assured the Bank that FDIC would be flexible in enforcing the terms of the 1988 MOU if the Bank demonstrated good faith efforts to address FDIC's concerns.[19] Tr. 1206:6-16 (Slattery). Mr. Ketcha's response was simply to observe that he didn't see anyone named Lutz in the room, and to insist upon strict compliance with the terms of the MOU. Tr. 1252:24-1253:13 (Slattery). At trial, Mr. Ketcha did not deny that Mr. Slattery asked him to honor Mr. Lutz's promise to be flexible in enforcing the 1988 MOU, or that Mr. Ketcha's response was simply that Mr. Lutz was no longer present. Tr. 4983:19-4984:8 (Ketcha). An internal FDIC memorandum actually records a conversation in which Mr. Ketcha declined Mr. Slattery's request that the Bank be given more time to satisfy the demands of the 1988 MOU (PX 207), although Mr. Ketcha denies any recollection of the meeting. Tr. 4998:9-4999:19 (Ketcha).

On another occasion, sometime before August 7, 1989, Mr. Slattery again approached Mr. Ketcha. Slattery informed Ketcha that the only way the Bank could raise $200 million was to sell the majority of its branch network, which in Slattery's view would be "madness." Slattery stated his belief that selling the majority of the branch network would be "a mother eating her young" and could only result in a worsening of the Bank's problems. Ketcha's response was that

[19] In addition to addressing his concerns about the Bank’s capital structure, the points on which Mr. Lutz wanted Meritor's cooperation were, principally: (1) replacing CEO Frederick Hammer; and (2) reorganizing the Board of Directors to be more engaged in the Bank's affairs. Tr. 1217:3-25 (Slattery). Both were done. Mr. Slattery replaced Mr. Hammer with Roger Hillas and fired half of the Board. Tr. 1218:1-1219:24 & Tr. 1223:25-1224:9 (Slattery).

he either could not or would not relax the demand for $200 million and that it was the responsibility of the Bank's managers, who were so highly paid, to see to it that that demand was satisfied immediately. Tr. 1248:11-1250:15 (Slattery). *See also* Tr. 2142:18-2143:24 (Hillas). The Bank understood that it had no choice but to consummate the sale, and quickly. Tr. 952:24-954:1 (High).

Mr. Ketcha did not deny, and in fact regarded it as likely, that he threatened Meritor with at least a Cease and Desist Order unless the Bank came up with the $200 million dollars. Tr. 4992:6-20, Tr. 4993:11-14, Tr. 5052:15-5053:11 & Tr. 5054:14-5055:16 (Ketcha); PX 249.

2. In Collaboration With Bankers Trust Meritor Presented FDIC With A Plan To Raise the $200 Million By Liquidating Two-Thirds Of The Franchise Which, Although Obviously Detrimental To The Bank, FDIC Not Only Accepted But Sought To Make Mandatory

After receiving letters from Mr. Ketcha threatening regulatory action absent an immediate $200 million infusion, Mr. Hillas hired Bankers Trust. Tr. 1244:3-1245:10 & Tr. 1251:12-24 (Slattery); Tr. 410:9-22 (McCarron). Bankers Trust concluded that selling the majority of the Bank's franchise was the only possible way to raise $200 million in tangible capital. Tr. 410:23-411:21 (McCarron). Bankers Trust agreed with Mr. Slattery that the branch sale ultimately would weaken the Bank, but insisted that there was no other way to satisfy FDIC's demand. Tr. 1243:18-1244:15 & Tr. 1248:6-1249:23 (Slattery).

FDIC had to approve Meritor's branch sale. Tr. 4991:7-4992:5 (Ketcha); Tr. 954:4-13 (High); PX 230. Bankers Trust incorporated the plan in a written proposal for submission to FDIC, with financial data input from Mr. High and his staff. Tr. 953:7-18 (High); PX 216. Even though the branch sale was the only possible way Meritor could satisfy FDIC's demand for $200 million, Meritor management was concerned that the agency might not approve the plan. Assistant Regional Director Piracci had already communicated to Mike High that he was concerned that the sale would hurt the Bank. Tr. 959:5-13 (High). For that reason, the written proposal was drafted in such a way as to address what Meritor believed was FDIC's primary concern, *i.e.*, protecting the bank insurance fund. The proposal actually analyzed for the benefit of FDIC how the proposed branch sale would reduce the potential exposure to the bank insurance fund from a liquidation of Meritor. PX 216 at 30-31.

FDIC did more than accept the proposed sale. The 1991 Written Agreement, which was first presented to Meritor shortly after the contract for the branch sale to Mellon was concluded, incorporated the capital ratio projections made in Meritor's January 1990 Business Plan, the cornerstone of which was the sale of the 54 branches and related assets based on the Capital Plan proposed by Bankers Trust. PX 236 at 1, 10; PX 249 at CSL005 0634. By incorporating those projections into the Written Agreement and making the realization of those projections mandatory, FDIC effectively sought to obligate Meritor to carry out the plan as described in the Bankers Trust proposal. Tr. 3788:19-3790:25 (Francisco).

The Bankers Trust written proposal also stressed, to the greatest extent possible, the potential benefits that could flow to the Bank from the contemplated downsizing. PX 216.[20] But no one at Meritor had any illusions but that the sale of two-thirds of its deposit franchise and better assets would substantially injure the Bank. But for FDIC's insistence upon an immediate infusion of $200 million in tangible capital, Meritor never would have even contemplated the sale to Mellon. Tr. 412:10-18 & Tr. 575:16-20 (McCarron); Tr. 951:2-13 (High); Tr. 719:8-721:13 & Tr. 728:20-729:9 (Hillas). Prior to FDIC's insistence upon the $200 million infusion,

[20] Arguing that the branch sale was not predictably deleterious for the bank, the Government has emphasized this aspect of the Bankers Trust Plan, stressing the statement in that Plan that its purpose was not only to help Meritor come "into compliance with its FDIC Memorandum of Understanding," but also to make "Meritor healthier and more viable in the future." PX 216 at 1. But as explained by Dr. Brumbaugh (who has prepared numerous such plans for

no member of Meritor's senior management ever even proposed a branch sale of such magnitude. Tr. 951:15-25 (High). Also, however, Meritor's purpose in carrying out the sale was not to make itself a more attractive merger target (Tr. 1082:14-19 (High)) nor to facilitate restructuring. Tr. 523:24-524:7 (McCarron). There was one and only one reason for the sale — to satisfy FDIC. Tr. 415:2-4, Tr. 416:4-7 & Tr. 523:24-524:7 (McCarron); Tr. 1082:14-1083:21 & Tr. 938:11-939:5 (High); Tr. 2153:17-22 & Tr. 717:21-718:8 (Hillas); Tr. 1251:8-11 (Slattery). *See also* Tr. 837:19-22 (Albertson); PX 9 at 2. Neither Meritor nor Bankers Trust believed there was any other way to raise the $200 million, and they believed that if the $200 million were not raised a Cease and Desist Order (or worse) would be the result. Tr. 954:25-955:11 (High). In Mr. Hillas' view, the sale to Mellon cost Meritor its "crown jewels," which would never have happened but for FDIC's demands. Tr. 630:9-631:7 & Tr. 636:4-10 (Hillas); DX 244. None of the regulators seriously disputed this. FDIC Examiner Valinote acknowledged that "ultimately" the purpose of the sale was to improve capital ratios (Tr. 2861:17-2862:2 (Valinote)), and Pennsylvania Secretary Hargrove acknowledged that it was the 1988 MOU that led to the branch sale. Tr. 1936:20-1937:3 (Hargrove).

3. Meritor Structured The Mellon Sale In Such A Way As To Leave Itself A Viable, Albeit Much Weakened, Institution

Mellon Bank paid a 6% premium ($337 million) on the deposits sold which was, at the time, an extraordinary sale. Tr. 957:19-958:10 (High). The high premium was paid because Mellon recognized the extraordinary value of the old PSFS franchise and the loyalty of its core depositors. Tr. 629:1-14 (Hillas); Tr. 420:3-10 (McCarron).

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submission to bank regulators), language of this kind is essentially “boilerplate” intended to foster optimism under adverse conditions. Tr. 5505:14-5506:7 (Brumbaugh).

In packaging the offer to Mellon, Meritor divided its branch network into two pools, one consisting essentially of the downtown branches in ethnic neighborhoods, the other consisting essentially of the suburban branches in the growth areas of the city. The purpose of the pooling was to ensure that the branch network Meritor retained would provide the foundation for a viable financial institution. Tr. 632:20-633:18 (Hillas); Tr. 952:1-953:6 (High); Tr. 1256:22-1258:1 (Slattery). Predictably, Mellon took the more lucrative pool of deposits in the suburban areas which, due to growth there, were the superior asset generators. Tr. 412:20-413:12, Tr. 415:11-18 & Tr. 439:15-18 (McCarron); Tr. 952:8-13 (High). Also, to make the offer attractive to Mellon, Meritor was forced to allow Mellon essentially to cherry pick assets to match the deposit liabilities. Tr. 424:15-18 (McCarron); Tr. 952:17-23 (High).

Notwithstanding the $337 million premium paid for Meritor's best assets and liabilities, the Bank netted only slightly in excess of the $200 million demanded by FDIC. Tr. 957:15-959:4 (High). Indeed, the offer was structured in such a way that Mellon could not accept the sale except upon terms that would guarantee Meritor's receipt of a net $200 million tangible capital infusion. Tr. 958:18-959:4 (High).

4. It Is Undisputed That The Branch Sale To Mellon Did Meritor Substantial Damage

Plaintiffs' expert Dr. John Finnerty demonstrated at trial that a reasonable, objective assessment of Meritor's condition in late 1992 leads to the conclusion that the Bank was indeed viable and, if given time, would have returned to profitability. There is no dispute, however, that the branch sale substantially weakened the Bank — and predictably so.

The sale sacrificed a large portion of Meritor's low cost funding franchise. Tr. 950:25 (High). As a result, Meritor's ability to earn profits would be substantially reduced, unless the premium received from Mellon were fully re-leveraged at a better spread — which of course

FDIC would not allow. Tr. 959:22-960:8 & Tr. 1013:9-21 (High); Tr. 3575:11-3578:7 (Hand). FDIC's examiners, who knew the Bank well, provided the most telling testimony on the damage done to Meritor by FDIC's insistence on the $200 million tangible capital infusion. Dennis Fitzgerald, who had examined PSFS and Meritor a dozen times, was very clear in his final examination report that Meritor's downsizing — particularly the branch sale — had sacrificed earnings: "Occasioned as it was by the sale of better earning assets, [Meritor's downsizing] . . . compromised the Bank's earning capability." Tr. 1170:14-17 (Fitzgerald); *see also* PX 407 at A-1. Mr. Fitzgerald was also clear where the fault for this damage lay: "an overemphasis on reaching capital goals at the expense of profitability." Tr. 1171:12-1172:3 (Fitzgerald); PX 407 at A-1.

Examiner Valinote, who authored the quarterly examination reports for Meritor, was of the opinion that the branch sale "seriously impaired the recovery of the institution" because it sacrificed much of the Bank's core franchise. Tr. 2862:10-21 (Valinote). Mr. Valinote also plainly saw, as Mr. Fitzgerald did, that the author of Meritor's self-inflicted damage was FDIC's demands for capital:

> The positive [result of the branch sale] was that the capital account, as well as I believe the reserve, the loan loss reserve, would have been supplemented.
>
> The negative side was that a good portion of the low cost funding would be lost, and that the ratios of adversely classified assets would, to a degree, skyrocket because of the cut and the total asset number.

Tr. 2866:18-2867:6 (Valinote). Indeed, Examiner Valinote was opposed to the branch sale at the time, believing as he did that it would hurt the Bank's prospects for recovery. Tr. 2893:12-17, Tr. 2897:15-25 & Tr. 2901:23-2902:9 (Valinote); DX 1607; DX 1610.

Both the documentary record and all fact witnesses addressing the matter agreed with Mr. Valinote's observation that the branch sale substantially compromised Meritor's asset portfolio as well as weakening its earning potential.[21] Plaintiffs' expert Mike Mancusi also discussed the fact that the MOU predictably compelled Meritor to sell its "crown jewels" and, with them, its "future earnings." Tr. 2039:6-22 (Mancusi). Because Mellon was of necessity allowed to pick and choose assets to match deposit liabilities, Meritor's nonperforming and nonaccrual loans constituted a much higher proportion of its total loan portfolio as a result of the sale. Tr. 631:22-632:7, Tr. 633:22-634:10 & Tr. 647:18-25 (Hillas); Tr. 440:2-9 (McCarron); Tr. 959:14-21 (High); Tr. 1400:20-1401:4 & Tr. 1170:1-13 (Fitzgerald); Tr. 3769:3-3771:3 (Francisco); Tr. 3311:13-21 (Shull); PX 335 at 2-1, 2-2. As Dr. Brumbaugh concluded: "By all accounts in the record, without, I believe, any contradiction by anyone, regulator, member of the supervisory staff of the institution or anyone else really, this represented the sale of some of the best, if not the best assets of the institution, and the most stable, lowest cost deposits." Tr. 5496:7-12 (Brumbaugh).

There is also no dispute that this increased concentration of nonperforming assets predictably had an adverse effect on Meritor's operating expenses, because the administration of nonperforming loans is costly. *See* Tr. 1170:18-22 (Fitzgerald):

> Q. [The downsizing] also increased in a relative way the bank's operating expenses because the management of troubled loans is costly; Correct?
>
> A. That's correct. The overhead expense on administering bad loans increases geometrically.

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[21] Mr. Ketcha frequently commented on the damage done by the branch sale, and in fact used that damage as his primary justification for imposing still more onerous capital demands in the 1991 Written Agreement. *See* PX 241; PX 300; PX 473; Tr. 5014-5017, Tr. 5029-5030 (Ketcha).

See also Tr. 1614:22-1615:8 (Fitzgerald). Additionally, of course, the sale of the Bank's better assets, quite apart from the loss of its deposit franchise, would compromise the Bank's earning capacity in the future . Tr. 442:3-19 & Tr. 575:9-15 (McCarron); Tr. 950:23-25 (High).

In the Confidential/Supervisory section of his 1992 Exam Report, Dennis Fitzgerald authored Meritor's epitaph. He there stated, somewhat over-dramatically perhaps, that:

> The 1990 sale of two-thirds of the branches, especially those outside the immediate downtown area, and the PSFS trade name to Mellon Bank, may have effectively doomed the institution.

Tr. 1178:20-1179:11 (Fitzgerald); PX 407 at A-1.[22] Dr. Finnerty's expert testimony shows that Mr. Fitzgerald overstated the issue, because Meritor in fact remained viable in late 1992. But all witnesses agreed that the branch sale to Mellon did the Bank serious damage by compromising its earnings capacity, compromising its asset portfolio, exploding its overhead expenses, and sacrificing at least a portion of its historic trade name. *See* Tr. 1012:21-1013:8 (High); PX 407 at A-1.

Plaintiffs' expert Dr. Steven Goldstein analyzed how Meritor could have performed absent FDIC's capital mandates. Dr. Goldstein did not attempt to model how exactly Meritor would have performed. Instead he very conservatively used a "baseline" scenario involving no managerial creativity of any kind. Using parameter values that are for the most part known with certainty from the historical record, Dr. Goldstein showed that had FDIC not breached 1982 promises, and had Meritor been allowed to function normally and without extravagant capital demands, the Bank could have returned to profitability as early as 1992 employing only the most

[22] Remarkably, the Regional Office instructed to Mr. Fitzgerald to delete the observation that the branch sale had doomed the institution. Tr. 1178:20-1179:9 (Fitzgerald); Tr. 5029:8-15 (Ketcha); compare PX 408 with PX 407 (at A-1). The deletion is remarkable because this language reappeared in the confidential section of the exam report, which ordinarily is seen by no one outside FDIC. It appears that the impact of the branch sale, which FDIC compelled Meritor to consummate, was regarded by the Regional Office as a rather sensitive matter.

minimal bank managerial tools. Tr. 1696:1-1697:8 (Goldstein). Dr. Brumbaugh concurred in Dr. Goldstein's overall conclusions. Tr. 5679:4-8 (Brumbaugh).

5. The Record Shows That The Reason FDIC Insisted On Meritor's Carrying Out The Branch Sale Was Its Concern About Tangible Capital And The Existing Buffer For The Insurance Fund, In Disregard Of The 1982 Agreement

It was Regional Director Lutz who imposed the 1988 MOU on Meritor, but it was his successor, Mr. Ketcha, who enforced it and drove the Bank to consummate the branch sale to Mellon. We review below the fact that Mr. Ketcha's immediate response to the consummation of the branch sale was to require a new, more demanding, Written Agreement. Revealingly, a confidential problem memorandum by Mr. Ketcha concerning the imposition of the Written Agreement states that the 1988 MOU had "served its purposes." PX 288 at 2. Every witness in this case, and a multitude of internal FDIC documents, confirm the many and serious injuries that flowed to Meritor from the radical downsizing that was compelled by the 1988 MOU. For this reason Assistant Regional Director Piracci was not in favor of the branch sale, believing it sacrificed too much value. JX 7 (Piracci Dep.) at 140-41. In his view, "they were selling something that was really critical to the institution." *Id.* at 143. Specifically, he saw that the sale would negatively impact the Bank's ability to produce earnings and would compromise the overall asset quality of the institution. *Id.*; s*ee also id.* at 171-73.

The only conceivable benefit to anyone that resulted from that downsizing was an increase in Meritor's tangible capital and thus an enhancement of the buffer for FDIC Insurance Fund. Mr. Ketcha's official statement that the 1988 MOU has "served its purposes" thus confirms that, in enforcing the 1988 MOU he had only one purpose in mind — to enhance protection for FDIC fund — and that that purpose completely overshadowed the welfare of the Bank itself.

As Dr. Brumbaugh put it, if the objective were to enhance Meritor's "ability to earn income then and in the future," forcing it to sell the branches is "exactly what we wouldn't want to do." Tr. 5496:13-17 (Brumbaugh). The only benefit to anyone from the branch sale (apart from Mellon), was to FDIC Fund, because the additional tangible capital would have "the effect of putting a larger buffer between any future deterioration of the institution and FDIC having to realize a loss." Tr. 5496:17-20 (Brumbaugh); *see also* Tr. 5496:23-5498:24 (Brumbaugh) (The predictable impact of the branch sale was to compromise the quality of Meritor's asset portfolio, compromise future earnings prospects, and compromise the ability to raise capital in the markets as well). There is therefore no room for ambiguity in identifying the "purposes" that were "served" by the 1988 MOU.

V. IN RESPONSE TO THE DAMAGE DONE BY THE BRANCH SALE TO MELLON FDIC REQUIRED MERITOR TO SIGN A WRITTEN AGREEMENT WHICH, AGAIN IN DISREGARD OF THE 1982 GOODWILL AGREEMENT, IMPOSED EVEN HIGHER CAPITAL REQUIREMENTS

On December 7, 1989 Mike High and Jack McCarron traveled to New York to meet with the Regional Office staff and to inform them of the terms of the agreement that had been reached between Meritor and Mellon and to advise them that Meritor would succeed in raising the $200 million in tangible capital required by the 1988 MOU. Tr. 421:9-422:15 (McCarron); Tr. 960:19-963:1 (High); PX 230. Meritor looked forward to having the MOU lifted, which was a cloud over the Bank in the financial community. Tr. 422:13-423:2 (McCarron).

To their surprise, High and McCarron were told that the Bank would now be required to sign a Written Agreement. The purpose of the new agreement, it was explained, was to put FDIC in a position where it "could take enforcement action against [Meritor] if they chose to do so in situations where the regulations might not otherwise permit them to." Tr. 423:13-18 (McCarron). Internal FDIC documents confirm that a Written Agreement is highly unusual at

FDIC, and that it was intended in this case to give FDIC leverage to take swift action against the Bank even though the regulations would not authorize such action. PX 24l. The thinking in the Regional Office is not difficult to decipher. After the sale to Mellon, as admitted in the Regional Office's memo to Washington recommending the Written Agreement, Meritor's "regulatory capital . . . greatly exceed[ed] the minimum requirements established by Part 325." PX 300 at CSL011 0333; *see* Tr. 3795:17-3796:1 (Francisco). Unless the Bank could be persuaded to agree to further regulatory demands, FDIC could not legally take action against the Bank for the sake of tangible capital. Obviously, a Cease and Desist Order would not be sustained by the Courts, so long as FDIC was held to the promises it made in 1982 and so long as Meritor's "regulatory capital . . . greatly exceed[ed] the minimum requirements established by Part 325." *Id.* Instead, FDIC relied on threats to secure Meritor's "voluntary" agreement to the setting of still higher capital requirements *See also* JX 3 (Ketcha Dep.) at 316-17 (Purpose of Written Agreement was to allow FDIC to take action against the Bank for capital inadequacy “with haste” and without the need for a series of hearings).

High and McCarron were therefore told at the December 7 meeting that, if an agreement were not signed, the Regional Office could issue a Cease and Desist Order based on a finding that Meritor was in a unsafe and unsound condition. Tr. 424:9-426:1 (McCarron). It was also made clear that the real problem was Meritor's shortage of tangible capital. High and McCarron were told, in language that by that time had become familiar, that the problem was the "quality" of Meritor's capital. Tr. 426:2-21 (McCarron); Tr. 978:11-23 (High). It was understood, and acknowledged, that the references to the "quality" of Meritor's capital alluded to the presence of goodwill. Tr. 426:16-21 (McCarron). In response, Mr. McCarron stated at the December 7 meeting had the FDIC given cash to PSFS in 1982 rather than goodwill, they would not be having this conversation. No one disagreed. Tr. 426:2-15 (McCarron).

In compelling Meritor immediately to raise $200 million when doing so made no economic sense, Mr. Ketcha had disregarded the promise made by Mr. Lutz that the Regional Office would be flexible in enforcing the 1988 MOU if the Bank proved itself responsive to FDIC's concerns. Tr. 1252:24-1253:13 (Slattery); Tr. 4983:19-4984:8 (Ketcha). In similar fashion, the immediate imposition of the 1991 Written Agreement violated assurances that Mr. Ketcha had himself made to bank management. An internal FDIC memorandum records a September 19, 1988 meeting at which Regional Director Ketcha had specifically given Meritor assurances that if the bank's downsizing negatively impacted short-term profitability, the Bank would *not* be subject to "regulatory criticism." PX 177 at 1-2; Tr. 5007:7-5008:3 (Ketcha). Precisely the opposite, of course, is what happened: Ketcha's immediate response, when Meritor consummated the branch sale to comply with the MOU, was to insist upon a Written Agreement with still higher capital ratios. Tr. 5014:21-5016:3 (Ketcha); PX 241.

On February 28, 1990, representatives of the Bank again met with representatives of FDIC Regional Office and the proposed Written Agreement was further discussed. Present were bank counsel (Rodgin Cohen and Jack McCarron) and, for FDIC, Regional Director Ketcha, Deputy Regional Director Mike Zamorski, Assistant Regional Director Piracci, FDIC counsel Sheldon Reisman, and Review Examiner Francisco. Tr. 429:11-430:14 (McCarron); PX 241. The purpose of the meeting was to communicate Meritor's objection to FDIC's using the projections in Meritor's business plan as the basis for the capital ratios mandated in the Written Agreement. Tr. 430:19-431:23 (McCarron); 963:6-24 (High); PX 241; DX 862. It was noted, for example, that the projections in the business plan assumed that Meritor would be able to sell its Florida subsidiary (FA) and, facilitating that sale, convert Income Capital Certificates (ICCs) into preferred stock. *Id.* The bank's representatives also stated their belief that in raising Meritor's capital ratio requirements, FDIC was penalizing the Bank for the presence of goodwill on its balance sheet. Tr. 432:7-20 (McCarron). The response by FDIC was to insist that a Written Agreement would have to be signed, and again FDIC representatives alluded to the fact that the agency believed it was in a position to issue a Cease and Desist Order against the Bank. Tr. 432:21-433:6 (McCarron).

The clear understanding given to Meritor, at these meetings and in other conversations, was that if Meritor did not sign the Written Agreement, FDIC would take even more severe action against the Bank. *Id.*; Tr. 645:12-24 (Hillas). And as plaintiffs' expert Mike Mancusi testified, the tools at the agency's disposal make it impossible to refuse. Tr. 2196:14-16 (Mancusi) ("[T]he fact [of] the matter is if the government or the regulatory agency wants something signed, it's going to be signed.")

The first known draft of the Written Agreement is dated March 6, 1990. It appears to have been drafted in Washington, and states incorrectly that Meritor is in violation of FDIC's primary capital requirements in Part 325 of the regulations. Tr. 3776:16-3777:12 (Francisco); PX 245. The error is telling. The truth was, as the Regional Office knew well, Meritor's regulatory capital at the time "greatly exceed[ed] the minimum requirements established by Part 325." PX 300. The natural assumption in Washington, by whoever was asked to prepare a template for use by the Regional Office, was that if the Regional Office was issuing a capital directive against the Bank it surely was in violation of the capital regulations. That would be true, however, only if the goodwill were disregarded.

A later draft of the Written Agreement (in which the error concerning Meritor's violation of Part 325 had been corrected by the Regional Office) was sent to Meritor on or about April 2, 1990. PX 249. Brazenly, this draft expressly set out *tangible* capital ratio requirements for the Bank. *Id.*; Tr. 3777:19-3779:25 (Francisco); PX 249 at CSL005 0630. All of the ratios in this initial draft were taken directly from the projections in the business plan Meritor had provided to FDIC, which called for the sale of two-thirds of Meritor's branch franchise, the conversion of the ICCs, and the sale of the Florida subsidiary. Tr. 963:6-13 (High); PX 236 at 133; PX 249 at CSL005 0634.

Sometime in the Spring of 1990 there was a third meeting with FDIC. Present were Frank Slattery, Jack McCarron, Roger Hillas and Mike High from the Bank. Regional Director Ketcha and Assistant Regional Director Piracci attended for FDIC. The Bank was concerned, among other things, that the ratios then set out in the draft Written Agreement were so high that the Bank might be in violation of the agreement the moment it was signed. Tr. 435:11-24 (McCarron). Again, it was made clear that the Bank had no alternative to signing, and that if it did not agree to the Written Agreement more severe action — a Cease and Desist Order at the minimum — would be issued. *Id.*; Tr. 968:16-969:7 (High); Tr. 645:12-24 (Hillas). It was also again stated that FDIC regarded the Western goodwill as valueless. Tr. 1267-8:21-1268:8 (Slattery).

It may have been at this meeting that Mr. Ketcha stated that, without an agreement, FDIC would cause Meritor's seizure. Tr. 1269:7-22 (Slattery). Mr. Ketcha acknowledged at deposition that, in the context of negotiating the Written Agreement, he communicated to Meritor management that their only alternatives to signing the agreement were either a Cease and Desist

Order or a proceeding to terminate the Bank's insurance. JX 3 (Ketcha Dep.) at 464-65; *see also id.* at 160-61, 526.

There was little actual negotiation on the Written Agreement. Tr. 1264:15-19 (Slattery). FDIC accepted few changes, and even refused to correct an erroneous business address in the draft. Tr. 771:1-772:2 (Hillas); Tr. 433:7-435:2 & Tr. 436:9-17 (McCarron). FDIC's only movement on the ratio requirements in the Written Agreement was to accept an 8.5% primary capital requirement and a 10.5 % risk-based capital ratio (the lowest of the primary and risk-based capital ratio projections in Meritor's five year business plan) in place of the precise projected ratios in the business plan. Tr. 963:20-24 & Tr. 965:15-20 (High). The 8.5% and 10.5% capital requirements raised Meritor's needed capital 200 and 250 basis points over the requirements applied to other banks. Tr. 455:20-456:11 (McCarron); Tr. 960:13-18 (High). It was very unusual to impose ratio requirements this high. Tr. 2070:9-12 (Mancusi).

The Bank insisted that the Written Agreement expressly provide that the Western goodwill would be counted towards satisfaction of the required ratios. Internally, at least, FDIC recognized that it was already obligated to do that. PX 284. FDIC, however, inserted language providing that the goodwill would be included only "to the extent recognized" by FDIC — language that caused the Bank considerable concern. Tr. 437:1-19 (McCarron). Part of the Bank's concern arose from their knowledge of FIRREA, and a fear that comparable legislation might be enacted affecting Meritor. Tr. 966:6-967:6 & Tr. 971:5-972:6 (High); PX 249; Tr. 433:17-434:7 & Tr. 437:20-439:2 (McCarron); Tr. 1270:18-1272:13 (Slattery). The Bank therefore requested and received a provision stating that if Congress disallowed the Western goodwill, the ratios in the Written Agreement would be renegotiated. Tr. 433:17-434:7 & Tr. 437:20-439:2 (McCarron); Tr. 971:5-972:6 (High); PX 287 at § 1(d); PX 207 at § 1(d).

It was understood by all that the conversion of the ICCs, and the sale of Florida FA, would be critical to the Bank's maintenance of the ratios in the Written Agreement. Tr. 978:24-979:6; Tr. 968:5-15 (High); Tr. 479:24-480:18 (McCarron); Tr. 745:6-10; Tr. 722:15-21 (Hillas); PX 249. There was an irony in this, because ultimately FDIC could determine whether Meritor would be permitted by the FSLIC Resolution Fund to convert the ICCs for stock. Tr. 964:10-15 (High). And, indeed, Meritor's efforts on this front were blocked, and the Bank was ultimately forced to retire the ICCs for over $40 million in cash, which was a hard hit to its capital accounts. Tr. 3823:6-3824:7 (Francisco); PX 578.

As was the case with the 1988 MOU, and as was the case in virtually every aspect of Meritor's regulation, the Pennsylvania Department of Banking played absolutely no role in the drafting, preparation, or negotiation of the 1991 Written Agreement. *See* Tr. 2133:16-21 (Hillas); Tr. 439:3-12 (McCarron); Tr. 1232:13-16 (Slattery); Tr. 1890:13-1891:2 (Hargrove); Tr. 3702:19-3703:1, Tr. 3759:2-10 & Tr. 3711:13-3713:10 (Francisco); DX 875 (PX 292); DX 876. In fact, the government has admitted in this case, in response to a Request for Admission, that "no officials from the Pennsylvania Department of Banking participated in negotiations with Meritor regarding the 1991 WA." Defendant's Response to Third Set of Requests for Admissions at 91.

VI. THE REASON FDIC FORCED MERITOR TO SIGN THE WRITTEN AGREEMENT WAS THE BANK'S TANGIBLE CAPITAL POSITION, IN VIOLATION OF THE 1982 GOODWILL AGREEMENT

According to its FDIC drafter, the core of the Written Agreement was its capital requirements. Tr. 3761:24-3762:3 (Francisco). As Dr. Brumbaugh testified, if FDIC's purpose were to address Meritor's earnings and asset problems it could and would have formulated supervisory actions specifically targeted at those issues, rather than erecting capital demands. Tr.

5513:15-5515:23 (Brumbaugh).[23] Beyond this, the testimony and exhibits introduced at trial make abundantly clear that FDIC's concern was Meritor's *tangible* capital, and that in assessing Meritor's capital, and in imposing the Written Agreement, FDIC completely discounted the goodwill.

A. Continuing Concern Over The Bank's Tangible Capital Account And The Welfare Of The Insurance Fund Drove The Written Agreement

Frequent disparagements of the "quality" of Meritor's capital by FDIC officials confirmed in the minds of Meritor management that FDIC discounted the goodwill and was focused on the Bank's tangible capital. Tr. 1117:3-24; 969:9-970:2 (High). Mr. Hillas was thus made to understand that a discounting of the goodwill, and a focus on tangible capital, had led to both the 1988 MOU and the 1991 Written Agreement.

> Q. Do you know if the fact that Meritor was — had supervisory goodwill on its books, if that had any effect on FDIC with regard to these new capital requirements [in the Written Agreement], based on your knowledge?
>
> A. Yes. From my personal experience, I had become aware, in connection with the raising of the 200 million, which is some time prior to, I believe, late '88, early '89, that in effect, FDIC was implying or saying that Western goodwill did not count as capital, which is the first that — I, as I stated earlier, and many others had lived under the assumption that this was capital — and I became aware that they were drawing this distinction, that this was not capital in their normal sense.
>
> Q. And in terms of that view of FDIC, how did that impact, based on your dealings with them, and with the board on this written agreement and the increase in capital ratios contained therein?
>
> A. In effect, they were saying we hear what you're saying, and we're just going to set these standards at a level that — whatever

[23] Based on his 18 years as a federal bank regulator, plaintiff's expert Mike Mancusi also observed that where the federal regulators wish to address asset quality or earnings problems, they typically fashion supervisory instruments that directly address those problems. Tr. 2078:11-22 (Mancusi).

> level we choose, and that's it. I think these were substantially above what other banks were to maintain. So analytically, you could say they were saying fine, we'll include it, but we'll ignore it by setting these percentages so high that it is meaningless.

Tr. 641:8-642:6 (Hillas). At a shareholder's meeting held shortly after the Written Agreement was signed, Meritor Chairman Roger Hillas explained to the Bank's owners that the reason Meritor was being forced to maintain such high capital ratios was the presence on its books of the Western goodwill. Tr. 644:2-25; PX 310 at 24. Mr. Hillas is known for his honesty.

As is true of most FDIC enforcement actions (*see* Tr. 3143:10-19 & Tr. 3219:8-14 (Lutz)), the 1991 Written Agreement was driven in significant part by the preceding examination report. And as with virtually every FDIC analysis of Meritor throughout the 1982-92 period, the 1990 exam report repeatedly assessed Meritor's capital on a tangible basis. For example:

> Regarding capital, the bank meets the present regulatory requirements for capital but the accounts include a significant volume of grandfathered goodwill and tangible capital is recorded at only 2.4% of total assets.

PX 274 at CSL001 0338-51. *See also* PX 274 at 344, 348; Tr. 3740:13-3741:7 & 3766:1-13 (Francisco).

The requirements in the draft and final versions of the Written Agreement were extraordinary. Review Examiner Francisco, who had a hand in drafting the Written Agreement, acknowledged at trial that, while an early draft of the Written Agreement would have imposed a tangible capital requirement, he is unaware of any other regulatory agreement in which a tangible capital requirement was injected. Tr. 3798:4-13 (Francisco). Similarly, Mr. Fritts (then Director of Supervision in Washington) admitted that it is extraordinary for FDIC to take regulatory action against a bank that is at the time well in excess of regulatory capital requirements. Tr. 2986:21-2987:4 (Fritts). Mr. Piracci, who was responsible for overseeing hundreds of institutions, could not recall a single instance in which a bank other than Meritor was required to meet an 8.5% primary capital requirement or a 10.5% risk-based capital requirement. JX 7A (Piracci Dep.) at 77.

These anomalies are easily explained by FDIC's admissions that a low tangible capital base was the driving factor for the Written Agreement. Given that Meritor was at the time well in excess of regulatory requirements — if the goodwill were counted — it is clear that the goodwill was being discounted when, in justifying the Written Agreement, the Regional Office described the Bank's capital as "grossly inadequate." Tr. 3791:1-3792:7 (Francisco); PX 294 at 1-3, 3. Assistant Regional Director Piracci admitted that the ratios imposed in the 1991 Written Agreement "were in part a function of the amount of Supervisory Goodwill that Meritor had on the books." JX 7A (Piracci Dep.) at 291-92.

The bottom line on the Written Agreement was protecting the bank insurance fund. And because goodwill provides no protection for the fund, it was of no value in the eyes of FDIC.

> Q. Mr. Francisco, am I right that the goodwill provides no buffer for the insurance fund?
>
> A. Goodwill, when its charged off, is an uncollectible asset and doesn't provide a buffer for the insurance fund; that true.
>
> *Q. And am I right that the basic reason for the 1991 Written Agreement was to enhance the buffer for the insurance fund?*
>
> *A. Yes.*

Tr. 3838:24-3839:7 (Francisco) (emphasis added); *see also* Tr. 3797:10-23 (Francisco) ("[T]he purpose of the Written Agreement was to achieve a higher level of capital protection . . . for the fund"); PX 241. Regional Director Ketcha also affirmed at trial his deposition testimony that the Written Agreement was "primarily focused on the low tangible capital base of the institution." Tr. 5041:2-20 & Tr. 5088-93 (Ketcha); JX 3 (Ketcha Dep.) at 470-71. These statements are admissions of breach.

In Washington, Mr. Fritts would have to sign off on the Written Agreement. In his view, of course, the goodwill was worthless. Tr. 2987:11-2988:20 (Fritts). Indeed, Director Fritts admitted at trial that the capital ratios in the Written Agreement were as high as they were in significant part to compensate for the goodwill on Meritor's books. Tr. 3045:12-24 & Tr. 3048:4-17. This accords with the "Washington Office Addendum" to Mr. Ketcha's memo recommending approval of the Written Agreement, which notes that "While management have been successful in implementing a number of measures to downsize and restructure, a low level of tangible capital [and other things] . . . are all factors which remain of serious concern." PX 300 at CSL011 0335.

Plaintiffs' expert Mike Mancusi, based on his 18 years as a bank regulator, and upon his review of the entire FDIC regulatory file on Meritor, testified that FDIC's reasons for imposing the Written Agreement were plain:

> The more capital you can bring into an institution, the more money you have before the deposit insurance funds. I believe the documents clearly show that FDIC was very concerned about the level of tangible capital, and by imposing those requirements, they were forcing the institution to continually bring more tangible capital into the institution.
>
> BY MR. BLOOM:
>
> Q. And why would FDIC do this?
>
> A. Protection against the insurance fund.

Tr. 2072:20-2073:5 (Mancusi); *see also* Tr. 2073:20-23 ("...[T]o a reasonable degree of certainty . . . FDIC would not have imposed the capital requirements contained in the 1991 written agreement but for its disregard of Meritor's goodwill") & Tr. 2195:17-21 (Mancusi) ("All you have to do is read the documents that were produced by FDIC, whether it was correspondence or reports of examination, or memoranda internally within FDIC, that clearly showed their focus was entirely upon tangible capital versus total capital.")

Dr. Brumbaugh agreed. The sheer magnitude of the capital demands in the 1991 Written Agreement, he testified, coupled with the extensive documentary record of examination reports and internal FDIC correspondence, make it clear "that the primary overwhelming concern of everybody in FDIC regulatory process was the fact that this institution had low tangible net worth, excluding the goodwill, and that was the problem that had to be overcome." Tr. 5517:4-7 (Brumbaugh).

The historical context at FDIC during this period is more than relevant. At this time, anxiety in the government over the potential insolvency of FDIC itself was growing acute. In late 1989, FDIC Chairman Seidman, reacting to the testimony Dr. Brumbaugh and his associates had prepared for Congress, announced that FDIC would have to borrow $25 billion over the coming year. Tr. 5508:10-17 (Brumbaugh). In 1991, FDIC was found insolvent for the first time in its history. *See* Tr. 5508:18-20 (Brumbaugh) ("By 1991, the GAO had actually assessed that FDIC was insolvent and out of cash reserves.")

B. Except For The Fact That It Would Provide Protection For The Insurance Fund, The Written Agreement Served No Purpose

The government has argued that the Written Agreement was intended by FDIC not to bolster the tangible buffer for FDIC fund, but was, instead, intended to strengthen Meritor financially. The idea is absurd.

There is no question that, after Meritor had been forced to sell two-thirds of its branch franchise and higher earning assets to Mellon, Meritor's earnings and asset quality were problematic. But as FDIC witnesses Hand and Francisco explained, these asset quality and earnings problems were of concern to FDIC *because they threatened to erode Meritor's capital* *buffer*. Tr. 3553:10-3554:1 (Hand); Tr. 3692:21-25 (Francisco). Indeed, compelling Meritor to maintain such high capital ratios as was required by the Written Agreement would quite possibly lead to its continued self-liquidation and decline.

Continued self-liquidation would be necessary to maintain the capital ratios required by the Written Agreement unless the Bank could produce earnings equal to or greater than the annual $54 million goodwill amortization. Tr. 3799:3-3801:5 (Francisco). If, as had happened in the past, FDIC's capital demands forced Meritor to liquidate its better assets, the result of the Written Agreement could be a "death spiral" in which negative earnings required the sale of quality assets (to replace lost capital), leading to still more negative earnings. Tr. 1266:19-1267:16 (Slattery); Tr. 1449:22-1451:7 (Slattery). As Dr. Brumbaugh testified, in this situation there “would be a continuing process of selling incrementally your best assets. It would be a process of selling incrementally probably some of your best deposits, and every time you do that, it becomes more difficult to earn income in the future.” Tr. 5507:20-24 (Brumbaugh).

Apart from the prospect of forcing continued self-liquidation, increasing Meritor's capital requirements restricted the Bank's ability to achieve profits by reducing the Bank's ability to leverage. *Id.*; Tr. 964:5-965:14; Tr. 1119:21-1120:5 (High); Tr. 645:25-646:23 (Hillas). No one at FDIC ever suggested to Meritor management that the purpose of the Written Agreement was to improve Meritor's profitability; on the contrary, the Regional Office was of the view that the continued downsizing of the Bank "was in the best corporate interest of FDIC." Tr. 970:3-12 (High); PX 578; Tr. 3826:15-3827:12 (Francisco).

The exaggerated capital requirements of the Written Agreement certainly were not generated by concerns about liquidity, because Meritor's liquidity was satisfactory and its depositor base extraordinarily loyal. Tr. 3767:14-3768:1 (Francisco); Tr. 3602:17-21 (Hand);

PX 274 at 1-2; *see also* Tr. 4662:10-14 (Hammer) ("unbelievable loyalty of the customer base"). Nor were there any noncompliance issues. The Bank had "fully complied with the requirements of the [1988] MOU". Tr. 3797:24-3798:2 (Francisco). Nor were there any issues about Meritor's management. On the contrary, the Regional Office believed that "Meritor's management was doing everything they possibly could for the benefit of this bank." Tr. 3793:12-17 (Francisco). Indeed, in official transmissions from the Regional Office to Washington, FDIC's assessment of Meritor's management team, under Chairman Hillas, could not have been more flattering:

> Management is favorably regarded relative to financial astuteness and ability to manage the loan portfolio. Policies are generally acceptable, and noted weaknesses were developed under the stewardship of former CEO, Frederick Hammer. The bank's present Chairman, Roger Hillas, leads a well-qualified management team that understands the bank's problems and that has developed a strategic plan designed to resolve these problems. Furthermore, the management has demonstrated the ability to actually reach the goals established by the strategic plans.

PX 300 at CSL011 333-34; *see* Tr. 3793:18-3794:11 (Francisco). At deposition Mr. Ketcha affirmed that this language expressed his view of Meritor management. JX 3 (Ketcha Dep.) at 358. *See also id.* at 92-93 (Mr. Ketcha had a very high regard for Chairman Hillas, CFO Mike High, Chief Credit Officer Cameron Clarke, and President Lou Cullen).

FDIC witnesses and documents thus establish the three reasons for the Written Agreement:

> (1) To address Meritor's low tangible capital;
>
> (2) To give FDIC the power to take further action against the Bank, on the basis of its capital account, when the law and the 1982 agreement would not otherwise support such action; and
>
> (3) If earnings were inadequate to cover the cost of amortizing the goodwill, to force the Bank to continue liquidating itself for the ultimate redemption of FDIC Insurance Fund.

All three rationales entail FDIC's complete disregard of the Western goodwill and a breach of the 1982 MOU. Taking action against the Bank on the basis of its tangible capital violates the core promise made in 1982. Imposing higher ratio requirements to compensate for the presence of the goodwill is simply another way of taking the goodwill away. And using the amortization cost as a ratchet to force the Bank to raise more tangible capital abrogates Chairman Isaac's promise that this particular cost would not be held against the Bank. Tr. 1546:7-18 (Isaac).

VII. BY EARLY 1991 AT THE LATEST FDIC HAD DETERMINED TO CLOSE MERITOR WHEN AND IF THE BANK REACHED ZERO TANGIBLE CAPITAL, IN COMPLETE DISREGARD OF THE 1982 AGREEMENT

Making a virtue of adversity, Chairman Hillas succeeded in negotiating a debt for equity swap with the holders of Meritor's 12% debentures in August, 1991. The deal ultimately approved called for a payment of 24 cents on the dollar and 180 shares of Meritor stock for each $1,000 in notes. PX 320 at CSL017 0003. The exchange resulted in the substantial dilution of existing stock values, to which none of Meritor's senior managers had any objection, refuting the government's suggestion that Meritor opted against a stock sale in 1989-90 for fear of dilution. Tr. 656:2-18 (Hillas); Tr. 981:12-982:19 (High); Tr. 1276:12-1277:1 (Slattery).

The Regional Office urged Washington to approve Meritor's application to allow this transaction to proceed. The analysis offered by Regional Director Ketcha in the recommendation memo is most telling. First, notwithstanding subsequent arguments by the government that the Bank was closed a year later out of "viability" concerns, Regional Director Ketcha plainly stated that the only reason he is concerned about Meritor's viability is the prospect that Congress might enact a statute, applicable to Meritor, analogous to FIRREA.

> Our concerns regarding the viability of Meritor center upon the possibility that new legislation may force a charge-off of regulatory goodwill. A precedent for such legislative action exists

> in FIRREA. For this reason, we recently included the bank among those that may fail during 1992.

PX 298 at 2.

More important still, Regional Director Ketcha wrote in his recommendation memo *that Meritor's life expectancy will be defined by its remaining tangible capital*. The memo stated that "this transaction could greatly extend the period of potential tangible capital insolvency, thereby providing the time needed for management to produce a recovery." As acknowledged by Review Examiner Francisco, who likely drafted at least part of the memo, this statement expressed the view that "*the time Meritor's management will have to produce a recovery is defined by the period of potential tangible capital solvency*." Tr. 3806:8-3809:10 & Tr. 3813:13-21 (Francisco); PX 298 at 2.

When the first (cash-only) offer to exchange the debentures failed, Meritor tried a second time, this time sweetening the deal with stock. The Washington office again recommended approval. Once again, Regional Director Ketcha's memorandum equated Meritor's potential life expectancy in terms of the Bank's tangible capital life. Tr. 3816:7-25 (Francisco); PX 320 at CSL017 006. Accordingly, the memorandum analyzes Meritor's capital projections, but does so on an exclusively tangible basis. Tr. 3819:17-3822:21 (Francisco); PX 320 at CSL017 005-06.

The phrase "tangible capital life" encapsulates FDIC's regulatory policy towards Meritor, its reason for imposing the Written Agreement and later closing the Bank, and its disregard of the 1982 contract. At trial Mr. Ketcha affirmed that this language, and the concept of Meritor's "tangible capital life," reflected his views. Tr. 5061:6-21 (Ketcha). As Dr. Brumbaugh testified, the approach taken in Mr. Ketcha's Confidential Memoranda (PX 298 and PX 320) is absolutely representative of the way in which federal bank regulators have always defined “viability.”

> As you can tell by the language that Mr. Ketcha used in his memorandum, he was associating viability with insolvency and the

> need to put the bank on the list of potential closures. The fundamental way it's done is the regulators take whatever measure of the institution's net worth they're going to use as a basis, and then they look at basically the earnings of the institution, and then based on the level of capital and the behavior of earnings over time, they calculate basically the time, and assuming for the sake of the example that earnings are negative, the time, given current earnings and the current net worth level, the amount of time it's going to take before that number reaches zero.

Tr. 5512:16-5513:2 (Brumbaugh).

The only FDIC-sponsored witness in this case who participated in the 1982 negotiations, Bob Gough, conceded that the 1982 agreement, at a minimum, prohibited FDIC from assessing Meritor's solvency or viability on a tangible basis. Tr. 2790:4-2791:1 (Gough). Even this much, standing alone, was a meaningful promise, because the time-honored practice at FDIC was to allow banks to remain in business so long as they remained solvent.[24] By early 1991 the record shows that FDIC was planning to ignore that promise. Perhaps the passage of FIRREA had had an effect on FDIC's thinking. Almost certainly, the financial strain being felt at the time by FDIC played a role. *See* Tr. 5491:19-25 (Brumbaugh) ("the insolvency of the fund was made official in 1991") Be that as it may, a determination to seize Meritor when it approached tangible insolvency had been made, and would be implemented.

VIII. THE TREATMENT OF MERITOR'S GOODWILL IN FDIC'S 1991 EXAMINATION REPRESENTS A COMPLETE ABROGATION OF THE 1982 GOODWILL AGREEMENT

The FDIC conducted sequential full-scale examinations of Meritor in late 1991 and mid-1992. The reports of these examinations served as the predicate for the seizure of the Bank in December 1992. Both exams reflected, and were heavily influenced by, the FDIC's complete

[24] Tr. 3679:19-21 (Francisco); Tr. 1569:24-1571:14 (Isaac); Tr. 5535:5-19 (Brumbaugh); Tr. 5533:14-5534:5 (Brumbaugh); PX 12A (FDIC's 1991 Annual Report) at 22; Tr. 4978:9-4979:3 (Ketcha); Tr. 3641:23-3642:2 (Hand).

disregard of the promises Chairman Isaac made in 1982. The breach that thus permeates these two final bank examinations is material because the FDIC necessarily relies upon the exam reports, in part at least, to justify its seizure and sale of Meritor in 1992.

In late 1991 William ("Stan") Shull commenced his examination of Meritor. Mr. Shull's assessment of Meritor's capital completely discounted the Western goodwill in blatant disregard of the 1982 agreement. In some ways, however, this breach is understandable, because, for whatever reasons, the Regional Office appears to have gone out of its way to avoid telling Mr. Shull anything about that agreement — or even that it existed.

1. FDIC's Failure To Educate Its Examiners About The 1982 Agreement With Meritor, Which May Explain In Part At Least The Examiners' Routine Failure To Honor That Agreement, Was Taken To A New Extreme In The Case Of Mr. Shull

As noted above, FDIC examiners generally were given no guidance regarding the promises made in 1982 and how those promises should be honored (except in the case of Paul Fritts, who as Regional Director in 1982 effectively instructed the examiners to ignore the 1982 goodwill agreement.)[25] The breakdown in communication with the examiners, whether deliberate or not, has serious consequences. As Regional Director Ketcha testified, the standard practice is for the Regional Office to initiate formal enforcement action against any bank receiving a composite rating of 4 or 5. Tr. 5053:12-16 (Ketcha). It is clear from the text of the exam reports that in every single examination conducted at Meritor after 1982, the examiners' CAMEL ratings for the Bank were driven down by their concerns about Meritor's tangible capital. Mr. Shull and Mr. Fitzgerald specifically admitted at trial that their ratings for the Bank were substantially influenced by the Bank's low level of tangible capital. Tr. 3370:16-21, Tr.

[25] For his part, Regional Director Ketcha does not recall whether, when he took charge of the New York Region in 1988, he ever even bothered to look at the 1982 MOU or to educate himself as to what promises FDIC had made to Meritor. Tr. 4948:19-4951:12 (Ketcha).

3372:1-9 & Tr. 3378:20-3379:8 (Shull); Tr. 1598:15-23, Tr. 1817:10-24 & Tr. 1393:2-12 (Fitzgerald). The failure to educate the examiners regarding the promises FDIC made in 1982 therefore set in motion a regulatory process strongly biased in favor of breaching those promises. This is so because, as several have testified, bank examiners instinctively disregard intangibles. *See, e.g.*, Tr. 2045:19-21 (Mancusi) ("Examiners in all agencies typically had disdain for goodwill, and not consider goodwill in looking at a bank's capital adequacy.").[26] If not instructed that Meritor had to be treated as a special case, the examiners' handling of goodwill was quite predictable.

But in Mr. Shull's case, the communication breakdown was even more striking. Coming from out-of-region, Mr. Shull had no reason to know anything about the 1982 agreement. The Regional Office kept it that way. When analyzing Meritor's capital, Shull was given no guidance whatsoever from the Regional Office. Tr. 3328:10-3329:4, Tr. 3392:9-12, Tr. 3396:20-3397:4 & Tr. 3399:4-18 (Shull); PX 367 at 9. When Shull contacted the Regional Office to ask for advice as to how he should analyze Meritor's capital and the goodwill account, the request was refused; instead, the Regional Office just told him to do his exam and it would review it when he was finished. Tr. 3392:9-19 (Shull). When Shull called the Regional Office to ask for a copy of the goodwill agreement, the Regional Office again refused. Tr. 3329:22-3330:10 (Shull). No one in the Regional Office ever told Shull that there had been a goodwill agreement predating the 1991 Written Agreement. Tr. 3350:20-3351:1 (Shull). As a result, as far as Shull knew, the only agreement between Meritor and FDIC regarding goodwill was the promise made, in the 1991 Written Agreement, that in calculating primary capital and risk-based capital goodwill would be

[26] *See also* Tr. 1519:19-21 & Tr. 1532:18-1535:9 (Isaac); Tr. 2702:4-21 & Tr. 2735:9-20 (Gough); Tr. 3117:23-3118:15 & Tr. 3173:19-25 (Lutz); Tr. 4970:23-4971:6 (Ketcha).

included "to the extent recognized" by FDIC. Tr. 3348:5-3349:23 & Tr. 3445:11-3446:2 (Shull); PX 308.[27]

2. But even to the limited extent Mr. Shull knew that promises had been made to credit the goodwill, he elected to disregard those promises

Mr. Shull at least understood that the Written Agreement obligated FDIC to include goodwill in calculating primary capital and risk-based capital. But even this obligation Shull set aside. In his personal working copy of the Written Agreement, Shull struck out the language requiring that goodwill be included. Tr. 3348:5-3350:1 (Shull); PX 308 at 2.[28] Mr. Shull's exam report reflects that the obligation to count goodwill towards capital had also been stricken from his mind. While on Shull's reading the only positive value of the goodwill consisted in Meritor's ability to count it in calculating primary capital (Tr. 3353:16-3354:24, Tr. 3416:8-3417:16 & Tr. 3419:5-14 (Shull)), his examination report, which calculates capital ratios dozens of times from several different perspectives, nowhere calculates primary capital. Tr. 3358:17-3361:5 (Shull); PX 335 at CSL015 0863-65. Instead, it focuses on Tier 1 and Tier 2 capital ratios, from which goodwill is excluded. PX 335 at CSL015 0863-65. Even Mr. Fitzgerald, who conducted the 1992 examination of Meritor, agreed that this was a violation of FDIC's promises. PX 418.

Beyond this, Shull took the position (in his exam report and elsewhere) that the recently-enacted (but not yet effective) FDICIA would eliminate Meritor's goodwill. Tr. 985:22-986:2 &

27 After a break, and on redirect, Shull testified that he had in fact seen the 1982 MOU. Tr. 3397:24-3398:12 (Shull). His testimony on cross, however, makes it clear that he did not understand at the time that there was any agreement regarding goodwill other than the 1991 Written Agreement. Tr. 3348:5-3349:23 & Tr. 3445:11-3446:2 (Shull); PX 308. His testimony at deposition reflected the same (lack of) understanding. JX 9 (Shull Dep.) at 285-87, 339-40.

28 Shull's working copy of the Written Agreement also has highlighting on it, which is plainly visible in the color photocopy that has been introduced as PX 308. At trial he claimed, however, that the striking out of the language regarding goodwill on his copy was actually highlighting. Tr. 3351:2-3352:24. A simple visual inspection of the document raises serious questions about the credibility of that testimony.

Tr. 987:16-988:8 (High); PX 369. Shull's aggressive interpretation of FDICIA also led to its premature enforcement: Shull acknowledged at trial that the fact that Meritor might well fall below the 2% tangible capital threshold established by FDICIA was an important factor in his assignment of a composite 5 rating to the Bank. Tr. 3370:16-19 & Tr. 3372:1-9 (Shull). He also questioned, in his exam report, whether it might in fact be improper for the Bank even to report a portion of the goodwill on its balance sheet. Tr. 3354:25-3355:17 (Shull); PX 335 at CSL015 0853.

No one from the Regional Office ever raised any issue with Mr. Shull regarding his reading of FDICIA or his focus on tangible capital. Tr. 3370:8-15 (Shull). On the contrary, the Regional Office cover letter transmitting the Shull Report to the Bank itself reflected the agency's concern that the depletion of tangible capital "would eliminate the protection for FDIC insurance fund." Tr. 3522:21-3524:3 (Hand). Similarly, PX 364, which notified the Bank of preliminary examination findings, "exclud[ed] the goodwill from its capital calculation and focus[ed] on the tangible capital." Tr. 2201:16-17 (Mancusi).

Apart from his rewriting of the 1991 Written Agreement and aggressive pre-enforcement of FDICIA, Mr. Shull analyzed Meritor's capital in a manner diametrically at odds with the promises made in 1982. In his view, because the underlying Western assets had been sold, the goodwill did not "have any real value to the bank." Tr. 3448:15-3449:3 (Shull). Apart from the fact that, subject to FDICIA, the Bank could include goodwill in calculating primary capital, in Shull's analysis the goodwill's only significance was negative because its amortization was a strike against earnings. Tr. 3404:16-3405:17 (Shull). Thus, on his analysis, the goodwill was worse than worthless, because it was solely an amortizing nonearning asset with no real value.

Tr. 3353:16-3354:19, Tr. 3416:8-3417:16 & Tr. 3419:5-14 (Shull); PX 335 at CSL015 0855, 0857, 0862.

The bottom line was that Shull assigned no value whatsoever to the goodwill. He admitted that if Meritor had had more tangible capital, his assessment of the Bank would have been a "whole new picture," *because tangible capital — unlike goodwill, in his view — is capable of absorbing losses*. Tr. 3450:9-3451:1 (Shull). And at deposition, Shull finally acknowledged after two days of questions that the presence of Meritor's supervisory goodwill was simply "irrelevant" to his analysis of the Bank's condition. Tr. 3421:2-16 (Shull); *see* JX 9 at 400:9-17. And all of this was done without a word of protest from the Regional Office.

IX. THROUGH PROJECT ZETA MERITOR PRESENTED FDIC WITH A WAY TO ELIMINATE ANY RISK TO FDIC FUND, AND AT THE SAME TIME SAVE VALUE FOR SHAREHOLDERS, BUT FDIC OPTED FOR SEIZURE INSTEAD

The Shull exam, the enactment of FDICIA and FDIC's announcement of a new "early intervention" plan, all led Meritor's senior management to explore the possibility of finding a merger partner. Tr. 992:3-14 (High); Tr. 447:2-13 & Tr. 448:3-449:11 (McCarron); Tr. 2112:2-2113:2, Tr. 2145:13-19 & Tr. 2146:6-11 (Hillas). The initiative came to be known as Project Zeta.

Project Zeta could have been structured in any number of ways, but the eventual concept was to sell the remaining deposits to a competing bank and to set up a group to work out the remaining troubled asset portfolio with a loan from FDIC. Tr. 991:10-19 (High); Tr. 449:20-450:24 (McCarron). The transaction would have cost FDIC nothing — indeed, it would have been profitable — because it contemplated only a market rate loan to fund the work out bank. Tr. 991:10-19 (High); Tr. 2147:9-14 (Hillas). The premise of Project Zeta was the understanding that the deposit base retained substantial unrealized value. Tr. 449:20-450:24 (McCarron). The objective was to rescue at least some of that value for the shareholders. Tr. 449:17-19

(McCarron). A precedent had been set by a comparable "good bank/bad bank" transaction consummated by Mellon in the mid-1980s. Tr. 450:17-21 (McCarron).

The concept was presented to FDIC in Washington in February 1992. Tr. 651:15-23 (Hillas); Tr. 450:25-451:18 (McCarron); Tr. 992:15-993:8 (High). Right up until the end, FDIC continued either to encourage Meritor on Project Zeta, or to equivocate. Tr. 454:9-15, Tr. 457:6-19 & Tr. 458:4-13 (McCarron); Tr. 996:2-13 (High); Tr. 2112:21-2113:2 & Tr. 2147:2-8 (Hillas).

The fact is, however, that project Zeta was appropriated by FDIC itself. FDIC began shopping Meritor, on a closed bank basis, in the early Fall of 1992. PX 422, PX 424, DX 766. As Mr. Ketcha himself acknowledged at his meeting with the Meritor Board on October 1, 1992, an open bank merger becomes virtually impossible once potential buyers are informed that they will have the option of acquiring a bank on a closed bank basis. Tr. 461:5-12 & Tr. 461:18-463:18 (McCarron); Tr. 1004:25-1005:17 (High); *see also* Tr. 4286:12-4288:1 (Hartheimer). The reason for this is FDIC's power to disaffirm unfavorable contracts (such as lease agreements, collateral requirements, and data processing contracts), with the result that the buying bank will have the option of avoiding undesired expenses. Tr. 461:5-12 & Tr. 461:18-463:18 (McCarron); Tr. 1004:25-1005:17 (High).

In addition, the effective date of FDICIA was looming, and Meritor could not get any assurance from FDIC that its 1982 Agreement would be honored. As FDIC's witnesses acknowledged, Meritor management repeatedly stressed to them that the possibility of consummating project Zeta hung in significant part on Meritor's receiving from FDIC an assurance that the goodwill would continue to count. Tr. 1192:6-18 & Tr. 1623:19-1624:2

(Fitzgerald); Tr. 3326:23-3327:2 (Shull). But Meritor could obtain no such assurance, and because its shares were publicly traded, deemed itself compelled to disclose that fact. DX 167.

As subsequent events would make clear, it in fact turned out that FDIC was very interested in project Zeta and that it was a perfectly viable plan. The terms of FDIC's seizure, sale, and liquidation of Meritor were essentially the same as had been proposed in project Zeta except that FDIC made itself the liquidator. Tr. 996:14-20 (High); Tr. 463:19-464:3 (McCarron); Tr. 1286:16-24 (Slattery). And the net result was extremely lucrative for FDIC. A $181 million premium was received. Tr. 464:4-7 (McCarron). The seizure and sale of Meritor also allowed FDIC to conclude Fiscal year 1992 in the black. Resolving Meritor at no cost (or even at a profit)[29] enabled FDIC to eliminate a loss reserve on its own books in excess of $840 million with the result that the Bank Insurance Fund could report itself solvent again after reporting insolvency for the first time in its history in 1991. Tr. 5525:21-5526:7 (Brumbaugh) ("[T]he net benefit to FDIC was a billion dollars. And that was the monetary incentive that existed at the time for them to negotiate the Mellon transaction, determine that they were going to close and resolve Meritor at that time"); *compare* PX 12 at 43 with PX 13 at 2, 77, 87; Tr. 5093:12-17 (Ketcha).[30] At the December 9 FDIC Board Meeting, at which Meritor's seizure and sale to Mellon were approved by the Board, Mr. Hartheimer stressed: "I think also notable is

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[29] For FDIC to realize a profit in the resolution of a bank was practically unprecedented. Tr. 5454:7-5455:7 (Brumbaugh).

[30] *See also* Tr. 5687:3-5688:17 (Brumbaugh):

> [A]t the time there was a big public policy question that FDIC was having to deal with, which was it had gotten authorization from the Congress to borrow up to $30 billion in order to arrange transactions, and they were doing everything that they possibly could to avoid in any way, shape, or form ever drawing down on that line of credit with Treasury. And the ability to put back on $800 million in reserve, actually, net, a billion, was something that would be very valuable to them at that time.

that our reserve for this resolution is $864 million so it's a — its quite a — a good transaction . . . ." PX 603 at 9.

As in most other significant developments at Meritor, the Pennsylvania Department of Banking played no role whatsoever in the review or implementation of project Zeta. Tr. 2171:10-15 (Hillas); *see* Tr. 1946:12-1949:8 (Hargrove).

X. FDIC'S FINAL EXAMINATION OF MERITOR, IN 1992, FOCUSED ITS CAPITAL ANALYSIS UPON TANGIBLE CAPITAL, AND ON THAT BASIS LED TO THE INITIATION OF INSURANCE REVOCATION PROCEEDINGS

Less than four months after Stan Shull concluded his exam report, Dennis Fitzgerald came on site to initiate another full-scale exam. One thing Mr. Fitzgerald was careful to do was to correct the record on Meritor's loan administration. Mr. Shull had made a number of allegations that Meritor's loan administration was weak, and had actually charged Meritor with deliberately avoiding (or misstating) loss recognition. At trial, Mr. Fitzgerald would not criticize Mr. Shull (solidarity among examiners is strong), but in his examination report he stated — almost immediately after Mr. Shull had left the property — that:

> The Loan Review Department of the bank appears to have a satisfactory grasp of existing and potential problems in the loan portfolio. The program, administered by a very small staff, is comprehensive in scope, timely in the identification of problems, and accurate in their assessment of loss exposure.

PX 406 at 1-3. But more critical to the issues in this case is the fact that, as he himself has admitted, Mr. Fitzgerald's assessment of the Bank in 1992 gave no credit for the goodwill.

A. The "Bottom Line" To The 1992 Report, And The Initiation Of The 8(a) Action, Was The Lack Of "Tangible Net Worth"

Mr. Fitzgerald's exam was completed in September, 1992, and his conclusions were presented to bank management at a meeting held on September 29. The exam report itself sets forth a multitude of capital calculations. PX 406 at 3-3-1. The report also analyzes all aspects of the Bank's financial condition in some detail. At the meeting with Meritor management on September 29, however, Mr. Fitzgerald made it clear that, in FDIC's view, there was one paramount fact: Meritor was running out of tangible capital. At that meeting Fitzgerald made numerous comments to the effect that the Western goodwill was of no real value to the Bank and that the Bank's critical problem was its lack of tangible capital. Tr. 998:13-999:11 (High).

Fitzgerald confirmed at trial that in his view the goodwill "contributed [nothing] to the ongoing viability of the institution." Tr. 1189:3-9 (Fitzgerald); Tr. 1388:3-16 (Fitzgerald); Tr. 1395:4-6 (Fitzgerald). In his view, as reflected in his examination and conclusions, goodwill contributed nothing to the Bank's capital account, and was a significant detracting feature vis-a-vis both earnings and assets. Tr. 1817:10-24 (Fitzgerald).[31] Mr. Fitzgerald's draft of the exam report even went so far as to suggest that Meritor was committing a violation of law merely by reporting its goodwill as capital. Tr. 1804:20-1805:5; PX 405 at 6-2. As had been true of Mr. Shull, Mr. Fitzgerald's assignment of a composite 5 rating to the Bank was driven at least in part by the Bank's lack of tangible capital. Tr. 1598:15-23 (Fitzgerald).

Contemporaneous notes taken at the September 29 meeting confirm the fact that, in FDIC's view, Meritor's dwindling tangible capital was the paramount fact. As confirmed by Mr. Fitzgerald at trial, those notes reflect that he stated to Meritor that:

> *The problem is, we're running out of tangible net worth.*

He also stated that:

> *The problem is tangible net worth.*

Most poignantly, Mr. Fitzgerald reported to the Bank that:

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[31] Mr. Fitzgerald commented, for example, that it was the amortization of the Western goodwill that "preclude any return to profitability" (PX 406 at 1), which bespeaks an approach squarely at odds with the 1982 agreement under which, according to Mr. Isaac's testimony, the effect of amortization on earnings should have been factored out. Tr. 1546:7-18 (Isaac).

Bottom line is we're running out of tangible [net] worth.

Tr. 1825:6-1826:7 & Tr. 1830:17-1831:1 (Fitzgerald); PX 443 at CSL031 193 & 195; PX 444A at CSL018 0304. The reason why Meritor's tangible capital account was of such great significance is easily understood: In Mr. Fitzgerald's view — like that of virtually everyone involved in the regulation of Meritor at FDIC — the Western goodwill had no value for purposes of absorbing losses or protecting the bank insurance fund. Tr. 1812:22-1813:7 (Fitzgerald).

The Pennsylvania Department of Banking played virtually no role in the 1992 examination of Meritor. Of twelve examiners assigned to the examination, only one was from Pennsylvania. Tr. 1389:4-11 & Tr. 1173:18-21 (Fitzgerald).

B. Unable To Receive Any Assurance From FDIC That The Agency Would Honor Its Commitments, Meritor Was Forced To Give Mr. Ketcha A Resolution Authorizing The Agency To Shop The Bank.

Mr. Fitzgerald's own account of his September 29 meeting with Meritor management records the following:

> [Meritor's Chairman, Roger] Hillas, a few minutes later . . . asked me if I could get a confirmation on the continuing worth or value of the regulatory goodwill. He mentioned this because he apparently has been in contact with several local institutions about some type of non-regulatory assistance.
>
> I again stated that FDIC Board of Directors was the ultimate authority on this question, but said that along with FOS Walsh, we would see what we could find out. *This response was intended to be more of a delaying tactic rather than to actually provide information*.

PX 442 at 2 (emphasis added). This issue would occasion a variety of "delaying tactics" by the government. The record shows, for instance, that by November 8, FDIC in Washington had prepared a formal response to the Bank's inquiries (PX 480 at 48076-77), but that response would not be provided to the Bank until the moment it was seized. Tr. 654:14-655:21 (Hillas); Tr. 481:13-482:9 (McCarron).

In the meantime, Mr. Ketcha took over. On October 1, 1992 the examination report was presented to Meritor's Board. Nick Ketcha ran the meeting, presenting the results of the examination and requesting a resolution from the Board of Directors authorizing FDIC to shop the Bank. Sarah Hargrove, Secretary of Banking for the Commonwealth of Pennsylvania, may have spoken (inconsequentially) for as much as 30 seconds. Tr. 999:17-24 (High); Tr. 2134:23-2135:8 (Mancusi); Tr. 472:8-17 (McCarron).

In response to Mr. Ketcha's request for Board resolution authorizing FDIC to sell Meritor to another bank, the Board refused, on the grounds that without legal advice the directors were not prepared to take action potentially adverse to the interests of the shareholders. Tr. 1000:10-1001:2 (High); Tr. 468:2-12 (McCarron). Mr. Ketcha's response was that if the Board did not issue the resolution he had asked for he could and would initiate proceedings to withdraw the Bank's federal insurance. Tr. 1001:3-8 (High); Tr. 660:7-11 (Hillas); Tr. 458:23-25, Tr. 466:3-12 & Tr. 578:16-18 (McCarron); Tr. 1288:3-10 (Slattery).

During the days following the October 1 meeting Mr. Ketcha and his assistant Mr. Piracci called the Bank repeatedly to inquire when they would obtain the Board resolution they had asked for. Tr. 471:15-472:1 (McCarron). Some of the senior managers at the Bank were unsure whether Mr. Ketcha had the legal authority to make good on his threat to withdraw insurance, and partly for that reason a letter was prepared asking Mr. Fritts, in Washington, for confirmation that FDIC would honor its 1992 commitments.[32] But on October 15 the Board convened an adjournment of the October 1 meeting. The meeting was conducted by special counsel to

[32] PX 454. The situation under FDICIA was unclear. The statute had been enacted in late 1991, with implementing regulations to take effect by December 19, 1992. Initial proposed regulations (Spring 1992) had a footnote allowing grandfathered intangibles; a later version dropped the footnote. *See* PX 401 at 1-2; PX 454 at 1-2. After the October 1 meeting, some members of Meritor's management questioned what Ketcha's legal basis for closure would

Meritor, Doug Faucette and John Hall. Tr. 2117:2-7 (Mancusi). At that meeting the Board issued the resolution that Mr. Ketcha had requested. PX 455.

XI. LACK OF TANGIBLE CAPITAL WAS THE REASON WHY FDIC CAUSED MERITOR'S SEIZURE, IN BREACH OF THE 1982 AGREEMENT

In December 1992 Meritor's tangible capital had dwindled to approximately $25 million. FDIC's traditional practice is to withdraw insurance when there is a "near-term threat of [in]solvency." Tr. 3679:19-21 (Francisco). Former FDIC Chairman Isaac testified that he was unaware of any bank ever being seized at the instance of FDIC where the Bank had as much as 7.5% capital. The policy for FDIC was not to unleash its regulatory weapons until a bank approached zero tangible capital. Tr. 1569:24-1571:14 (Isaac). FDIC's policy had always called for closure when a bank reached zero tangible capital — a policy that FDICIA specifically modified by raising the bar to 2%. Tr. 5535:6-19 (Brumbaugh); *see also* Tr. 5533:14-5534:5 (Brumbaugh). FDIC's 1991 Annual Report makes precisely the same point: Prior to FDICIA "an institution typically was closed only after its capital had been exhausted." PX 12A at 22. And Regional Director Ketcha confirmed that in his lifetime with FDIC he could only recall one instance where a bank was allowed to operate with zero tangible capital, and in that case the Bank's tangible insolvency lasted for only one day. Tr. 4978:9-4979:3 (Ketcha). As used by Senior Examination Specialist Hand, at least, the "Failing Bank List" that FDIC used to identify banks likely to fail within the next two years equated "failure" with tangible insolvency. Tr. 3641:23-3642:2 (Hand). Meritor's closure in 1992 followed this practice. The only difference is that in Meritor's case FDIC had promised to act otherwise.

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be, and they wrote the letter partly to assess that question. Tr. 475:18-476:22 (McCarron); Tr. 1289:6-1290:3 (Slattery).

A. Meritor's Impending Tangible Insolvency Drove The Seizure Of The Bank, In Violation Of The 1982 Agreement

The evidence is overwhelming that FDIC disregarded Meritor's goodwill in late 1992 and for that reason caused the closure of the Bank for want of capital. Every FDIC examiner and official who testified has admitted as much, and the operative documents confirm it. Plaintiffs' experts, who reviewed all of this material, concluded unequivocally that tangible capital authored Meritor's closure.

1. All key FDIC witnesses and all key FDIC documents prove that tangible capital was determinative.

(a) The Fitzgerald Examination.

The 8(a) action was based upon Mr. Fitzgerald's examination report. Dennis Fitzgerald himself summarized the conclusion reached by his 1992 examination of Meritor: The "bottom line is that we're running out of tangible [net] worth." PX 444A at CSL018 0304. As a general matter, Mr. Fitzgerald's analysis of Meritor's capital account was in complete violation of the 1982 Agreement, because Mr. Fitzgerald gave the Bank no credit whatsoever for the goodwill. Mr. Fitzgerald acknowledged that he "treated the goodwill on Meritor's books precisely the way [he] would have treated the goodwill on other banks' books, except for the fact that [he] allowed Meritor to include it in calculating capital ratios." Tr. 1169:8-13(Fitzgerald). He also admitted that "in assessing the bank's capital as a cushion against loses, [he] personally viewed the goodwill as worthless." Tr. 1174:1-4 (Fitzgerald). He also admitted that, as he viewed it, the goodwill conferred no benefit on the Bank whatsoever. Tr. 1382:16-18 (Fitzgerald).

The text of the exam report itself, and comments made to the Bank by Mr. Fitzgerald, demonstrate that he put these attitudes into action:

> Capital: Superficially is okay. However, this includes $264mm in goodwill . . . . There is only $23 million tangible capital remaining.

PX 443 at CSL031 0192-93. And in the exam report itself:

> The bank's capital accounts, while superficially at moderate levels, include $264,944,000 in goodwill which is not capable of supporting Loan or Other Asset charge-offs or absorbing continuing operating losses. Tangible net worth has now deteriorated to $23,381,000 which represents only 0.41% of average total assets.

PX 405 at CSL015 0771. And in the Confidential/Supervisory section of the report:

> Executive Vice President and Chief Financial Officer Michael High performs in a satisfactory manner, but is reluctant to give up on the idea of the regulatory goodwill counting as capital.

PX 407 at A-1.

> The December 19, 1992 phase-in of FDICIA capital requirements will likely impact subject bank by disallowing the regulatory goodwill as a capital component. Even if this does not occur, the bank will soon exhaust remaining tangible capital and thereby lose the ability to absorb operating and credit losses.

PX 407 at A-2.

Consistent with FDIC procedures Mr. Fitzgerald, as examiner-in-charge of the 1992 examination, was tasked with drafting the memorandum recommending insurance revocation. Mr. Fitzgerald admitted at trial that he probably would not have recommended a Section 8(a) proceeding had Meritor's goodwill been tangible capital. Tr. 1181:23-1182:9 & Tr. 1183:13-1184:20 (Fitzgerald). He also acknowledged that in every one of the approximately five cases where he has personally recommended an 8(a) proceeding, the bank in question was at or approaching zero tangible capital, and that Meritor's case fit this pattern. Tr. 1182:11-1183:7 (Fitzgerald).

(b) Pollack's Notations on the Reports of Condition.

Review Examiner Linda Pollack was responsible for reviewing the monthly "reports of condition" that Meritor submitted under the 1991 Written Agreement. Before sending the reports on to her superiors in the Regional Office, Ms. Pollack made notations on the Bank's transmittal letter to highlight for her superiors the critical elements of the report. *See* PX at 332, PX 338, PX 356, PX 461 and PX 482. The notations set out only one thing: Meritor's capital ratios. Even more telling, Ms. Pollack's notations prior to October 1992, set out three ratios — the two ratios required in the Written Agreement, and tangible capital. Starting in October, however, the only notation made is for tangible capital. *Compare* PX 356 with PX 461, PX 482.

(c) The "8(a) Memo".

Ms. Pollack also drafted the Regional Office's formal memorandum recommending withdrawal of insurance. The operative document itself, the so-called "8(a) Memorandum," included on its face calculations of Meritor's capital with goodwill included. PX 420. But the narrative portion of the memorandum prominently noted Meritor's tangible shareholders equity ratio and concluded that "[w]ithout the inclusion of regulatory goodwill," Meritor would be considered "critically under capitalized per FDICIA . . ." *Id.* at 2. More poignantly, Ms. Pollack testified at deposition that the reason for the preparation of the "8(a) papers" was the fact that "[w]e believe that Meritor would become insolvent based on its operating losses." JX 8 at 101. Because Meritor had at the time over $200 million in regulatory capital, the "insolvency" that motivated FDIC was clearly tangible insolvency.

FDIC witnesses have tirelessly stressed that capital helps earnings because it represents an interest-free asset. But no one can deny that, in FDIC's eyes, the *primary* virtue of capital is the buffer it provides for FDIC fund. Review Examiner Linda Pollack testified:

> Q. Now what is capital?
>
> A. Capital is the protection. It's actually the amount that represents the stock holders equity. It's the cushion that really protects the — its the cushion that protects FDIC from having to use the Deposit Insurance Fund to pay off the depositors.

JX 8 (Pollack Dep.) at 25. *See also id.* at 86:

> Q. You look at capital ratios to judge the capital cushion of an insured institution?
>
> A. That's correct.
>
> Q. You look at them with a long term goal of protecting the Deposit Insurance Fund?
>
> A. Yes.
>
> Q. By making sure that an insured institution has enough capital?
>
> A. Yes.

Ms. Pollack testified at deposition that in formulating the 8(a) action against Meritor goodwill was excluded from capital calculations because, in FDIC's view, Meritor's supervisory goodwill "is not really capital in this sense that it can protect the bank against losses. It's not — it doesn't really give the bank a level of protection. If all they had left was goodwill, it wouldn't be a viable institution." JX 8 (Pollack Dep.) at 277. Ms. Pollack also testified at deposition that "the underlying theory behind the 8(a)" was FDIC's conclusion that Meritor's capital "was going to be depleted," JX 8 (Pollack Dep.) at 283-84, and that "the amount of tangible capital in hand" was "a critical factor" in the decision to initiate the 8(a) proceedings. JX 8 (Pollack Dep.) at 347-48.

(d) <u>Assistant Regional Director Michael Piracci</u>.

Mr. Piracci, the Assistant Regional Director responsible for Meritor in 1992, testified that the purpose of capital is to absorb losses, that in Meritor's case only its tangible capital was relevant to capital adequacy, and that for want of tangible capital the Bank was not "allowed to go on in existence."

> Q. Third line, third sentence, third paragraph: Capital was described as inadequate and below the level specified in the written

agreement. But it was added that this included $252 million in supervisory goodwill allowed under the written agreement. It was pointed out that the bank has almost depleted tangible capital capable of absorbing operating losses.

When an individual tells you that capital is inadequate, what does that mean to you?

A. I think it generally means what he says below, that for the level of the risk and the level of loss needed to absorb the amount of capital required for that is not there.

Q. And that's what it means to you also?

A. That's what this means to me, and that's what it means to me also, correct.

Q. And then there was a focus again on the depletion of tangible capital capable of absorbing operating losses. In assessing the viability of an institution, how important is that fact?

A. Is the fact of —

Q. The depletion of tangible capital.

A. Quite important.

Q. And why is that?

A. Because that's what's there to absorb losses, and if there's no — if there's no level of tangible capital to absorb losses, then the bank can't go on in existence.

Q. And why not?

A. It would be operating with a negative tangible capital ratio, and generally that's not permitted.

Q. And why is that ordinarily not permitted?

A. It just shows that the bank is in a very unsafe, unsound condition, can't continue operations, has no cushion between its assets and liabilities.

JX 7A (Piracci Dep.) at 184-86.

(e) Regional Director Nicholas Ketcha.

First, the record shows that Mr. Ketcha himself treated Meritor's supervisory goodwill as worthless. Mr. Ketcha testified repeatedly at deposition that the presence of the goodwill on Meritor's books did not effect his analysis of the Bank's condition. He testified that there was, in his view, no difference between supervisory goodwill and GAAP goodwill other than their having different amortization periods. JX 3 (Ketcha Dep.) at 77. He acknowledged that he had no recollection as to "under what circumstances RAP goodwill and GAAP goodwill were treated differently . . . ." JX 3 (Ketcha Dep.) at 80, 190. He admitted that, as he viewed the Bank, a low tangible capital ratio would merit a 5 CAMEL rating even if the Bank had 14% capital in the form of supervisory goodwill. JX 3 (Ketcha Dep.) at 276-77. Mr. Ketcha testified that the goodwill on Meritor's books had no impact on his "viability" determination in late 1992. JX 3 (Ketcha Dep.) at 401-02. In fact, if the goodwill had any impact at all, its impact was negative, inasmuch as the amortization was viewed as a substantial drain on earnings. *Id.* at 402-07. *See also* Tr. 5106:9-20 (Ketcha).

Mr. Ketcha insisted that, in his view, the goodwill agreement between FDIC and Meritor constrained FDIC in no way whatsoever. JX 3 (Ketcha Dep.) at 182-84. As far as he was concerned, notwithstanding the 1982 goodwill agreement, FDIC was free to impose upon Meritor capital ratio requirements from which goodwill would be excluded. JX 3 (Ketcha Dep.) at 321-23. In his opinion at the time, FDIC was free "to disregard Meritor's supervisory goodwill in determining the overall condition of the bank." JX 3 (Ketcha Dep.) at 447. The basis for these opinions is a little unclear, because Mr. Ketcha admitted at deposition that he did not have any recollection of ever having looked at or seen the 1982 goodwill agreement. JX 3 (Ketcha Dep.) at 221-22.

Mr. Ketcha's August 26, 1992 letter to Pennsylvania Secretary Hargrove, PX 426, is even more revealing. In his 1992 examination of Meritor, Dennis Fitzgerald had noted that Stan Shull had calculated capital ratios incorrectly and in violation of the goodwill agreements existing between FDIC and Meritor. PX 418. Secretary Hargrove had taken notice of the memorandum from Mr. Fitzgerald on this subject, and had written to Regional Director Ketcha asking for an explanation. PX 421. Mr. Ketcha's response, PX 426, plainly articulated FDIC's official position that FDIC (and Pennsylvania) were free to disregard Meritor's goodwill for any and all purposes other than calculating the ratios described in the 1991 Written Agreement. The letter stated that "*the only required use of primary capital* [as opposed to capital ratios from which goodwill is excluded] *is to determine whether or not Meritor is in numerical compliance with the capital maintenance requirements of the written agreement. It is not required to be used on an ongoing basis in determining the overall condition of the bank.*"

James Hand, the author of PX 426, Tr. 3536:13-16 (Hand), confirmed that the quoted language expressed the official policy of FDIC. Tr. 3550:6-13 (Hand). The policy was that FDIC would use capital measures that excluded goodwill for any purpose other than assessing compliance with the requirements of the Written Agreement. Tr. 3537:23-3547:15 (Hand). *See also* JX 3 (Ketcha Dep.) at 673 (PX 426 expresses Mr. Ketcha’s view that FDIC was obligated to count the goodwill when calculating the ratios included in the 1991 Written Agreement, but was free to exclude goodwill in calculating any other ratios). PX 426 is an official and categorical admission of breach.

Mr. Ketcha’s treatment of Meritor's goodwill, and his statements of position, are particularly significant in this case, because Mr. Ketcha was designated by the Department of Justice as a 30(b)(6) witness with respect to: (a) the decision by the Washington Office of the

FDIC to approve the 1991 Written Agreement; and (b) the decision by the Washington Office of the FDIC to initiate insurance revocation proceedings in 1992. *See* JX 3 (Ketcha Dep.) at 528-31.

The record also shows that the basis for Mr. Ketcha's recommending the 8(a) proceeding was Meritor's shortage of tangible capital. As noted above, Mr. Ketcha made it clear, more than a year earlier, that his intent was to close the Bank when it ran out of tangible capital. PX 298; PX 320. The "Financial Interim Report" dated June 25, 1992, is consistent. It sets forth, for the benefit of the Washington headquarters, a detailed analysis of Meritor's capital prospects. Its analysis and projections are made exclusively on a tangible basis, exclusive of goodwill, as Mr. Ketcha confirmed at trial. PX 394; Tr. 5079:8-5082:10 (Ketcha). The Section 8(a) memo to Washington, which Regional Director Ketcha signed, accordingly stressed the impending "depletion" of Meritor's "tangible shareholders equity." PX 473 at 3. Mr. Ketcha also admitted at deposition that it is likely that he "communicat[ed] to representatives of Meritor in 1991 or 1992 that a lack of tangible capital was, in [his] view, the bank's primary problem." JX 3 (Ketcha Dep.) at 483.

(f) <u>Director Stanley Poling.</u>

The Director of the Division of Supervision authored the memorandum to FDIC Board of Directors recommending revocation of insurance. His memorandum focuses on Meritor's tangible capital on the grounds that the Bank's supervisory goodwill will be excluded by FDICIA.

> Although an adjusted Part 325 Tier 1 capital ratio of 4.4% was calculated at a July 20, 1992 examination, the bank would be 'critically undercapitalized' if the more than $252 million in remaining goodwill booked in connection with its 1982 FDIC-assisted acquisition of a failing savings bank were excluded from capital. FDIC has permitted the inclusion of such goodwill in measuring compliance with the provisions of the Written

> Agreement, but these items will be excluded from tangible capital for purposes of Prompt Corrective Action, Section 38 of the FDI Act, which becomes effective on December 19, 1992. Tangible capital of $28,018,000 reported on the September 30, 1992 call report was 0.66% of tangible total assets.

PX 498 at 1. Director Poling's approach, therefore, was the same as Mr. Shull's. In short, they enforced FDICIA against Meritor before FDICIA took effect. It was Mr. Poling, of course, who signed the letter, delivered to Roger Hillas on the day of Meritor's seizure, stating that FDIC would officially disregard the goodwill under FDICIA. PX 511; Tr. 654:14-655:21 (Hillas); Tr. 481:13-482:9 (McCarron). Plaintiffs' expert Mike Mancusi concurred that Mr. Poling's assessment of Meritor's condition excluded goodwill from capital "and focus[ed] on tangible capital." Tr. 2205:18-19 (Mancusi).

(g) Executive Director Paul Fritts.

In 1992 Paul Fritts was Executive Director for Supervision and Resolutions, and he personally presented the proposed 8(a) revocation to FDIC Board of Directors. *See* PX 502B; PX 603. Fritts acknowledged at trial that the 8(a) proceeding probably would not have been initiated if Meritor's goodwill had been cash, and Meritor would not have been seized. Tr. 2993:7-2994:3. There can be no doubt that Mr. Fritts himself would have seen a very different picture if the goodwill had been, or were treated as, real capital. Mr. Fritts testified that in his view the supervisory goodwill contributed *nothing* to the Bank's capital adequacy. The analysis is simple: Mr. Fritts (like most at FDIC) equates capital adequacy with the capacity to absorb losses, and goodwill (supervisory or not) cannot — in his view — absorb losses. Therefore, the supervisory goodwill had no value whatsoever. Tr. 2971:18-2972:25 (Fritts). And, as noted above, on Mr. Fritts' reading the 1982 Agreement only obligated FDIC to include goodwill in calculating capital ratios which, according to Mr. Fritts, are meaningless. *Id.*

(h) The 8(a) Notification.

The actual notification sent to the Pennsylvania Department of Banking reveals that in FDIC's view, the goodwill had already been extinguished. The notice (PX 505) provides that Meritor can avoid revocation of insurance if it can raise $271 million in five days. In the first place, this "corrective action" provision was absurd. Mr. Ketcha testified at deposition that allowing a bank 30 days to raise capital, in an 8(a) notification, would be a "very short" period of time. JX 3 (Ketcha Dep.) at 135-36. The notion that capital could be raised in 5 days is ridiculous. *See also* Tr. 2992:16-23 (Fritts).

Dennis Fitzgerald testified at trial regarding the generation of the $271 million figure. That figure, which was created by Mr. Fitzgerald's examination team, was intended to "inject enough cash cushion into the institution that we would feel comfortable . . . ." Tr. 1184:21-1187:11 (Fitzgerald). The premise is that Meritor's goodwill provides no "cushion." That premise is expressly articulated in the memorandum by which Mr. Ketcha transmitted the $271 million figure to Washington. *See* PX 500. In that memorandum Mr. Ketcha presents a *pro forma* capital ratio on the assumption that the $271 million actually materializes. That pro forma calculation makes a "reduction for goodwill disallowed" in the total amount of all Western goodwill then remaining on Meritor's books. PX 500 at 1. The attached spreadsheet, prepared by Mr. Leary of Fitzgerald's staff, JX 5 (Leary Dep.) at 150, further clarifies that the calculations were made "without goodwill." PX 500 at 2.

A year earlier, Mr. Shull's examination team had made note of a statement by Mr. Piracci that Mr. Ketcha would discuss "extinguishing [Meritor's] goodwill" with Washington. PX 362 at 3; *see* Tr. 3375:16-22 (Shull).[33] At the same time, the Regional Office prepared for the Shull team's usage a model designed to project Meritor's insolvency on a tangible basis. PX 362 at 3; *see* Tr. 3372:10-3374:15 (Shull). Mr. Ketcha's December 9, 1992 memo to Mr. Poling in Washington (PX 500) makes it perfectly clear that in FDIC's mind the goodwill had indeed been fully "extinguished."

The Notice to Primary Regulator recited among other things FDIC's conclusion that Meritor was "operating with inadequate capital." PX 505 at 2. As noted above, former FDIC Chairman Bill Isaac testified that he was unaware of any bank that had ever been seized by FDIC with 7.5% capital. Tr. 1569:24-1571:14 (Isaac). With goodwill, Meritor's primary capital ratio at the end of 1992 was over 8%. The Notice to Primary Regular thus reflects FDIC's view that the goodwill no longer existed.[34]

(i) Secretary Hargrove

Ms. Hargrove testified that in a conference call with FDIC she was told that one of the reasons for closure was Meritor's "absolute level" of capital, which referred to tangible capital. Tr. 1888:15-25 (Hargrove); PX 448. This may go a long way towards explaining why Secretary Hargrove requested indemnification from FDIC. According to the transcript of FDIC Board Meeting of December 9, 1992, the request for indemnification was made "with regard to the

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[33] At trial Mr. Ketcha could not deny that he had stated to Mr. Piracci that he, Ketcha, would be discussing with Director Stone the "extinguishing" of Meritor's goodwill. Tr. 5071:1-5072:7 (Ketcha).

[34] The Notice also recites Meritor's "violation" of the Written Agreement, but both Mr. Ketcha and Mr. Fitzgerald confirmed that any alleged violation of the capital ratio requirements of the 1991 Written Agreement were at most a minor concern in the issuance of an 8(a) proceeding. Tr. 5067:5-9 (Ketcha); Tr. 1616:23-1617:9 & Tr. 1188:10-1189:2 (Fitzgerald). Notably, the drafts of the Notification to Primary Regulator created by the Regional Office did not even include a violation of the 1991 Written Agreement as a basis for the withdrawal of insurance; language to that effect came in as an afterthought in Washington. PX 496 at FSL007 0106; PX 473 at 4-5.

issue of supervisory goodwill, as [Ms. Hargrove] is concerned about that issue." PX 603 at 12. Having been told that Meritor's closure was linked to its lack of tangible capital, Secretary Hargrove knew perfectly well that its closure would result in litigation.

(j) FDIC Board of Directors

The transcript of FDIC Board of Directors meeting on December 9, 1992 further demonstrates the primacy of Meritor's tangible capital condition in FDIC's decision making. Mr. Fritts initiated the discussion succinctly,

> Well, Meritor's Savings Bank is a $5 billion savings bank in Philadelphia and it is rapidly running out of capital as the accompanying case suggests. And the staff has concluded that we want to recommend that we initiate notification of the removal of deposit insurance. And that's the recommendation.

PX 603 at 2. Director Hope than inquired:

> When you say rapidly running out of capital, will you explain that in a little more detail?

Id. Mr. Fritts' response:

> Well, I mean, they have — they have .66 [percent] in the tangible equity capital. So they have less than 1% tangible capital.

Id. Mr. Fritts went on to mention the amortization of Meritor's goodwill as a burden on the Bank, but insofar as he responded to Mr. Hope's request that he "explain" what he meant by "running out of capital," Mr. Fritts's only response was that "they have .66 [percent] in the tangible equity capital. So they have less than 1% tangible capital." *Id.*

Later Mr. Fritts explained that the Board's approval of the Section 8(a) proceeding is "sort of a December 19th kind of an action before December 19." *Id.* at 3. Again, Mr. Fritts, the Executive Director of Supervision and Resolutions, is demonstrating: (a) that tangible capital is the critical factor; and (b) that like Stan Shull and Stanley Poling before him, Mr. Fritts saw the seizure of Meritor as the implementation of FDICIA prior to that statute's taking legal effect.

Based on his experience serving on FDIC Board of Directors, plaintiffs' expert Mike Mancusi noted that the record of the Board's December 9 meeting shows that the Board excluded goodwill from Meritor's capital and "focused solely on tangible capital, to the exclusion of the goodwill." Tr. 2208:6-8 (Mancusi).

The transcript of FDIC's Board of Directors meeting of November 10, 1992 is equally telling. As it relates to Meritor, the subject of that meeting was whether the Board would respond to Mr. Hillas's October 14, 1992, letter requesting clarification of how Meritor's goodwill would be treated under FDICIA. The minutes reveal that, as of November 10, 1992, a response had already been prepared, stating that the goodwill would be eliminated under FDICIA. PX 602 at 1. But FDIC Director John Stone stated, at the November 10 meeting, that even if FDICIA allowed the agency to count the goodwill, the Division of Supervision would prefer to repudiate the 1982 Agreement and write off Meritor's supervisory goodwill. *Id.* The determination was made, however, not to tell Meritor that FDIC had already made up its mind on this issue. One of the reasons for keeping Meritor in the dark, Mr. Stone noted, was the fact that a Director of Meritor had stated in the press that if the agency repudiated the goodwill agreement, litigation would be initiated, and a lawsuit "could thwart the resolution activity and schedule that DOR and the state authority had set up." PX 602 at 2. In other words, FDIC determined to keep its decision to repudiate the 1982 goodwill Agreement a secret so that it could seize Meritor by surprise and prevent the Bank from accessing the Courts.

2. Plaintiffs' Expert Mr. Mancusi Has Shown That Capital Drove The Decision To Seize The Bank

During Mancusi's long tenure as a federal bank regulator, he was at one point personally responsible for making the final decision on bank closures.[35] Mr. Mancusi testified, based on his review of the entire regulatory file on Meritor, that FDIC's actions in late 1992 were clearly driven by the perceived imminence of Meritor's tangible insolvency. The basis for this conclusion was:

> [T]he reams of material in which there is considerable discussion about the tangible capital and the concerns that the FDIC has about the tangible capital. In a lot of their memoranda, that is the principal point that is discussed, although they do fill-in with some other issues in their discussion about the institution.
>
> But the primary focus was on tangible capital and the FDIC's belief that the institution would be insolvent on a tangible capital basis, not a total capital basis, but a tangible capital basis in short order.

Tr. 2197:18-2198:2 (Mancusi).

Mr. Mancusi noted that the Confidential/Supervisory section of Mr. Fitzgerald's 1992 exam report, in accordance with FDIC's "normal supervisory practice," focused on tangible capital.

> Q. [The] second sentence reads, "The December 19, 1992 phase-in to the FDICIA capital requirements will likely impact subject bank by disallowing the regulatory goodwill as a capital component. Even if this does not occur, the bank will soon exhaust remaining tangible capital and thereby lose the ability to absorb operating and credit losses."
>
> Based on your experience, how would you conclude FDIC is treating goodwill in this document?

35 *See* Tr. 2206:19-25 (Mancusi) ("The 18 years that I was with the banking agency, the Office to the Comptroller of the Currency, and particularly in the latter six years or so, I was involved in the determinations of whether banks should be closed. And my last three years, I served on a number of occasions as the deciding official when a national bank should be closed.")

> A. Well, they were disallowing the goodwill and they were looking only at tangible capital, both in context to the pending legislation, and then, in the context of — without the pending legislation; just in their normal supervisory practices.

Tr. 2202:15-2203:2 (Mancusi); PX 407 at FSL003 1190.

Mr. Mancusi also noted that the 1992 exam report paid lip service to the alleged violation of the 1991 Written Agreement, but reflected FDIC's actual concern was tangible capital, to the exclusion of goodwill. Counsel first read the language from the report, then inquired as to its significance:

> Q. . . . The capital accounts of Meritor Savings Bank, by any measure, are completely inadequate to support the ongoing operations to the bank. As previously cited, capital as computed under the outstanding written agreement is substantially below the agreed upon minimums." And it goes on to describe "at capital levels, on a tangible capital basis," the last sentence says "these tangible net worth calculations which are detailed on pages 3 to 5, 3-5 and 3-6 of this report, further reveal that, as of June 30, 1992, remaining tangible capital has fallen to the extremely hazardous level of only $23,381,000."
>
> In your view, and based on your experience, how would you conclude FDIC is considering Meritor's goodwill?
>
> A. Here again, they are focused primarily on tangible capital versus total capital. Even in the first couple of sentences you read, you know, there is the passing comment about the written agreement, and that they are substantially below the requirements. "Substantially" is an alarming word.
>
> And looking at the ratios just above it, I don't see that they were substantially below the requirement, but it was sort of dismissed casual — I mean, it was a comment in the report and then they focused totally on the tangible capital.

Tr. 2203:9-2204:8 (Mancusi); PX 405 at CSL015 0772.

It is notable that, as early as January, 1991, the Regional Office was informing Washington that Meritor's tangible capital was likely to run out in late 1992:

> The bank has projected 1991 losses of $104,500M after a $53,200M amortization of goodwill. The loss of this magnitude will significantly impact upon the bank's tangible equity ratio. Capital includes $345,800M goodwill and tangible capital is calculated at 1.83% on 12-31-90. Tangible capital will decline to about $50,100M by December 31, 1991, should management's loss projections be accurate, and the potential exists to eliminate the tangible capital position by the end of 1992.

PX 298 at CSL011 1720; *see* Tr. 2199:5-2200:11 (Mancusi). Given this long-term and continuing focus on Meritor's "tangible capital life," it is no surprise that Mr. Mancusi concluded that tangible insolvency was the dispositive factor in Meritor's closure:

> Q. Mr. Mancusi, let me ask the question, therefore, again, And that is, but for FDIC's discarding of goodwill, do you believe that an 8(a) action would have been brought against Meritor in December of 1992?
>
> A. No, sir, not in my opinion. The bank had substantial capital at that time, and I think the — you know, the termination of insurance proceedings was unusual given the level of capital that they had.

Tr. 2207:6-13 (Mancusi).

B. A Finding Of Nonviability Was Not The Basis For FDIC's Seizure Of Meritor

The government has argued, and some of its witnesses have claimed, that the seizure of Meritor was based not upon the Bank's impending tangible insolvency but, instead, upon a finding that the Bank was not "viable." But as a practical matter, as plaintiffs' experts Dr. Brumbaugh and Mr. Mancusi testified, FDIC does not, and cannot, close banks on that basis. In addition, the testimony of FDIC witnesses confirms that insofar as the 8(a) proceeding was the result of a viability determination, "nonviability" was equated with lack of tangible capital. Finally, to the extent the word viability is being used in its normal sense — the ability to turn profits in the foreseeable future — the complete absence of any effort to assess Meritor's future shows that viability was not even an issue.

1. Dr. Brumbaugh Has Shown That Capital, Not Viability, Drove The Decision To Seize The Bank

It is possible that no one alive today knows more about the savings bank crisis, and the regulators' responses to it, than Dr. R. Daniel Brumbaugh. Dr. Brumbaugh has written extensively on the subject, and his writings have heavily influenced federal policy-making in the area. Based on those studies, and upon his career as a bank regulator, and upon his study of the documentary record in this case, Dr. Brumbaugh strongly rejected the suggestion that FDIC's actions in 1992 were based upon an analysis of Meritor's “viability."

> Q. Mr. Ketcha has testified in this case that while capital — the lack of capital was an issue, that he closed it because it wasn't viable, because it didn't have prospects in terms of earnings to pay for its losses and to make money in the future. Assuming that's a correct characterization and he did use the word "viability," did you, based on your historical study of the banking industry, know of any documentation in the FDIC to support that sort of view in terms of seizing an institution?
>
> A. No, no. And the only other — the only other major reason for closing an institution, notwithstanding the fact that at the time of closure there was always a substantial amount of language about what characterized an unsafe and unsound condition, the overwhelming number, above 90 percent, above 95 percent of institutions that are ever closed, especially by the FDIC, is due to the fact that, as I just said, capital has reached zero by the relevant operating capital level that's being used.
>
> The only other time is primarily when there's been a cease and desist order and the cease and desist order deals with some grievous problem approaching criminality, and there's a violation of the cease and desist order. That's the other major component of why institutions are closed for an unsafe and unsound condition.
>
> Moreover, that statement is inconsistent with what he wrote in the confidential Memorandum of 1991 in which he said — in which he defined viability [in] associat[ion] with the elimination of goodwill, which would then take them down to a capital level below which closure became likely, and that's why they put them on the list. In addition, it's inconsistent with all the regulatory documents, including the board resolution minutes when the institution was actually seized.

Tr. 5534:21-5536:3 (Brumbaugh). Dr. Brumbaugh also testified that the entire course of FDIC regulatory conduct over the 1982-1992 period illuminates and confirms the motivation for the seizure of the Bank:

> I think that if you look at the institution and the treatment [given it by the regulators] beginning from immediately after the [1982] agreement, the record is overwhelming that what was motivating the decision making at FDIC was . . . maintaining the highest possible tangible capital level, excluding the goodwill, in order to protect the Federal Deposit Insurance Corporation Fund, and I believe the method of closure is consistent with that . . .

Tr. 5454:9-16 (Brumbaugh); *see also* Tr. 5521:20-5522:9 (Brumbaugh):

> Q. Ultimately, Meritor was seized on December 11th, 199[2]. Did you analyze the record to determine what you believe to be the basis for the seizure of the institution?
>
> A. Yes, I did.
>
> Q. And what did you conclude?
>
> A. I concluded that the closure process that was followed was consistent with the process that had existed all the way up until that point. The documents clearly state that the focus of attention was on the tangible capital level of the institution, which at that time as a ratio was under 1 percent. It was absolutely clear in all the regulatory documents that for the purposes of calculating that tangible capital, the goodwill that was associated with the original 1982 MOU was not included and never was included.

2. FDIC Witnesses Have Admitted That They Equated A Lack Of "Viability" With A Lack Of Tangible Capital

As conceded by Review Examiner Linda Pollack, who drafted the "8(a) Memo," “tangible capital” was a “critical factor” in determining Meritor’s “viability.” JX 8 (Pollack Dep.) at 271-73, 346-47. Ms. Pollack elsewhere reconfirmed the link between "viability" and solvency, and the fact that Meritor's goodwill, in her view, contributed to neither:

> Q. And viability is dependant on the amount of tangible capital that an institution has?

> A. I think if a bank had 15 percent capital and it was all goodwill, they wouldn't be a viable bank.

JX 8 (Pollack Dep.) at 320:

Michael Piracci, the New York Assistant Regional Director, affirmed that FDIC disregarded Meritor's supervisory goodwill in considering the "viability" of the institution and subsequently testified that Meritor's goodwill, to the extent it was considered at all, was actually deemed a *negative* factor since it represented a non-earning asset:

> Q. So the only focus of the supervisory goodwill for purposes of your [viability] analysis would be the [amortization] charge-off, and in a sense, that's only a negative, isn't it?
>
> A. In that it comes out of earnings and that it negatively impacts capital, yes.

JX 7A at 288; *see also* JX 3 (Ketcha Dep.) at 401-07. The decision to cause Meritor's closure consequently turned on the institution's *tangible* capital:

> A. Because that's what's there to absorb losses, and if there's no — if there's no level of tangible capital to absorb losses, then the bank can't go on in existence.
>
> Q. And why not?
>
> A. It would be operating with a negative tangible capital ratio, and generally that's not permitted.

JX 7A (Piracci Dep.) at 185-86.

Mr. Ketcha also admitted that a bank is, except in extraordinary circumstances, "not viable" when it runs out of tangible capital. Tr. 5105:17-25 (Ketcha). *See also* JX 3 (Ketcha Dep.) at 287 ("Q. Could you have an institution with zero percent tangible capital that was viable? A. Yes. It would have to be a zero for a very short period of time; i.e., a day."). Thus, FDIC personnel who were most intimately involved concede that the finding of "nonviability" was based on the decision not to treat Meritor's goodwill as regulatory capital.[36] *See also* JX 8 (Pollack Dep.) at 347-48.[37] This exclusion of goodwill from viability analysis is a clear breach of the 1982 goodwill agreement, even as construed by Mr. Gough, the FDIC's witness. *See* Tr. 2806:23-2807:16.

3. The Absence Of Any Meaningful Effort By FDIC To Project Meritor's Earnings Potential Confirms The Fact That The Bank's "Viability" Was Simply Not A Consideration

As was true in Mr. Shull's 1991 examination of Meritor, it is significant that Mr. Fitzgerald's 1992 examination did not attempt any meaningful projections of future bank performance. Similarly James Hand, who had attempted to project the life expectancy of Meritor's capital account at year-end 1991 (PX 341), made no effort to assess how the Bank's earnings could improve or deteriorate with changes in the economic environment. Tr. 3567:19-3570:14 (Hand).[38] This refutes the government's suggestion that the decision to close Meritor was based not on capital considerations but on a determination that the Bank was not "viable."

Viability (the ability to produce earnings in the foreseeable future — *see* Tr. 1189:13-15 (Fitzgerald)) — cannot be assessed without performing at least some analysis of future earnings prospects. We do not suggest that FDIC was obligated to perform a *pro forma* analysis as

[36] The 8(a) memorandum also noted that to avoid loss of insurance Meritor must increase its Tier 1 capital "exclusive of goodwill." *See* PX 473 at 3.

[37] The fallacy in the government's argument that "viability" was the touchstone in 1992 is also highlighted by the simple fact that FDIC has never closed a bank with Meritor's level of regulatory capital. Mr. Ketcha could not recall a single instance of a bank whose insurance was withdrawn having tangible capital in excess of 5%. JX 3 (Ketcha Dep.) at 637; *see* Tr. 5100:23-5101:12 (Ketcha). Assistant Regional Director Michael Piracci could not recall a single instance, other than Meritor, of a bank with greater than 5% primary capital having been seized. JX 7 (Piracci Dep.) at 116, 118

[38] At the pages cited Mr. Hand explained that the examiners on-site would ordinarily perform analyses of how changes in economic conditions might affect future bank performance, but the record shows that in the 1991 and 1992 examinations of Meritor no such analysis was in fact performed. *See, e.g.,* Tr. 1190:18-1191:7 & Tr. 1615:9-15 (Fitzgerald).

thorough as that offered by Dr. Finnerty at trial. We do submit, however, that the absence of *any* effort to assess Meritor's future earnings, by way of even the most rudimentary projections, reveals that the Bank's "viability," in the ordinary sense of the word, was not a relevant issue to FDIC. For the Fitzgerald examination team, the only projections even cursorily attempted were those for 1992-93, because, as Mr. Fitzgerald candidly admitted, anything beyond that time period was not “germane." Tr. 1808:18-1809:20 (Fitzgerald); PX 406 at 4-5. That projections beyond 1993 were, in FDIC's view, irrelevant is confirmed by the fact that no such projection was attempted in the Fitzgerald exam report: if they held any significance, Mr. Fitzgerald was obligated to include them in the report. Tr. 1788:4-7, Tr. 1803:14-1804:2 & Tr. 1189:16-1190:2 (Fitzgerald). Any projections beyond 1993 were not “germane" to FDIC for the simple reason that Meritor's tangible capital was not likely to survive beyond 1993 if its losses continued at the current rate. In Fitzgerald's view, tangible capital is what really mattered, because the goodwill was useless for paying bills or absorbing losses or protecting the fund. Tr. 1616:7-22 & Tr. 1176:4-1177:6 (Fitzgerald).

Up to the very end Meritor had remained hopeful that its 1982 contract would be honored, but as Dennis Fitzgerald dryly noted in the Confidential/Supervisory Section of his Report of Examination as of July 20, 1992, the hope was vain. Mr. Fitzgerald there chastised Meritor’s CFO Michael High for being “reluctant to give up on the idea of the regulatory goodwill counting as capital.” PX 407 at A-2.

XII. FDIC, NOT THE STATE OF PENNSYLVANIA, CAUSED MERITOR'S SEIZURE

The Government has contended that it was the State of Pennsylvania, not FDIC, that seized Meritor. The argument ignores several realities.

First, it ignores the fact that throughout the years relevant to this lawsuit FDIC, not the State of Pennsylvania, dominated the regulation of Meritor. In his four years at the Bank, Roger

Hillas saw Secretary Hargrove a total of three or four times. Tr. 2171:2-7 (Hillas). Hargrove never played a significant role in any regulatory event relating to Meritor, and in cases where Pennsylvania representatives attended Meritor's meetings with FDIC regulators, they did so as observers. Tr. 2135:9-2136:5 (Hillas). On the day of the seizure itself, Hargrove's only act was to ask Mr. Hillas to help her cash a check (Mr. Hillas had to initial it). *Id.*

Second, the Government's argument ignores the fact that, as the insurer, FDIC will necessarily dominate regulatory decision-making, as Dr. Brumbaugh explained:

> Q. What was the role of the Department of Banking of Pennsylvania in this process?
>
> A. It was essentially the role that is always taken by the state regulator in a closure of this type. Formally, without exception with any federally insured depository, if it's state regulated, the actual formal legal responsibility to close the institution resides with the state regulator. The way it works, in fact, always is that because the insurance of deposits is the overwhelmingly important issue, the state regulator defers to the FDIC or the relevant federal deposit insurer in the timing and the nature of the resolution. It just is the way it was done here. The reason is perfectly logical. The state doesn't want to close an institution if the FDIC doesn't want to and is going to uphold its insurance deposits, because then the state becomes liable for the insured depositors. It's logical from the FDIC's standpoint, because if the FDIC is actually going to bear the burden of paying the insured depositors, it doesn't want to concede to the state responsibility for the closure in determining how much they're going to have to pay. As a result, the process works out as I've just testified and as it worked out here. The FDIC made the determination that it was going to close the institution. It was the entity which attempted to arrange — talked to all the potential bidders and ultimately accepted the Mellon bid, and then it worked out an arrangement whereby under those conditions the state person would go in and serve the formal papers, Ms. Hargrove. That's perfectly consistent with the affidavit that she signed in this case.

Tr. 5526:8-5527:12 (Brumbaugh). Secretary Hargrove acknowledged that she could never close a bank without FDIC "cooperation" because she "had no money to pay depositors" Tr. 1898:15-19 (Hargrove). As Dr. Brumbaugh testified, the state and federal regulators almost always work "in a mutually agreeable way," but that invariably it is "the deposit insurer who is the driving force, because it bears the responsibility ultimately for the insured deposits . . ." Tr. 5453:22-5454:6 (Brumbaugh).

Third, the Government's argument ignores the fact that once FDIC took steps to withdraw insurance the State of Pennsylvania was legally compelled to withdraw the Bank's charter. *See* 7 P.S. § 105 (1999); Defendant's Response to Third Request for Admission at 11; JX 3 (Ketcha Dep.) at 118, 378-79; Tr. 1893:22-1894:1 & Tr. 1920:14-21 (Hargrove). Accordingly, as former Chairman Isaac testified, an FDIC action to terminate insurance "almost guarantee[s] the closure of the bank by the State Banking Department;" in the few cases where the states have not immediately seized a bank whose insurance has been challenged by FDIC, FDIC sued the state and closure followed. Tr. 1572:6-1573:6 (Isaac); Tr. 5532:15-5533:6 (Brumbaugh). *See also* Tr. 1604:25-1605:9 (Fitzgerald): "As Mr. Isaac pointed out earlier, if FDIC does take action to terminate insurance, virtually every state authority would, at that point, move to seize an institution." *See also* Tr. 5094:15-5095:2 (Ketcha). Finally, Ms. Hargrove specifically acknowledged under oath that the 8(a) notice alone was sufficient to "cause the Department of Banking to take possession of Meritor." PX 527 at 3.

Fourth, even absent such statutory compulsion, an 8(a) notice absolutely forces the State's hand because, unless closed, the Bank will almost certainly suffer a disastrous run on deposits: "[T]he FDIC's initiation of an 8(a) proceeding effectually terminates the Bank, because once the public notice is out that FDIC is terminating insurance, you have the risk of a run on the bank, and state regulators' hands are tied and they are likely to be forced to close the bank." Tr. 2210:16-21 (Mancusi). *See also* Tr. 2981:3-10 (Fritts).

Fifth, the Government's argument also runs afoul of Secretary Hargrove's own affidavit. At trial Secretary Hargrove confirmed that she signed the affidavit with assistance of counsel and that every statement in the affidavit is accurate and truthful; the affidavit was admitted as her trial testimony. Tr. 1862:2-13 (Hargrove); Tr. 1863:18-1867:2 (Hargrove); Tr. 1877:9-1878:11 (Hargrove); PX 527; *see also* PX 571. The affidavit confirms that the State of Pennsylvania had taken no steps whatsoever towards the seizure of Meritor until Ms. Hargrove was contacted on her car phone by Regional Director Ketcha on December 8, 1992, three days before the seizure, and until the section 8(a) proceeding was initiated against the Bank.[39] PX 527 at 2. Ms. Hargrove's affidavit establishes that, because she anticipated FDIC would seize Meritor under FDICIA on December 18, 1992, she had no plan or intention of revoking the Bank's charter until she received a phone call from Nick Ketcha on December 8, 1992. PX 527 at 3, 4. In her telephone call with Mr. Ketcha, he stated that FDIC had received a very favorable bid for the assets and liabilities of Meritor from Mellon Bank, and communicated "FDIC's desire to move quickly to preserve and secure the Mellon bid and to promptly consummate a sale of Meritor to Mellon . . . ." *Id.* Mr. Ketcha further stated that FDIC feared "that the Mellon bid might be lost if Meritor were not closed promptly."[40] *Id.* Because FDIC did not have the power to seize Meritor at that time, Ketcha asked Hargrove to immediately seize Meritor to preserve the Mellon bid. *Id.* Ms. Hargrove agreed, and the Department of Banking seized Meritor at the specific request of FDIC on December 11, 1992. *Id.* Ms. Hargrove testified that she had no intention of

[39] Secretary Hargrove did sign the so called "failing bank letter," but the documents and testimony reveal that this letter was in fact prepared by FDIC and that FDIC instructed Secretary Hargrove to sign it. Tr. 1867:13-20 & Tr. 1885:25-1886:12 (Hargrove); PX 527 and PX 421.

[40] The transcript of FDIC Board of Director's meeting that occurred the very next day, December 9, 1992, confirms that FDIC was anxious that the Mellon deal might "not stick." PX 603 at 9. *See also* Tr. 4320:18-4321:8 & 4339:24-4340:11 (Hartheimer) (Resolutions team was worried that the Mellon deal might "unravel").

seizing Meritor at that time (*id.*), and that FDIC handled all the steps toward seizure, including preparing the failing bank letter for Ms. Hargrove's signature. *Id.* at 4. Ms. Hargrove's role in the seizure was limited to signing the certificate of possession and getting a check cashed, albeit with the help of Roger Hillas.

Although Ms. Hargrove agreed on December 8 to seize Meritor three days later on December 11 for the FDIC, it was only on the condition that the state be indemnified by FDIC for its actions. Secretary Hargrove was worried about the goodwill issue, because with the goodwill Meritor was far from insolvent. The minutes and transcripts of FDIC Board of Directors meetings confirm that this was a serious request and was taken seriously. PX 603 at 12-30; Tr. 2986:4-8 (Fritts). The request was made precisely because the Pennsylvania Department of Banking had been embroiled for months in litigation arising out of Secretary Hargrove's closure of two banks. Tr. 1889:1-20 (Hargrove). The basis for the lawsuits had been the allegation that the banks were seized without an opportunity for a hearing and because the banks were seized when they still had capital (both of which would be true in Meritor's case.) Tr. 1889:21-1890:12 (Hargrove). Any suggestion that Pennsylvania would have taken the initiative in closing Meritor is thus most implausible. And the request for indemnity confirms the reality that in revoking Meritor's charter Secretary Hargrove saw herself as FDIC's agent. The "context" thus confirms her sworn testimony that she would not have done so otherwise.

The historical context also bears on Ms. Hargrove's testimony. As Dr. Brumbaugh noted, Ms. Hargrove's claim that she acted independently in withdrawing Meritor's charter is "not consistent with any closure of a state chartered, federally insured depository that ever has taken place in this country to my knowledge." Tr. 5527:18-20 (Brumbaugh).

Ms. Hargrove's affidavit is also corroborated by the transcript of FDIC's Board meeting on December 9, 1992. The context of the December 9 Board Meeting is important. The Board already had in hand an offer from Mellon that would allow FDIC to liquidate Meritor at a profit — a virtually unprecedented opportunity. Tr. 5455:107 (Brumbaugh); PX 603 at 12. If FDIC were to wait even a week, FDICIA's implementing regulations would take effect on December 19 and FDIC would not be able to take possession of Meritor until after the expiration of substantial notice periods. Tr. 5529:12-20 (Brumbaugh). FDIC was anxious to consummate the deal with Mellon lest it slip away; but, according to the Board minutes, Secretary Hargrove was not willing to revoke Meritor's charter and hand the Bank over to FDIC at that time. Director Steinbrink asked Mr. Fritts whether the State would close Meritor in the absence of the Section 8(a) notification, to which Mr. Fritts responded:

> They will close it, down the road. Down the road, which costs us money and-well, it costs FDIC money.

PX 603 at 3-4. Earlier, Mr. Fritts had observed that the state of Pennsylvania would be "willing to close this bank sooner rather than later if they have a basis on which they feel as though they can," and on that basis was recommending that the Section 8(a) notification be issued. *Id.* at 3. Thus, the minutes of the Board's December 9 meeting confirm that the Section 8(a) Notice was issued by FDIC specifically because FDIC knew that Secretary Hargrove would not revoke the bank's charter without that action: "The problem that's occurring now is that, for one reason or another, the State Commissioner is having some difficulties." PX 603 at 7. Director Steinbrink accordingly expressed concern that the Section 8(a) Notice was somewhat disingenuous — a "CYA 8(a)" intended solely to give the state political cover.

> Does this — does this — I mean, I don't know if I even ought to ask this kind of question on the record. I mean, does this — appears, if I was sitting and looking at this in my own agency, that this is a CY — CYA 8(a).

PX 603 at 5.

Accordingly, unless the FDIC could somehow impel the State of Pennsylvania to revoke Meritor's charter, seizure of the bank would have to take place under FDICIA and could be delayed for as much as three months. Executive Director Fritts noted at the Board Meeting that, unless Secretary Hargrove could be persuaded to act, "for sure it's going to be delayed a week; could be delayed several months or three months or whatever it takes beyond December 19 to get the job done." PX 603 at 18. The issue, Mr. Fritts continued, was whether "we'll close it today as oppose to maybe three months down the road." PX 603 at 19. And later Executive Director Fritts explained that "one of the reasons they were trying to speed the process up is because the Commissioner right along has gotten cold feet . . . ." PX 603 at 9. The understanding of Mr. Fritts and the Board clearly is that Secretary Hargrove would **not** close the Bank at that time unless the 8(a) notice were issued. And that is precisely what Ms. Hargrove's affidavit indicates.

XIII. HAD IT NOT BEEN SEIZED MERITOR WOULD HAVE SURVIVED AND PROSPERED.

Notwithstanding the persistent recession and the hurdles erected by FDIC, by late 1992 the accomplishments of the Hillas management team were impressive. They included: (1) the write-off (on a GAAP basis) of $800 million in goodwill; (2) the reduction of high cost liabilities from $2 billion to $400 million, eliminating the Bank's interest rate gap; (3) the rationalization of real estate assets, and positioning of excess office space for sale; (4) the generation of $700 million in capital; and (5) downsizing the Bank from $18 billion to $4 billion in only four years. Tr. 2140:15-2141:10 (Hillas).[41] In addition, almost a billion dollars in securities depreciation

[41] As Dr. Brumbaugh noted, Meritor "basically went from $20 billion to $5.8 billion in the four-year period beginning in 1987. That kind of shrinkage is unbelievable. Managing that kind of shrinkage is a horrendous task." Tr. 5506:18-21 (Brumbaugh).

had been eliminated, adding a billion dollars to the institution's net worth. Tr. 2141:18-2142:3 (Hillas); Tr. 5676:14-5677:1 (Brumbaugh); *see* DX 1699A at 35.

No one disputes that problems still beset the Bank, but the future was promising. At some point the real estate recession simply had to ease up, which would allow Meritor to sell its excess office space (one of its most costly problems). Tr. 1098:4-25 (High); Tr. 1107:2-22 (High); Tr. 1808:2-5 (Fitzgerald). In fact, by late 1992, the commercial real estate recession was already beginning to ease up. Tr. 2106:9-13 (Hillas). FDIC Review Examiner Francisco acknowledged that the Bank had reasonable plans for bringing its overhead expenses under control after they had predictably ballooned as a result of radical downsizing. Tr. 3825:13-3826:14 (Francisco). In addition, in the first nine months of 1993 half of the Bank's remaining $438 million in high-cost liabilities would run off. Tr. 2141:11-17 (Hillas). Meritor's capital account was strong — close to 10% after the sale of the Florida subsidiary. Tr. 2103:5-24 (Hillas); Tr. 2124:5-8 (Hillas). If the goodwill had been counted, this capital account would have given the Bank several years to work out of its remaining problems. The bank also had a very large loan loss reserve, approximately $100 million, which — according to FDIC witnesses — should have been fully adequate to absorb any remaining losses that might eventuate in its loan portfolio. Tr. 3438:9-3439:5 (Shull). In addition, the sale of F.A. had brought the Bank into compliance with the capital ratios in the 1991 Written Agreement. Tr. 2394:25-2397:7 (Finnerty); PX 530 at 22-23.

CFO Michael High testified that in his view, as of late 1992, what Meritor needed to return to profitability were: (1) improved interest rate spreads; (2) the ability to dispose of office space; (3) improved value in the mortgage-backed securities portfolio; and (4) time to let high cost debt roll off. Tr. 1134:12-1135:15 (High). With the benefit of hindsight, it is apparent that all of this in fact would have happened over a one to three year period. *Id.* The bond portfolio would have been strengthened. Tr. 729:12-20 (Hillas). Interest rate spreads had improved. PX 586A; Tr. 5521:1-10 & 5553:2-5554:25 (Brumbaugh). Interest rates also came down. PX 588; Tr. 5555:2-5556:8 (Brumbaugh). Like Germantown and Wilmington Savings, Meritor would have survived and prospered if given time. Tr. 1014:3-25 (High). And *time,* of course, was one of the essential benefits of FDIC's original promise to count the goodwill as capital.

For a bank that is experiencing difficulties, the principle advantage of a large capital account is the fact that, by absorbing losses, the capital gives the Bank *time* to work out of its problems and return to profitability. Tr. 3374:16-23 (Shull); Tr. 3749:24-3750:3 (Francisco); Tr. 3525:4-13 (Hand). The promise to count the goodwill was thus a promise to give Meritor extra time to work through its problems, in exchange for relieving FDIC of an $800 liability. Tr. 2078:1-10 (Mancusi) ("[T]he advantage of the goodwill for Meritor . . . . was to provide time."), *see also* JX 7 (Piracci Dep.) at 131-36 (the benefit of a large capital account is that, even for a institution that is suffering serious ongoing losses, the capital provides the ability to absorb those losses and thus provides time to experience possible changes in economic conditions and fortunes.) Meritor President Cullen told Dennis Fitzgerald in late September, 1992, that all the Bank needed was two to three years to clean up its remaining problem loans and return to profitability. Tr. 1829:20-1830:1 (Fitzgerald); *see* PX 443 at CSL031 0195-96. Had the goodwill been counted, Meritor would have had more than 2 to 3 years to work out of its problems.[42] And there was also always a possibility that Meritor could accomplish a merger. As

42 In PX 341 (an internal FDIC analysis performed at the end of 1991) James Hand illustrates how the computation would work. He there noted that — if the goodwill were counted — Meritor would survive beyond two years because its normalized losses, plus annual goodwill amortization, would not exhaust *regulatory* capital for at least that long. Tr. 3555:1-3559:2. At year-end 1992, Meritor's monthly loss rate was approximately $2 million (PX 603 at 2), and amortization of the goodwill remained a flat $54 million yearly, for a total annual drain

Regional Director Ketcha testified at deposition, "my opinion was if anybody would pull a marriage with someone in the Philadelphia ... market, it was probably Roger Hillas because of his reputation, because of his standing with the banking community." JX 3 (Ketcha Dep.) at 114.

The fact that Mellon paid $180 million premium for Meritor's deposits reflects the value and prospects of the franchise. Tr. 2125:9-15 (Hillas); Tr. 667:16-24 (Hillas). Certainly, the Bank faced no liquidity problems. In 1988 Regional Director Lutz viewed Meritor's 20% liquidity level as adequate. PX 135 at 4. In 1992, Meritor's liquidity was over 28%. Tr. 1818:14-1821:2 (Fitzgerald); PX 406 at 5-a. The stability of Meritor's deposits during these very volatile years reveals the extraordinary strength of the franchise and its depositor base. Tr. 402:5-7 (McCarron); Tr. 664:15-25, Tr. 2147:15-2148:8 & Tr. 619:24-620:3 (Hillas). And, as noted, every FDIC examiner and official acknowledged that Meritor's management team was superb.

XIV. DR. FINNERTY'S EXPERT TESTIMONY CONFIRMS MERITOR'S VIABILITY AND SOLVENCY IN DECEMBER, 1992

Dr. John Finnerty is a Professor of Finance at Fordham University. Since studying economics as a Marshall Scholar at Cambridge University and receiving his Ph.D., Dr. Finnerty has worked in the areas of corporate finance for almost 25 years. He has published extensively (55 articles and 8 books) on securities valuation, financial management, financial institutions,

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of $78 million (assuming the continuation of then-current losses, which would not in fact have happened). With more than $260 million remaining in the capital account (tangible capital plus remaining goodwill) (PX 498 at 1), Mr. Hand's approach in PX 341 shows that, if given credit for the goodwill, it would be more than three years before insolvency became an issue for Meritor *assuming no change in earnings* — *see* Tr. 3566:21-3567:14(Hand). But in three years a lot can happen, and between year-end 1992 and year-end 1995 a lot did happen: rate spreads widened, real estate at long last rebounded, and MBS securities appreciated. *See* Tr. 5538:15-17 (Brumbaugh) ("[W]hat we now know about what happened immediately after was almost universally positive for this institution across a large number of fronts.").

and debt valuation. His entire career has been devoted to the financial services industry, and he was both a founder and CFO of College Savings Bank. PX 530 at 1.

Dr. Finnerty's role in this case is to respond to the government's suggestion that in late 1992 Meritor was "insolvent", or not "viable." He performed, and presented in court, a detailed and sophisticated analysis of Meritor's financial condition as of December 1992, an analysis of the performance of comparable institutions that were not closed, and an analysis of Meritor's solvency under three well-accepted analytical methods. PX 530; PX 539; PX 540.

The result of Dr. Finnerty's comparables analysis is that:

> [W]eaker banks than Meritor, which unlike Meritor were given the chance to do so, survived and profited in the years after 1992. The regulators evidently believed in 1992 that these comparable banks were viable, and hindsight proves that they were right. The . . . comparison also suggests that Meritor was denied continued existence because, unlike these other institutions, a large portion of Meritor's capital consisted of grandfathered goodwill. In most other respect Meritor was as strong as, or stronger than, the comparable banks that were allowed to continue.

PX 530 at 29. The first of the three solvency tests applied by Dr. Finnerty, which focuses on net asset value, revealed that Meritor's net asset value as of December 11, 1992 was $336.5 million. PX 530 at 37. The second solvency test employed by Dr. Finnerty, which employs market multiples analysis, revealed Meritor's equity value to be $109.1 million. *Id*. at 39. Finally, an analysis of Meritor's cash flow and capital cushion confirmed Meritor's solvency and likely future strength. *Id*. at 39-48.

Dr. Finnerty's report and testimony reflect both the wealth of experience and expertise he brings to this case, and his exhaustive analysis of Meritor's financial history, condition and prospects. His testimony and report strongly corroborate the opinions of Meritor's managers -- that Meritor would have survived and prospered if given the opportunity. His testimony and report also corroborate the fact that, when it closed Meritor in December 1992, FDIC was not in fact focused on the question whether Meritor was a viable institution. The regulatory record, including the near-total absence of meaningful efforts at projecting Meritor's future earnings, indicate that those involved in closing Meritor did not even ask the question whether Meritor was then viable. Dr. Finnerty has established that, had they asked that question, the answer would have been affirmative.

CONCLUSION

In April 1982, PSFS entered into a contract with the Federal Government under which PSFS assumed, for the Government's benefit, liabilities approaching $900 million. Every member of the negotiating teams, including the Chairman of FDIC himself, testified that the 1982 Agreement obligated FDIC to treat Meritor's supervisory goodwill as real capital for purposes of assessing the Bank's capital adequacy, solvency and viability. Beyond this, and with equal unanimity, the negotiators of the 1982 Agreement testified that the goodwill was to be regarded as the equivalent of tangible capital for purposes of providing the FDIC Insurance Fund a buffer and for absorbing losses. In addition, FDIC promised that the Bank would not be penalized in any regulatory way for the presence of the goodwill on its books. This included a promise to factor out the impact of amortizing the goodwill on earnings, and giving the Bank consideration, in analyzing its earnings, for the fact that the presence of the goodwill (which is a non-earning asset) would predictably make PSFS less profitable than its peers.

As Dr. Brumbaugh testified, the challenge in this case is not to find documentary or testimonial evidence reflecting FDIC's breach of those promises. Instead, it is virtually impossible to find an FDIC-created analysis of Meritor that does **not** evidence breach. From the moment the Agreement was signed in 1982, FDIC continuously focused on Meritor's tangible capital in every examination report, every quarterly analysis, every internal memorandum, and in each and every regulatory decision. As was true at most banks, Meritor certainly had its problems, and the presence of those problems undoubtedly heightened FDIC's concern for the adequacy of the buffer that Meritor's capital account provided for the fund. But in viewing that buffer strictly on a tangible basis FDIC fundamentally abandoned the promises made in 1982. The sworn admissions of every FDIC witness to testify in this case further establishes that, contrary to the promises made in 1982, FDIC did not treat the goodwill as contributing to capital adequacy; it did not view the goodwill as contributing to the buffer for the Insurance Fund; it did not view the goodwill as capable of absorbing losses; it did not discount the amortization of the goodwill when assessing Meritor's earnings; and it did not soften its critique of Meritor's earnings performance in consideration for Meritor's having put this non-earning asset on its books for the benefit of FDIC.

The evidence in this case thus establishes a thousand breaches. But three breaches, in particular, destroyed the oldest savings bank in America. The extraordinary demand for a $200 million tangible capital infusion embodied in the 1988 MOU could only have been motivated by a singular desire on the part of the regulators for enhanced capital protection, in violation of the promise to treat the goodwill as providing such protection. The 1991 Written Agreement, with its extraordinarily high capital ratio requirements, is also shown by abundant evidence and inescapable logic to be the result of FDIC's focus on tangible capital in abrogation of the 1982 Agreement. Taken together, the 1988 MOU, the 1991 Written Agreement, and FDIC's relative inflexibility in enforcing the demands that those instruments imposed, compelled Meritor to engage in a four year bloodletting that substantially compromised the Bank's ability to make money and substantially weakened its asset portfolio.

Incredibly, Roger Hillas and his uniformly-praised management team survived these pressures and, at the same time, positioned Meritor so that (had it been allowed to) the Bank would have survived and prospered in the economic good times that lay ahead. But FDIC, again demonstrably fixated on Meritor's shrinking tangible capital account, and officially discarding even a pretense of complying with the 1982 Agreement, chose instead to seize the Bank and sell its assets (at an enormous gain) rather than honor its promises.

Wherefore, Plaintiffs respectfully request the entry of Judgment against the United States.

Respectfully submitted,

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