IN THE UNITED STATES COURT OF FEDERAL CLAIMS

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

DEFENDANT'S REPLY TO PLAINTIFFS' POST-TRIAL MEMORANDUM

Defendant, the United States of America, respectfully requests the Court to enter judgment against plaintiffs Frank P. Slattery, Jr., et al.

INTRODUCTION

Plaintiffs have now been heard as to their interpretation of the trial record and their theories as to whether a breach occurred in 1988, 1991 and 1992. As we demonstrate below, in light of all the evidence, judgment for the United States is appropriate with respect to those claims.

The Court is faced with a number of questions to resolve at this point, including a number of factual disputes.[1] Plaintiffs, however, have utterly failed to establish their version of the

[1] Plaintiffs made a number of misleading or unsupported statements in their Post-Trial Memorandum ("Pl. Br."). To some extent, we will highlight the more significant of those factual misstatements in our reply. However, in the interest of a more coherent argument, we have addressed many of these inaccuracies in an Appendix, which is incorporated by reference into this reply and is attached.

facts by a preponderance of the evidence and, therefore, those factual disputes should be resolved in defendant's favor.

In support of their breach allegations, plaintiffs' post-trial memorandum focuses almost entirely on the many references to tangible capital found in the record. There is no dispute that regulators considered Meritor's tangible capital level on a number of occasions during the period from 1982 to 1992. The question is whether, despite the absence of any contemporaneous record that the parties to the 1982 MOU viewed such consideration as inappropriate, the references to and consideration of Meritor's tangible capital level by regulators were a breach of contract. Clearly, these were not breaches of contract.

To begin with, the trial record establishes the importance of the relative level of a financial institution's tangible assets over its liabilities, its "tangible capital," as an important indicator of its financial health and, thus, the safety and soundness of that institution. For example, plaintiffs' expert Dr. Brumbaugh testified that, generally, an institution left open and operating without tangible capital would be expected to fail. Tr. 5656.[2] He also agreed that regulators have a legitimate reason to be concerned about an institution's level of tangible capital at all times. Id. He also stated that

[2] "DX" and "PX" refer to defendant's and plaintiffs' trial exhibits, respectively, while "JE" refers to Joint Exhibits. "Tr." refers to the trial transcript at the referenced page. "PFOF" refers to defendant's proposed findings of fact.

regulators should be free to look at anything that they think is important, and agreed that it would have been appropriate for regulators to look at Meritor's tangible capital ratio in assessing its financial condition. Tr. 5685-86, 5692-93; PFOF 375. Further, he agreed that the FDIC is always concerned with an institution's financial condition in setting its minimum capital ratios. Tr. 5656.

Regulators have a number of significant reasons to look at the tangible capital level of an institution. PFOF 163, 263-64, 372-80. Moreover, Meritor's own documents indicate its management fully appreciated the importance of a higher level of tangible capital in improving Meritor's financial performance, especially its earnings. DX 428 at CSL076 0351; DX 228 at 9; DX 482 at CSL076 0379-80; DX 376 at 3; PFOF 89-90, 125, 131-33, 151. As noted in our original brief, there was near universal agreement that Meritor needed a higher tangible capital level from at least 1987 to 1992, Tr. 695-96 [Hillas]; JE 10 at 64-65 [Slattery]; DX 228 at 9; PFOF 131, 179-180. However, no regulation or statute required Meritor to achieve or maintain any particular level of tangible capital prior to its closure in late 1992.

The question then is whether, in the 1982 MOU, the parties agreed that, for fifteen years, in exercising their safety and soundness responsibilities, regulators could not consider PSFS/Meritor's tangible capital as a financial indicator, could not recommend that a higher level of tangible assets was appropriate, and could not look at the relative level of Meritor's tangible assets in deciding upon an appropriate minimum regulatory capital ratio or regulatory action. The answer is clear -the simple forbearance agreed to by the FDIC in 1982 did not bar such monitoring and corrective actions. The correct interpretation of the agreement, as seen from (1) the parties' interests in 1982, (2) the language of the agreement, (3) the interpretation by the parties over the years, and (4) the testimony of the participants to the agreement, does not bar such consideration by regulators of the relative level of Meritor's tangible capital for either monitoring or corrective actions.

<u>The 1982 MOU</u>

A review of the record easily establishes the parties' interests in 1982. PSFS needed to restructure to survive and the FDIC sought to buy time until interest rates fell, restoring the value of Western's assets. Tr. 1512, 1522-23, 1525-26, 1534-35 [Isaac]; PFOF 5, 13.

Plaintiffs concede that the entire savings bank industry was in "desperate" condition in 1981. Pl. Memo. at 11. This was true of PSFS as well, which was insolvent on a market basis at the beginning of 1982. PFOF 30. PSFS's management anticipated a huge loss in 1982, which ultimately would have wiped out a third of its capital by the end of the year in the absence of the merger with Western. PFOF 24-26. PSFS management viewed the bank's survival as dependent upon restructuring the bank's operations. PFOF 26. The chance to merge with Western offered PSFS the desired option to restructure, as well as desirable deposits, branches, and new customers, as well as the advantage of substantial financial support received from the FDIC in connection with the merger. PFOF 5, 15, 26, 29, 30-31, 33-34, 42, 53-54. The FDIC, in contrast, desired to defer any need to take some action regarding Western. Tr. 1512, 1522-23, 1525-26, 1534-35 [Isaac]; PFOF 5, 13.

The parties' agreement was memorialized in the 1982 MOU:

> Regarding the <u>use by Bank of certain accounting methods</u>, the FDIC <u>would not object</u> to the following:
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> . . .
>
> > 3. The difference between the liabilities assumed and the total of the market value of the Western assets, less reserves, <u>may be treated as goodwill</u> and amortized on a straight-line basis up to fifteen (15) years. [DX 665; PFOF 35 (Emphasis added)].

By approving these accounting methods, the FDIC agreed that PSFS could treat the marked-to-market difference between the Western assets and liabilities as goodwill. In addition, the FDIC yielded its traditional insistence upon an immediate write-off of any goodwill generated, thus allowing the transaction to proceed. PFOF 11-13. The use of the term "accounting methods" is important in emphasizing the limited nature of the MOU's promise. The MOU gave PSFS a dispensation from the normal accounting policies of the FDIC, but did not exempt the institution from safety and soundness regulation. In addition to the portion shown above permitting PSFS to amortize the goodwill over 15 years, another paragraph of the MOU permitted PSFS to count the capital notes, normally accounting liabilities, as capital. The MOU did not purport to affect regulation of PSFS/Meritor beyond these accounting forbearances.

Thus, the transaction simply authorized PSFS to use purchase accounting and to amortize the goodwill over a 15 year period. Mr. Nocella testified that the goal of PSFS in the negotiations over goodwill was to "walk out of the room" with enhanced capital because of the capital notes and no deduction from capital due to the goodwill. Tr. 88 ("we knew we had 6 ½ percent capital and we wanted to walk out of the room with more than 6 ½ percent capital"); PFOF 44. PSFS was successful in obtaining the necessary accounting forbearances to do so.

However, <u>nothing</u> further in the way of regulatory forbearances or dispensations was necessary to achieve the parties' goals here. As this case makes clear, any deal further affecting regulatory concerns beyond accounting forbearances would have required detailed negotiations for the agreement to be capable of reasonable implementation by the FDIC. Yet the evidence indicates that there was little negotiation over this aspect of the Western merger. PFOF 45, 46, 50, 51.

The FDIC and PSFS representatives who negotiated and signed the 1982 MOU both understood that the document would not affect the FDIC's analysis for capital adequacy, as to which the FDIC had published its official policy the year before. PFOF 45, 55, 66-68. Under that policy, the FDIC indicated that it would make a qualitative evaluation of critical variables that directly bear upon an institution's overall financial condition, including the quality and type of assets, current and historical earnings, market depreciation in asset portfolios, management and risk. DX 442 at 2. Thus, in any such subjective analysis of PSFS/Meritor's capital adequacy, the Western goodwill would be categorized and treated as goodwill, an intangible, non-earning, amortizing asset. PFOF 37, 44-48, 52, 56, 87. There was no agreement to treat the goodwill as if it were a tangible asset, an earning asset, or even as cash.[3] Id. See PFOF 66-68, 274.

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[3] Plaintiffs' argument that there was an agreement to treat the goodwill as "cash for all regulatory capital purposes" is especially flimsy. Their brief (pp. 16 -18) contends that Mr. Isaac testified to this, with a heading to that effect. He said no such thing. In fact, Mr. Isaac resisted plaintiffs' attempts at trial to induce him to testify that the goodwill was used in lieu of cash or that the goodwill would be treated as a "tangible hard asset." Tr. 1523-28, 1538. In the testimony cited by plaintiffs, he notes that "It is what it is. . . . The goodwill is clearly what it is." Plaintiffs also cite Mr. Ryan and Mr. Cooke for the proposition that the goodwill was to be treated "as good as" cash. Pl. Br. at 26. None of the citations support that proposition. In fact, the citation to Mr. Ryan includes his statement that "it was obviously not the equivalent of cash, it's not cash." Tr. 338. Mr. Cooke, in response to a question about whether the goodwill would be treated as cash, testified "we regarded it as an asset," but noted that for the purposes of the
(continued...)

At the same time, it was also clear that in computing PSFS's compliance with minimum capital ratios subsequent to the parties entering into the 1982 MOU, Meritor personnel understood that the goodwill would not be subtracted. PFOF 68, 91; DX 1365 at 13 ("Through the [1982] agreement between the FDIC and Meritor, the goodwill created by the acquisition of [Western] is not deducted from primary capital. . . . [All other goodwill] is deducted from primary capital"); DX 1364 (same).

The FDIC clearly did not intend to hamstring its ability to monitor and correct the condition of PSFS/Meritor over the next fifteen years when it entered into this simple forbearance. To the contrary, Mr. Isaac and Mr. Gough both testified that the FDIC closely monitored PSFS after the merger and that the FDIC retained its ability to take actions to "fix" perceived PSFS/Meritor problems, unimpaired by the 1982 MOU. PFOF 39-42, 56. As Mr. Isaac put it, "if [PSFS] got into trouble, we wanted to be able to get it corrected promptly." Tr. 1583 [Isaac]. Clearly, the FDIC's financial interests in monitoring its vast "investment" (the financial assistance to PSFS) and its regulatory interest in ensuring the safety and soundness of the banking system, including Meritor, would mandate that the FDIC be

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[3](...continued)
agreement, it was "as good as cash". Tr. 304. To the extent that the purpose of the agreement was to ensure that the capital ratio was not reduced due to the goodwill, this is correct. The goodwill, like other assets, would be counted towards minimum required capital ratios.

able to analyze Meritor's assets fully for "type and quality," and, in devising a way to correct the institution's problems, be able to look at what the institution already possessed to do so. As Mr. Piracci testified, a regulator could not appropriately regulate a bank if he was unable to look at the composition of its assets, and whether or not those assets were earning or nonearning assets. JE 7A at 331.

Plaintiffs suggest that it would have been "madness" for PSFS to enter an agreement that did not artificially distort the manner in which regulators evaluated the financial condition of PSFS/Meritor and would ignore the "reality of the circumstances existing at the time". Pl. Br. at 9, 27. But plaintiffs ignore the simple fact that, as PSFS was a mutual savings bank in 1982, the FDIC's ability to force an increase in its capital and capital ratios was quite limited. Tr. 2697-99 [Gough]. Additionally, the suggestion that PSFS would be forced to respond to any arbitrary capital level (purportedly set by regulators to offset the Western goodwill) ignores the reality that savings institutions could challenge, through the administrative process and in court, a cease and desist order, including one directing them to raise their minimum capital ratio.

In fact, the primary motivation for the statute underlying promulgation of the FDIC's capital regulations in 1984-85 was to overcome the effect of an adverse court decision in just such a challenge. DX 444 at 6-7. The judgment in question had overturned a regulatory order to raise an institution's capital equity to assets ratio to 7.0 percent.[4]

Furthermore, as Mr. Fritts testified, the accretion of discount (that would have eventually completely offset the amortization of the Western goodwill if the acquired assets were retained) could be considered in any analysis of the Western goodwill and PSFS's capital following the acquisition. PFOF 62-63. Coupled with the almost $300 million in FDIC assistance and the opportunity to improve the bank's chances for long-term survival, it would have been "madness" for the bank's management not to accept such a limited agreement, and they did so.

To the contrary, the one-sided agreement that the plaintiffs urge upon the Court, where the FDIC would give PSFS almost $300 million in assistance and help create an almost $10 billion bank (DX 510 at 5-6), but hobble itself to the point where it could not adequately supervise PSFS because the FDIC would not analyze the bank's capital accounts to determine whether the goodwill was being replaced with earning assets over time, or monitor the relative level of PSFS' tangible assets (those capable of generating earnings) to determine how to fix the institution's problems over a fifteen-year period, would be "madness" for the

[4] First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 684-87 (5th Cir. 1983) (court concluded that, with sound assets, earnings, liquidity, and deposit structure, "unsafe and unsound" finding as to capital ratio was unsupported).

FDIC. Such an agreement also would be completely inconsistent with the agency's contemporaneous intent to monitor the institution closely and to have a senior examiner make quarterly reports on "any FDIC action needed to protect our investment." DX 896 (emphasis added); PFOF 39-42.

The 1988 MOU

That the regulators' continued prodding of PSFS and later Meritor to increase its surplus of tangible assets over liabilities was intended to help the institution deal with its problems is confirmed by the near-universal agreement that Meritor needed more tangible capital from 1987 to 1992. Plaintiffs correctly note in their brief that increases in tangible capital also have the effect of increasing the buffer for the FDIC's insurance fund, which was certainly of interest to the FDIC, and then assert this as the regulatory motivation driving all FDIC actions.

However, increasing the tangible capital buffer for a continually deteriorating bank will only delay the date when the insurance fund will have to pay the depositors. The FDIC recognized that the ultimate buffer is a viable institution that is adding to its capital accounts. "It's in our interest not to see institutions fail. It is in the best interest of all concerned to see the institution succeed." JE 7 at 17 [Piracci]. See Tr. 4234, 4304-05 [Hartheimer]. This was the FDIC's desire throughout the decade from 1982 to 1992. As Mr. Gough put it:

"[o]ur sole purpose in entering into this agreement [in 1982] was to get a bank that was viable into the foreseeable future, and we wanted to do everything we possibly could to make sure it succeeded. There was no other reason for entering into the agreement." Tr. 2816-17.

This was certainly true in 1988. Mr. Hammer confirmed that Mr. Lutz, the FDIC's Regional Director, would have liked to see more capital because "Mr. Lutz was a very rational guy" who "was worried about the health of the institution". Tr. 4673-74. Plaintiffs cite to Mr. Lutz's testimony (at Tr. 3181-83) that he did not agree with his examiners' views regarding the significance of the Western goodwill, Pl. Br. at 35, but then cite extensively to the reports of examination and testimony of examiners Modla and Albertson to show the FDIC's motivations in 1988. For example, plaintiffs cite Mr. Albertson's speculation ("if I were guessing") about what role Meritor's goodwill played in the $200 million contingent requirement of the 1988 MOU. Pl. Br. at 43-44. However, as Mr. Albertson testified, the review examiner, Maurice Henderson in the case of the 1988 MOU, would have inserted the actual numbers into the MOU with the final decision by the regional director, Mr. Lutz. As Mr. Albertson explained, "I didn't have much input into an exact number. . . . That's a regional office decision." Tr. 861-63.

Plaintiffs' citations of various out-of-context statements by Mr. Lutz ignore his testimony that he considered the goodwill as adding to the strength of Meritor and as a benefit in allowing it to leverage its balance sheet. PFOF 153. His statements that the goodwill was not cash, a loan, or a security, and was a nonearning asset, a drain on earnings, and did not earn any interest, are fully consistent with the understandings of the parties (set forth in the 1982 MOU) to treat the difference in Western's assets and liabilities as goodwill, a non-earning, amortizing asset. PFOF 35, 37, 44-48, 52, 56, 87. Mr. Lutz's statement that tangible capital is an important remedy for problems which goodwill cannot solve (cited at Pl. Br. 54-55) is also fully consistent with the 1982 MOU, which did not limit the regulator's powers to intervene and resolve problems.

It is now beyond dispute that Meritor's financial condition in 1988 fully justified raising its capital ratio under the FDIC's capital regulations, which called for higher capital ratios for banks with financial problems. PFOF 106-07. It is also clear that, even without the goodwill issue, the FDIC would have sought an MOU. PFOF 164. Indeed, the MOU addresses a number of issues besides capital, including the level of classified assets. In fact, plaintiffs' experts do not seriously question the appropriateness of that portion of the 1988 MOU which raises Meritor's minimum primary capital ratio to 6.5 percent. Tr. 2308 [Mancusi] ("I don't think the hundred basis points [involved in reaching 6.5 percent from the regulation's 5.5 percent], in and of itself, is unusual"). Dr. Brumbaugh agreed that a 50-100 basis increase in minimum capital ratios would be consistent with what might be imposed upon an institution if those ratios were based primarily upon economic conditions, but had not analysed the 1988 MOU to exclude economic factors. Tr. 5631.

Nevertheless, the same experts assert that the 1988 MOU's contingent requirement to inject $200 million was unusual, and thus perhaps indicative of not counting the goodwill as an asset. Meritor's capital structure in 1988 was also unusual. The "Western" capital notes, not normally considered capital for accounting purposes but treated as capital under the 1982 MOU, matured in early 1989. Thus, 20-25 percent of PSFS' regulatory capital was about to evaporate in early 1989. Plaintiffs' expert Mr. Mancusi testified that the maturing notes were probably a consideration underlying the $200 million. He agreed that if that were the motivation, that the $200 million requirement would not be inconsistent with the 1982 MOU. Tr. 2310-12; PFOF 160. Dr. Brumbaugh agreed that regulators would have been considering the expiration of those capital notes in raising the $200 million requirement.[5] Tr. 5594-95; PFOF 161. The testimony of fact

[5] He also conceded that the unrealized losses in Meritor's portfolios would have been a concern to regulators at the time. Tr. 5594. Dr. Brumbaugh's pronouncements on the FDIC's motivations as to the 1988 MOU, however, must be taken with a grain of salt. He had not reviewed and was not aware of the side agreement with the FDIC (DX 101) as to the ICC exchange counting towards the $200 million requirement, Tr. 5595-96, did not recall (continued...)

witnesses and contemporaneous documents established that the looming expiration of those notes was the actual motivation of regulators in asking for the $200 million contingent requirement in 1988, as well as a concern of Meritor's management. PFOF 127, 129, 156, 160, 162.

Moreover, the ultimate structure of the 1988 MOU undercuts plaintiffs' theories as to the agreement. The deal as signed included a side agreement with the FDIC that allowed the exchange of the Income Capital Certificates (ICCs) for Meritor preferred stock, a paper transaction, to satisfy all but $82 million of the $200 million contingent requirement, and virtually all of the net increase of $125 million required after restructuring.[6] This

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[5](...continued) that $75 million of the $200 million could be used in restructuring transactions (Tr. 5596), and was unaware of Mr. Hillas' testimony (Tr. 721; PFOF 201) that the branch sale was a "compromise transaction" (Tr. 56040), but conceded that Meritor probably did want to restructure in 1988. Tr. 5602-03. When confronted with the actual structure of the 1988 MOU, including the ICC agreement, in hypothetical form, Dr. Brumbaugh stated that this made the FDIC and the 1988 MOU appear "frivolous," but that, even if the MOU were structured that way, things turned out differently. Tr. 5615-16.

[6] Mr. High confirmed that the August 1989 capital plan assumed that the $118 million arising from the ICC transaction would satisfy a portion of the $200 million requirement. Tr. 5177; PX 216 at 27. His further dubious claim that Meritor personnel, prior to submitting that capital plan to the regulators, actually had been told that the ICC exchange was not going to proceed (Tr. 5173), but still made it a "precondition" to selling the branches (PX 216 at 23), is also not consistent with a contemporaneous Meritor report indicating that the ICC exchange was still being pursued as of October 23, 1989. PX 226 at CSL008 2287-88.

paper transaction would not increase the "buffer" for the FDIC; it would merely transform one form of paper claim to another. The $75 million to be consumed by "restructuring" would also not be an addition to the "buffer" for the FDIC's insurance fund. Thus, plaintiffs' theory that the 1988 MOU benefitted only the insurance fund by raising a tangible buffer "in front of the deposit insurance fund" is clearly without basis. Pl. Br. at 60-61.

Plaintiffs admit that "Meritor's condition in 1991-92 was indeed poor," but then blame that on downsizing forced by the FDIC. Pl. Br. at 62-63. As noted above, that downsizing was a deliberate choice by Meritor's management. Indeed, Mr. Hillas admitted that even in the absence of any regulatory agreements, he probably would have reduced the bank's size to $10 billion, sold up to 27 branches, and taken many of the steps ultimately taken by the institution, but conceivably at a slower pace. PFOF 143, 201, 280. Mr. Slattery tried, but failed, to sell all of the Meritor branches in late 1988, and would not have objected to such a sale in 1989-90. Tr. 1247-48, 1459-60; PFOF 204. The notion that the sale of all of Meritor's branches, or only 27 of them, would be beneficial, but the sale of 54 branches was a sure road to disaster, is not only inexplicable, but completely contradicted by Mr. Hillas' and Mr. Slattery's agreement that the August 1989 capital plan projections (showing a quick return to profitability after selling the 54 branches) were reasonable.

Tr. 761-62 [Hillas]; Tr. 1439 [Slattery]; PFOF 204. Moreover, the suggestion that the FDIC would have foreseen (Pl. Br. at 63) that this "frivolous" agreement, as Dr. Brumbaugh termed it, would badly injure Meritor and force it to downsize massively is ludicrous. The evidence, as we pointed out in our previous brief, is clear. Meritor's management chose downsizing over raising capital at the insistence of its major shareholders, even though many of its directors felt that capital could be raised. PFOF 157, 183-85. As Mr. Hammer put it, they chose to "gamble" on Roger Hillas, even though the "only way" Meritor "could have remained viable" was to raise capital. DX 430 at 20; Tr. 4639-40; PFOF 185. Plaintiffs, nonetheless, claim that the management's willingness in mid-1991 to swap debt for equity, when the institution was on its last legs, with shares valued below $1 a share (DX 736 at 57), demonstrates the shareholders' openness to capital raising in 1989-90. Pl. Br. at 91. The more relevant question is whether management's willingness to swap debt for equity in 1991 shows that shareholders would have been willing to raise capital in 1987-88 (when their shares were worth $4.75 a share at year-end 1988), which appears to be when Meritor decided to downsize. PFOF 248. The evidence cited above demonstrates that the major shareholders were not willing to do so in the earlier period. In any event, the willingness to swap debt for equity in 1991 is understandable, given the need for

Meritor to get rid of high-cost debt. The notes exchanged for equity paid 12 percent interest. PFOF 281-85.

The 1991 Written Agreement

In arguing that the 1991 Written Agreement was a breach of contract, plaintiffs use the novel tactic of adding additional alleged promises to the FDIC's 1982 commitment to allow the unamortized Western goodwill to remain on the balance sheet, and then claiming that the new promises were violated. One of these is a claim that Mr. Ketcha did not honor a promise by Mr. Lutz to "be flexible" in enforcing the 1988 MOU. Pl. Br. 68, 79. However, the testimony by Mr. Slattery cited as support for this contention suggests that Mr. Lutz was promising to be flexible in negotiating some of the terms of the 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"). Tr. 1206; PFOF 175. As to any further promise, Mr. Slattery testified that Mr. Lutz promised to be flexible and "go to bat for you" once they had "done what was required on the capital structure." Tr. 1230. Any failure by Mr. Ketcha to be "flexible" prior to Meritor having met those capital requirements, and at a time when they had fallen out of compliance with regulatory minima, with no immediate prospect of regaining compliance, is hardly surprising and fully consistent with this alleged promise. PFOF 186, 188.

Plaintiffs reach still further when they claim that Mr. Ketcha's proposing what became the 1991 Written Agreement in early 1990 "violated assurances that Mr. Ketcha had himself made to bank management." Pl. Br. at 79. The cited document, PX 177 at 2, indicates that when Meritor management, in September 1988, asked that their downsizing, which would "sacrifice [] short-term profitability for long-term viability" not be subject to regulatory criticisms as a result, Mr. Ketcha "gave such general assurances." Plaintiffs apparently believe that these "general assurances" should have stayed the hand of the FDIC in 1990 despite the $210 million loss in 1988 ($120 million of which was reported after that September meeting), the $56 million loss in 1989, and the $209 million loss in 1990 (net of the $330 million premium). DX 71 at 6; PX 177.

Finally, plaintiffs cite testimony by Mr. Isaac (Tr. 1546) that he recalled that the "policy" was to look at an acquiring bank's earnings prior to amortization, when comparing their performance to their peers. Pl. Br. 18. No other evidence was presented as to this "policy," and there is no evidence that, if it existed, it was communicated to PSFS personnel or influenced the content of the MOU in any way in 1982.[7] Nevertheless, at

[7] As we have noted before, in the absence of an integration clause in the 1982 agreement, the Supreme Court would consider these to be statements of current background rules which could be changed. See United States v. Winstar, 518 U.S. 839, 862-63 (1996).

page 91 of their brief, plaintiffs cite the "abrogation" of this "promise", with further noncompliance claimed at fn. 31, p. 102, and assert at p. 138 that "contrary to the promises made in 1982, FDIC . . . did not discount the amortization of the goodwill when assessing Meritor's earnings."[8]

Plaintiffs' concession of the obvious--that Meritor was in poor condition in 1991-92 (Pl. Br. at 62)--permits us to focus on whether the FDIC proposed the 1991 Written Agreement because it

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[8] This attempted transmutation of a policy into a promise would not offer much help to plaintiffs in any event, given how much worse Meritor was performing than its peers. Mr. Isaac testified that if Meritor's earnings were not comparable to its peers before amortization, he would expect regulators to go in and fix the problem and do "whatever they needed to do." Tr. 1546. Dr. Finnerty's report, which uses GAAP income (under which Meritor's amortization was eventually only a few million dollars annually) demonstrates that Meritor was doing far worse than the average of all thrifts from at least 1988 to 1992 in the categories of percentage of nonperforming assets, net charge-offs, return on average assets, return on average equity, core earnings ratio, and net interest income ratio. DX 1699F at tab 11. DX 482, page CSL076 0379 indicates that Meritor in early 1988 was doing far worse than its "peers" with high levels of tangible capital, even setting aside amortization. DX 736, a capital plan, indicates the same abysmal performance in contrast to peers. Meritor's financial performance was abysmal as well compared to the peer groups selected by defendant's expert Mr. Clark. DX 1699B at 19-20, 22-24. Even if amortization were ignored, then Mr. Lutz had to deal with a $17-19 billion institution that lost $18 million in 1987 and $180 million in 1988. <u>See</u> DX 69 at 1. Under Mr. Isaac's guidance, Mr. Lutz should have acted to fix the problem in 1988, and he did. Using the same technique of backing out amortization from GAAP net income, Meritor lost $31 million in 1989 and $195 million in 1990, shortly before they entered into the 1991 WA. <u>See</u> DX 71 at 1. Indeed, as we have noted, Meritor would have had to improve its 1992 ratio of net interest income to average assets by approximately 70 percent just to match the average of Dr. Finnerty's comparable <u>troubled</u> institutions. PFOF 390.

was not counting the Western goodwill towards Meritor's minimum capital ratios, or because it viewed the heightened minimum capital ratios as necessary due to that poor condition. The answer is clear. Had the FDIC been completely discounting Meritor's goodwill at the time of entering into the 1991 WA, then the minimum capital ratios set by the FDIC would have been appreciably higher due to Meritor's financial problems. At the end of 1990, Meritor's primary capital of $655 million was composed largely of $191 million of shareholders equity (of which $94 million was GAAP goodwill (DX 71 at 22, 25)), $262 million of RAP goodwill, $134 million of capital notes payable in 1998, and $92 million of loan loss reserves, minus $24 million of goodwill related to a subsidiary. Thus, without counting the Western goodwill, Meritor's primary capital ratio (as set in the 1991 Written Agreement) would fall to under 5.0 percent, less than the required regulatory minimum. See DX 71 at 6.[9] It is inconceivable that, given Meritor's increasingly troubled condition, the FDIC set the ratios in the 1991 WA, without

[9] Given its over $418 million of nonperforming assets (DX 71 at 18), had the FDIC viewed Meritor's primary capital without the loan loss reserve, the ratio would fall to about 3.5 percent. Without inclusion of the capital notes, which Mr. Slattery had already urged the FDIC be largely repaid (PX 207), and which it was soon thereafter to buy back, Meritor's primary capital ratio would be about 2.9 percent. If goodwill, capital notes, and loan loss reserve were not included, Meritor's primary capital ratio would fall to about 1.5 percent. Both of the last two ratios would have been deemed unsafe and unsound under the FDIC's regulations because they were below 3 percent. PFOF 108.

counting Meritor's goodwill, below the minimum ratio set for institutions in good financial condition. PFOF 106.

Plaintiffs also display a certain lack of logic in their assertions as to FDIC motivations with regard to the 1991 Written Agreement. They claim that the FDIC acted to obtain Meritor's agreement to the 1991 WA, because in its absence, "[o]bviously, a Cease and Desist Order would not be sustained by the Courts." Pl. Br. at 78. Two pages later, plaintiffs claim that Meritor was forced to sign the 1991 WA by threat of one of those same Cease and Desist orders that "obviously . . . would not be sustained by the Courts." Pl. Br. at 80. The truth is, as plaintiffs conceded in 1994, that both the 1991 Written Agreement and the 1988 MOU were consensual (PFOF 176), because in each case regulators were being reasonable in their demands.

The demand in the 1991 Written Agreement merely required Meritor to fulfill the least onerous capital ratio in the financial projections that it had generated internally. PFOF 241, 271-72. At the time Meritor agreed to the terms of the 1991 Written Agreement, it was well above the minimum ratios set. However, to stay in compliance with those minimum capital ratios, Meritor would need to achieve the goals reflected by its projections, raise new capital, or shrink. Id.[10]

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[10] Plaintiffs' support for their viewpoint on the 1991 Written Agreement is especially weak. For example, they cite Mr. Piracci's statement that he "could not recall a single instance (continued...)

Besides all of the other highly credible evidence indicating that the economic problems of Meritor, rather than an alleged FDIC decision not to count the Western goodwill towards Meritor's capital accounts, "drove" the higher ratios in the 1991 Written Agreement, PFOF 241-251, 257-68, 270, 274-76, 279, the Regional Office recommendation that the FDIC enter into the Written Agreement belies plaintiffs' assertions. This memorandum makes clear that the asset and earnings problems were the primary motivation for regulators at the time. DX 410. The memorandum cites the uniform bank ratings from the previous exam, which gave "5" ratings to the assets and earnings components, but a "4" rating to the capital component, and notes "the most recent examination confirmed that this proposed action is appropriate at this time. The volume of criticized assets are excessive and the bank is suffering operating losses because of the volume of

[10](...continued)
in which a bank other than Meritor was required to meet an 8.5 % primary capital ratio." Pl. Br. at 85-86. They fall to note that this is due to his lack of memory, as he testified on the same deposition page that "I don't know if I specifically recall any institution being required to maintain any level of primary capital. I'm sure there were. I just don't recall." JE 7A at 82. Plaintiffs also assert that Mr. Piracci admitted that the ratios in the 1991 Written Agreement were in part a function of the amount of supervisory goodwill. This is mere speculation as Mr. Piracci admitted he had limited experience in this area of formal enforcement (JE 7A at 13), and that he didn't know where or how the numbers in the 1991 Written Agreement were developed, clarifying "I don't recall what I concluded at the time. It possibly may not have been enough given the lack of earnings [or] the losses being encountered." JE 7A at 76-77, 84-85.

nonaccrual loans, low net interest margin, and high overhead." DX 410.

Mr. Ketcha testified that a "5" component rating would signal that the element itself could lead to the failure of the institution. Thus, the "5" ratings in assets and earnings from the 1990 examination were the most critical ratings and the ones that the FDIC would put the heaviest emphasis on being corrected. Tr. 4908-09 [Ketcha]. The memorandum's emphasis on the asset and earnings problems correctly reflected the indication from the individual ratings that these were the most significant problems to the regulators at the time, rather than the bank's capital accounts.[11] Id.

[11] In fact, Mr. Mancusi admitted that regulators may very well have raised Meritor's minimum capital ratios in 1991 because of its financial condition, and that he had himself probably raised an institution's minimum capital ratio by more than the 300 basis points above the regulatory minimum required by the 1991 WA. Tr. 2223, 2226, 2308-09. Dr. Brumbaugh indicated that he thought that the problems at Meritor in 1991 might well have required a higher capital level of up to 1.5 percent above regulatory minima. Tr. 5516, 5645-46. However, as with the 1988 MOU, Dr. Brumbaugh's conclusions are suspect given his sketchy knowledge of the FDIC, its regulatory structure, and the agreement at issue. Dr. Brumbaugh based his opinions as to the 1991 Written Agreement upon the faulty premise that the 8.5 percent minimum primary capital ratio agreed to was 550 basis points (5.5 percent) above regulatory minima (rather than the actual 3.0 percent above), stating: "[the required capital ratios are] just so far above and so unusual that it's more consistent with [the theory] that the primary overwhelming concern . . . was the fact that the institution had low tangible net worth"). Tr. 5516-17, 5645-46. Dr. Brumbaugh also was confused about which capital ratios were in the agreement, and was mistaken as to what the FDIC's regulatory minimum tier 1 ratio was in 1991 (he believed it was 5.5 or 6 percent, as opposed to the actual 3-4 (continued...)

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The record also manifests that Meritor's unquestioned (at least at the time) lack of viability impelled the FDIC's actions in late 1992, PFOF 289-90, 301-05, 317-19, 339-42, rather than the same apocryphal decision to no longer count the Western goodwill. As noted in our previous brief, the experts' testimony established that it would have been virtually impossible for Meritor, as constituted, ever to return to profitability after December 1992. PFOF 320, 374-75, 385-88, 394.

In support of their 1992 breach theory, plaintiffs assert yet another dishonored "promise," based upon the assertion that Mr. Gough testified that the 1982 MOU prohibited the FDIC from assessing Meritor's solvency or viability on a tangible basis. Pl. Br. at 93. However, given Mr. Gough's definition of viability, it would appear he only expected the Western goodwill to be viewed in a negative sense in any such analysis. At Tr. 2790, he made it clear that the goodwill would count towards solvency, but not "toward" viability:

> A: Solvency is when you reach zero in capital, you are no longer solvent. Viable means or may mean that you are not earning money that is going to allow you to continue for the foreseeable future. My definition.

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[11] (...continued)
percent). Tr. 5645-46; see DX 72 at 25. Further, despite his purported expertise and his views on interpreting the 1982 MOU, he did not know at his deposition whether the FDIC had capital regulations or not in 1982, but thought there probably were. At the trial, he still did not know. Tr. 5568-69.

> Q: And goodwill would be counted toward both?
> A: No.
> Q: It would be counted toward the solvency of the institution?
> A: It would count towards solvency.

Thus, while Meritor's looming tangible insolvency would have been appropriately considered in regard to a lack of viability, Meritor was not closed for regulatory insolvency, as to which the goodwill counted. PFOF 357, 368, 370-71, 379-84, 400. As Mr. Gough testified:

> The state may not be able to close it because it is still solvent, but we could take supervisory action on it because, although it has a minimum capital ratio that's okay, its earnings may be bad, its liquidity may be bad, its assets may have problems that have to be corrected and will require supervisory action.

Tr. 2791-93 [Gough]; PFOF 57. See PFOF 108.[12]

As previously discussed, the record establishes beyond dispute that the FDIC did not bind itself to ignore an important indicator of Meritor's economic decline over a fifteen year period. Such would have been inconsistent with not only the FDIC's safety and soundness responsibilities, but also with its interest in ensuring that the FDIC's almost $300 million investment in the future health and profitability of PSFS, which was the fundamental goal of the FDIC in 1982, was not wasted. As

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[12] This FDIC capability to act to correct the bank's problems despite Meritor's satisfying minimum capital ratios also supports the regulatory actions in 1988 and 1991.

noted above, even plaintiffs' experts do not seriously dispute that the FDIC would have raised Meritor's capital requirements in 1988 and 1991 due to its financial condition--they merely suggest that those ratios might have been somewhat lower if the goodwill were not a consideration. However, it is clear that, had the goodwill not been counted, those capital ratios would have been higher and, in all likelihood, Regional Office personnel would have recommended much more severe action. PFOF 163, 259-61.

Meritor in late 1992 was an economic disaster. Other than Dr. Finnerty, who projected a quick Meritor turn-around by ignoring much of the contemporaneous documentation and viewing the rest through rose-colored glasses, PFOF 388-410, the rest of the world recognized that Meritor was very near the end of its economic rope, and not because of any alleged regulatory non-compliance with a simple accounting forbearance. PFOF 289-90, 301-30, 336-42, 346, 416. Action was required of the regulators to deal with a very serious situation affecting a large bank. That the regulators made the right decision at the time is reflected in the fact that not one person, including the board of directors, the management, the employees, and the shareholders, including the plaintiffs, ever challenged the state authorities' decision to close Meritor without even holding a hearing. In fact, plaintiffs concede the propriety of the state's actions. PFOF 371.

CONCLUSION

For these reasons, we respectfully request the Court to enter final judgment for the Government regarding plaintiffs' breach claims.

Respectfully submitted,

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May 24, 2000

CERTIFICATE OF SERVICE

I certify under penalty of perjury that on this 24th day of May 2000, I caused to be placed in the United States mail, postage prepaid) copies of "DEFENDANT'S REPLY TO PLAINTIFFS' POST-TRIAL MEMORANDUM" and "APPENDIX TO DEFENDANT'S REPLY TO PLAINTIFFS' POST-TRIAL MEMORANDUM" addressed as follows:

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