

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
(Loren A. Smith, Senior Judge)**

**PLAINTIFFS' ANSWERS TO THIS COURT'S QUESTIONS AS
SET FORTH IN THE COURT'S OCTOBER 17, 2003 ORDER**

Pursuant to the Court's Order of October 17, 2003, plaintiffs set forth their answers to the questions contained in that Order. Plaintiffs today are also filing their Post-Trial Memorandum in Support of Their Claims for Damages. Per the Court's request, plaintiffs will file electronic copies of both pleadings on or before December 1, 2003.

1. Was it foreseeable that Meritor would convert from a mutual to a stock form at the time of the 1982 deal?

Yes. Dr. Brumbaugh has “written academic papers on this exact issue,” and he confirmed that “all of the federal deposit insurance agencies that insured mutual savings institutions and thrifts were aware of the need to convert from mutual to stock” during the 1981-82 time period. Dmgs. Tr. 213:20 – 214:13 (Brumbaugh); *see also* Dmgs. Tr. 88:2 – 89:13 (Brumbaugh) (finding conversion foreseeable, noting that trend towards mutuals began in late 1970s and continued through the mid-1980s); Dmgs. Tr. 1863:14-16 (Lutz) (confirming trend toward mutuals).

The Pennsylvania Department of Banking specifically advised William M. Isaac, Chairman of the FDIC, in writing, two months prior to the PSFS acquisition of Western that “we have introduced legislation in Pennsylvania which would permit conversion of mutual savings banks to stock savings banks.” DX 643 (McEnteer letter) at 4; Dmgs. Tr. 360:24 – 363:7 (Brumbaugh). By the time PSFS acquired Western, the FDIC was thus aware both of the general trend favoring conversion from stock form to mutual form, as well as the fact that the Pennsylvania Department of Banking had introduced specific legislation before the state legislature to make it a reality in Pennsylvania.

2. Was it foreseeable in April 1982 that Meritor would sell off all of the discounted Western assets so rapidly and, as a consequence, choose to forego the \$512 million in accretion of purchase discount represented in Mr. Brummett's model as a "cost of performance?"

Yes.

Prior to the merger PSFS managers "analyzed their ability to liquidate . . . and liquidate . . . quickly" "every single major group of assets that Western had . . ." Dmgs. Tr. 3015:1-7 (Hamm); *see* PX 15 (Functional Merger Analysis) at CSL 124 0064, CSL 124 0083, CSL 124 0084, CSL 124 0085, CSL 124 0086, CSL 124 0142, CSL 124 0143, CSL 124 0144, CSL 124 0145, CSL 124 0152, CSL 124 0162; Dmgs. Tr. 175:17 – 178:7 (Brumbaugh). Selling the assets was Meritor's plan from the beginning (Liab. Tr. 192:3-10 (Nocella); Liab. Tr. 309:7-24 (Cooke)), and that fact may have been known to the FDIC. Liab. Tr. 284:9-19 (Cooke).

FDIC's policy was to encourage banks to replace long-term assets such as Western's with shorter term investments. Dmgs. Tr. 165:21--173:4 (Brumbaugh). FDIC Chairman Isaac testified that the agreement was designed to enable PSFS to sell the Western assets, and that "we **wanted them** to restructure their balance sheets." Liab. Tr. 1542:12 – 1543:8 (Isaac); Liab. Tr. 1516:19 – 1517:1 (Isaac) (emphasis added). *See also* Liab. Tr. 338:3-18 (Ryan); Liab. Tr. 338:24 – 339:6 (Ryan).

The government's witnesses agreed. Liab. Tr. 2753:5-9 (Gough) (selling Western's assets was "left up to PSFS's management"); Dmgs. Tr. 1633:2-5 (Gough) (FDIC was encouraging thrifts to replace long-term assets); Liab. Tr. 1632:9-20 (Gough) ("[I]n fact, it would be anticipated that they would sell off a number of these assets ... if ... conditions were appropriate ..."). Dr. Hamm admitted that the IMA "was structured specifically so that Meritor would be free to sell the Western assets[.]" (Dmgs. Tr. 2919:22 – 2920:1 (Hamm); Dmgs. Tr. 2941:18-25 (Hamm)) and further admitted that liquidation of the Western portfolio was foreseeable to the

FDIC. Dmgs. Tr. 3141:5-12 (Hamm) (“I think it's likely that they would have considered that a possibility.”)

3. Do Meritor's operating losses from 1982 to 1992 render plaintiffs' calculations of expectancy damages unreliable?

No.

To the extent the operating losses of Meritor from 1982 to 1992 are relevant, they are reflected in the calculation of plaintiffs' expectancy damages. Plaintiffs are seeking expectancy damages based on the value of Meritor as of the dates of the first and third breaches, that is, August 1, 1988 and December 11, 1992. PX 853 (Finnerty Report) at ¶ 38. The August 1, 1988 valuation is based on the market capitalization of the institution as of that date, *id.* at ¶ 39, thus any operating losses from 1982 to August 1, 1988 are embedded in that valuation. As to the December 11, 1992 valuation of \$112 million, that calculation is based on a valuation of Meritor's assets and liabilities in liquidation, with certain adjustments. *Id.* at ¶¶ 61-66. Thus, the operating losses of the institution during the period 1982 to 1992 would be reflected in that valuation as well.

If the plaintiffs were pursuing lost profits based on a but for the breach model of Meritor as of some future date post-seizure, then the financial performance of the institution during the period 1982 - 1992 would be relevant, particularly to demonstrate the legitimacy of the but for the breach performance model. However, as stated above, that is not the case.

4. Given Meritor's loss of regulatory capital during the period 1-1-88 to 12-31-89, how much asset shrinkage would have been necessary for the thrift to remain in compliance with the standard minimum capital requirements (i.e., 5.5%/6.0%)? How much shrinkage would have been necessary to maintain a 0.5% regulatory capital cushion?

Dr. Goldstein's model shows that, absent the MOU, Meritor would remain in capital compliance through year-end 1989 by shrinking by approximately one-third, from \$17.8 billion to \$11.4 billion. PX 541A (Goldstein Report) at Ex. 1 p. 1. Regulatory capital equals the sum of total equity (\$391.9 million as of 12/89), reserves (\$84.4 million), subordinated debt (\$175.5 million), and secondary capital (\$36.7 million) (total = \$688.9 million) divided by total assets (\$11,427.3 million). *Id.* Arithmetically, regulatory capital as of 12/89 increases from 6.03% to 6.50% if total assets are further reduced to \$10,598.5 million, or 60% of the December, 1987 total.

Month Year	Dec 1987	Dec 1988	Dec 1989
BALANCE SHEET			
Total Assets	17835.21	16102.67	11427.3
Total Liabilities	17060.94	15494.96	11035.4
Total Equity	774.267	607.71	391.8999
TOTAL LIABILITIES & NET WORTH	17835.21	16102.67	11427.3
Primary Equity/Assets	6.09%	6.11%	5.71%
Regulatory Equity/Assets	6.25%	6.30%	6.03%

Dr. Goldstein is the only witness to perform this analysis on the basis of a fully elaborated model. Importantly, however, his model is conservative, because it assumes no restructuring or capital-generating asset sales. Liab. Tr. 1683:18 – 1684:15 (Goldstein); Liab. Tr. 5715:17 – 5716:4 (Goldstein); Answers to Questions 39, 128, 130. Given Mr. Hillas's restructuring expertise, it is unlikely that the bank would have been as uncreative as Dr. Goldstein conservatively assumes. *See* Dmgs. Tr. 1312:5 – 1313:1 (Hillas). Also, the downsizing required would have been substantially less had the FDIC been willing to extend the \$216.25

million in capital notes that came due in the Spring of 1989. *See* Liab. Tr. 1230:8 – 1231:15
(Slattery).

5. What non-breach-related factors, if any, could have caused Meritor's share price to decline relative to the NASDAQ Bank Index during the periods: (a) January 1, 1986-April 30, 1988; (b) May 1-August 1, 1988 newspaper articles; and (c) August 2, 1988-December 11, 1992?

As a threshold matter, the reasons for any drop in Meritor's share price from January 1, 1986 - April 30, 1988 are irrelevant to Meritor's expectancy damages, because the plaintiffs are not seeking damages to Meritor's share price as a result of any actions taken by the government during that period. In addition, to the extent the drop in the share price from 1986 to 1988 was due to non-breach related actions, the impact of those actions are embedded in Meritor's August 1, 1988 share price, which is the basis for its 1988 expectancy damages claim.

As to the May 1 - August 1, 1998 period, Dr. Finnerty established at trial that the drop in Meritor's share price vis-à-vis the NASDAQ Bank Index during that period was due to various references to possible regulatory action relating to Meritor's tangible capital in several newspaper articles, *see* PX 727 (*American Banker* article) and PX 868 (*Philadelphia Inquirer* article), and in its F-4 disclosure statement. *See* DX 46 at FSL011 0864. *See also* Dmgs. Tr. 3208:24 – 3210:11 (Finnerty); PX 867 (Valinote memo re Shareholders' Meeting).

With regard to the drop in share price from August 1, 1988 to December 11, 1992, the court has already determined that the 1988 MOU, the 1991 Written Agreement and the seizure of the institution were the causes of the loss of the institution's equity value during that period. *See Slattery v. United States*, 53 Fed. Cl. 258, 260-261, 282-286, 290 (2002) (“*Slattery*”).

6. Did Meritor face financial problems unrelated to the breach during the May, 1988-December 11, 1992 period?

Meritor, like every other institution, faced financial problems during the period 1988 to 1992. However, for purposes of its expectancy damages, the sole issue is whether the three breaches, individually or together, were a substantial factor in the demise of the institution. *Westfed v. United States*, 55 Fed. Cl. 544, 553 (2003). This was an essential issue in the liability case, and the court specifically resolved the issue in favor of plaintiffs. *See Slattery v. United States*, 53 Fed. Cl. 258, 260-261, 282-283, 285 and 290. The court held that “Meritor would not have sold the 54 branches as it did” but for the 1988 MOU, *id.* at 283; that “selling the fifty-four branches to Mellon proved to be critical in Meritor's demise” and effectively “doomed the bank;” that selling the 54 branches was the beginning of the end for Meritor; *id.* at 260; that “the sale of the fifty-four branches to Mellon lead to a deterioration in assets which spurred the 1991 Written Agreement and later problems at Meritor,” *id.* at 282, and that “this lead to a downward death spiral for Meritor.” *See id.* at 285. The court further found that FDICIA precluded Meritor from any chance of meeting the 2% tangible equity threshold, and that the FDIC unlawfully seized the institution. *See id.* at 286, 290. As of the time of the seizure, Meritor, with the goodwill, had regulatory capital of 11.237%, and risk-based capital of 10.524%. Liab. Tr. 2395:3-19. (Finnerty).

7. From what source(s) would the increased expected earnings needed to justify a control premium have come in August 1988 (after Mr. Hillas was hired)?

The control premium propounded by Dr. Finnerty was not based on expected earnings of Meritor after the retention of Mr. Hillas, but rather on comparable change of control premiums paid for financial institutions similar to Meritor as of the August 1, 1988 breach. *See* PX 853 (Finnerty Report) at ¶¶ 42-43 and Ex. 2 and 2a. Dr. Finnerty further testified that a control premium could be paid for many reasons, including: (1) synergy between firms; (2) belief that an acquiror can do better; (3) elimination of competition; and (4) market share. Dmgs. Tr. 1015:4-1016:11 (Finnerty); Dmgs. Tr. 1017:1 – 1018:6 (Finnerty); Dmgs. Tr. 1019:4 – 1020:15 (Finnerty); Dmgs. Tr. 1155:25-1156:6 (Finnerty). Further, it was established at trial that control premia were paid in almost all sales of the majority of the shares of a company. *See* PX 853 (Finnerty Expert Report) at ¶¶ 39-46 and Ex. 2A; *see also* Dmgs. Tr. 2072:3 – 2073:14 (Epstein). It was also well established that under-performing institutions such as Meritor commanded high than average control premium. Dmgs. Tr. 1015:25 – 1016:11 (Finnerty); Dmgs. Tr. 2075:3-13 (Epstein); Dmgs. Tr. 3181:23 – 3182:23 (Finnerty).

Furthermore, any potential acquiror of Meritor as of August 1, 1988 would base any change of control premiums on the earnings of Meritor as of that date, as opposed to unknown or projected earnings after the hiring of Mr. Hillas.

8. How did Meritor's pre-breach operating problems affect the damages calculated by Dr. Finnerty?

Because Dr. Finnerty's expectancy damages calculations are based on the value of Meritor as of a specific date, as opposed to some future date based on a but for the breach model, any losses from operating problems of Meritor prior to the breaches in question would be reflected in his damages calculations for those dates. For example, Dr. Finnerty's damages calculations for the August 1, 1988 breach are based on the market capitalization of Meritor as of that date, plus a 50% change of control premium. PX 853 (Finnerty Report) at ¶¶ 43-46. Any operating problems prior to August 1, 1988 would naturally be reflected in Meritor's stock price, because such problems would have been disclosed to the public.

The same is true of Dr. Finnerty's December 11, 1992 expectancy damages calculation, which is based on an analysis of the books and records of the institution in liquidation. *Id.* at ¶ 15. While the government contests Dr. Finnerty's accounting methods, it is undisputed that any valuation of Meritor's assets and liabilities after it was seized, as is the case with Dr. Finnerty's December 11, 1992 valuation, would reflect the impact of any prior operating problems.

9. Did Meritor's shedding of Western's assets proximately cause, or was it just a contributing factor, to Meritor's problems in 1988?

Neither.

While the sale of the assets produced large economic losses (PX 1060; PX 882 at 21; Dmgs. Tr. 516:2 – 517:13 (Brummett); Answer to Question 52), it also produced several benefits, including:

1. **\$221 million in gains, and an equal increase in capital** (PX 854 (Brummett Report) at Ex. A line [e]; Dmgs. Tr. 163:23 – 164:9 (Brumbaugh); Dmgs. Tr. 173:15 – 174:17 (Brumbaugh); Dmgs. Tr. 643:13-17 (Brummett); Dmgs. Tr. 3322:21 – 3324:2 (Brummett); Dmgs. Tr. 2804:12-16 (Hamm); Dmgs. Tr. 447:23 – 448:4 (Brummett); Dmgs. Tr. 2985:1-4 (Hamm); Dmgs. Tr. 513:14 – 514:7 (Brummett); PX 854 (Brummett Report) Ex. L.2.
2. **Reducing the interest rate risk created by long-term fixed-rate investments.** Dmgs. Tr. 164:18 – 165:14 (Brumbaugh); Liab. Tr. 99:10-22 (Nocella); Liab. Tr. 3029:2-24 (Fritts).
3. **Reduced credit risk.** Dmgs. Tr. 164:18 – 165:14 (Brumbaugh); Dmgs. Tr. 175:17 – 177:16 (Brumbaugh); Liab. Tr. 205:22 – 206:12 (Nocella); Liab. Tr. 209:1-8 (Nocella); Liab. Tr. 2872:19-23 (Valinote); Liab. Tr. 3029:2-24 (Fritts).
4. **Increased liquidity.** Dmgs. Tr. 164:18 – 165:14 (Brumbaugh); Dmgs. Tr. 175:17 – 177:16 (Brumbaugh); Liab. Tr. 205:22 – 206:12 (Nocella);); Liab. Tr. 209:1-8 (Nocella).
5. **Divesting hard-to-administer out-of-territory loans.** Dmgs. Tr. 179:12 – 180:14 (Brumbaugh); Dmgs. Tr. 3390:6 – 3391:7 (Brumbaugh); Dmgs. Tr. 1569:23 – 1570:6 (Gough); Dmgs. Tr. 2351:9-20 (Hargett); Liab. Tr. 3029:2-24 (Fritts).
6. **Enhanced ability to go public** (and raise another \$369 million). Dmgs. Tr. 164:10-17 (Brumbaugh).
7. **Facilitate diversification of operations.** Liab. Tr. 5617:25 – 5618:15 (Brumbaugh); Liab. Tr. 5677:16 – 5678:24 (Brumbaugh); Liab. Tr. 259:15 – 261:17 (Cooke); Liab. Tr. 287:7-25 (Cooke); Liab. Tr. 289:9 – 14 (Cooke); Liab. Tr. 128:21 – 130:13 (Nocella); Liab. Tr. 131:10-18 (Nocella); Liab. Tr. 927:18 – 928:3 (High).

Had Meritor held the assets, it would have captured additional accretion, but no witness presented a rigorous analysis showing that Meritor would have performed better by not selling.

Dr. Hamm purported to present such an analysis, but he admitted that it produced meaningless

results for all years after 1987 (Dmgs. Tr. 3029:6 – 3030:14 (Hamm)) and it therefore omits over \$2.5 Billion in expenditures. *See Answer to Question 123.*

The deposit outflow immediately following the merger actually suggests that, but for the sales, a liquidity crisis might have ensued. Dmgs. Tr. 181:17 – 182:5 (Brumbaugh); Dmgs. Tr. 3286:14 – 3287:22 (Brumbaugh); PX 15 (Functional Merger Analysis) at 31; Dmgs. Tr. 2352:10 – 2353:1 (Hargett); PX 33 at 9; PX 676 at 1; Dmgs. Tr. 3585:8-24 (Hamm). We are aware of no FDIC statements in the 1987-88 timeframe suggesting that Meritor's problems in 1988 were caused by the sales. Dmgs. Tr. 676:17 – 677:2 (High); Liab. Tr. 100:15-20 (Nocella); Liab. Tr. 209:1-8 (Nocella); Liab. Tr. 914:20 – 915:7 (High).

10. What were PSFS/Meritor's expectations at the time of the contract regarding the impact on earnings of the Western acquisition?

PSFS anticipated that the acquisition of Western would serve to enhance its earnings, assuming a stable interest rate environment and the ability to leverage the goodwill by, among other things, allowing it to restructure its balance sheet and providing an opportunity for deposit growth and increased market share. PX 15 (Functional Merger Analysis) at CSL124 0062, CSL124 0158; Liab. Tr. 160:5-17 (Nocella); Liab. Tr. 311:13-21 (Cooke). PSFS also recognized, however, that the transaction entailed risks which could have a negative impact on its future earnings, including an inability to achieve expected cost reductions, the possibility of significant deposit outflows from the Western branches resulting in a “major liquidity problem,” and the questionable quality of Western's commercial mortgage and private placement portfolios which could compromise their sales potential and present “a series of unpleasant surprises.” PX 15 (Functional Merger Analysis) at CSL124 0081, CSL124 0084-85, CSL124 0089, CSL124 0158.

11. Were changes in market interest rates after the Western acquisition sufficient to restore the acquired assets to their par value?

Yes, but only assuming: (a) that Meritor did not sell the assets; and (b) that defaults were not substantial.

Meritor estimated that an interest rate decline of 367 Basis Points would produce break-even earnings (PX 15 at CSL 124 0089-90), and in most of the years of the late 1980's most treasury rates were more than 367 BP lower than their 1982 averages. The book yield on Western's assets ranged from 5.358% to 9.766%. PX 33 at 4. Most of these assets, if retained by Meritor and not defaulted, would have been "in the money" by the end of the decade.

Meritor's sale of the assets resulted in its monetizing a total of \$221.045 million in restored value. PX 854 (Brummett Report) at Ex. A line [e]. Hence the remainder of the discount was never restored. Also, had Meritor held the assets, defaults would have resulted in an unknowable amount of losses. *See Answer to Question 13.*

12. Was the IMA designed to essentially insulate the assets and liabilities that were acquired from Western against interest rate risk during the 1982-1992 period, as long as Meritor did not exercise its option to terminate the agreement?

To a limited extent.

First, Meritor was expected to sell Western's assets, restructuring the bank's risk profile. *See* Answer to Question 2. Relatedly, as assets ran off, their replacements were unprotected. Dmgs. Tr. 713:5-17 (High).

Second, loss of asset value, caused by any increase in interest rates, was unprotected. Dmgs. Tr. 2361:22 – 2362:6 (Hargett); Dmgs. Tr. 2883: 4 – 2884:5 (Hamm).

Third, Meritor was protected against net interest losses only if its actual cost of funds was no higher than the IMA's benchmark rate. Otherwise, the IMA would produce losses. *See* Dmgs. Tr. 2875:6-11 (Hamm).

Fourth, the IMA notional balance was less than Western's actual assets and deposits (PX 990; PX 992; Dmgs. Tr. 3280:20 – 3284:8 (Brumbaugh); Dmgs. Tr. 2875:20-25 (Hamm); Dmgs. Tr. 2876:11 – 2877:12 (Hamm)) and the term of the IMA was considerably shorter than the term of Western's assets (Dmgs. Tr. 2877:13-16 (Hamm); PX 990; Dmgs. Tr. 3280:20 – 3284:8 (Brumbaugh); Dmgs. Tr. 3398:10-25 (Brumbaugh); PX 21 (MAA) at p. 9 ¶ 6.02(a)), leaving a large quantity of assets totally unprotected.

The proof is in the pudding. Meritor CFO Nocella testified that Meritor sold Western's assets specifically to reduce the interest rate risk inherent in the WSFS balance sheet.

Western . . . was primarily. . . a long-term corporate bond bank; very little amortizations, very little cash flow, and lots of interest rate risk. One of the primary things we had to do was to immediately start to reduce the interest rate gap.

Liab. Tr. 99:18-22 (Nocella); *See also* Dmgs. Tr. 713:15-17 (High) (“[Y]ou’re trying to get me to say it protected them for ten years. It did not.”) The bank's managers did not regard the IMA as solving this problem.

13. Was the FDIC assistance package that was provided to Meritor in connection with the Western transaction structured so as to essentially guarantee Meritor against loss with respect to the assets and liabilities acquired from Western?

No.

First, the MAA provided only limited protection against credit risk. There was no protection for investments under \$1 million. Liab. Tr. 905:14 – 906:1 (High); Dmgs. Tr. 3405:20 – 3406:19 (Brumbaugh); Dmgs. Tr. 3429:18 – 3433:4 (Brumbaugh); Dmgs. Tr. 2884:20 – 2885:9 (Hamm); PX 670 at 1; PX 675 at 2; PX 664 at 5. A large percentage of Western's assets fell into this unprotected category. Dmgs. Tr. 3396:8 – 3397:17 (Brumbaugh); Dmgs. Tr. 3397:18 – 3398:8 (Brumbaugh). Asset types comprising 40% of the portfolio were also completely unprotected. Dmgs. Tr. 2884:6 – 19 (Hamm). In addition, the protection provided for covered loan types in excess of \$1 million was limited to the lesser of 95% of market value or 80% of book value which, because the portfolio was deeply devalued already, equaled only 32.2% of total investments and mortgages. Dmgs. Tr. 3399:6-15 (Brumbaugh). *See also* Dmgs. Tr. 2886:17 – 2887:20 (Hamm); Dmgs. Tr. 2889:2-25 (Hamm); Dmgs. Tr. 3294:15 – 3297:2 (Brumbaugh). The limited nature of credit protection was significant, because the Western portfolio was in fact troubled. *See, e.g.*, PX 15 at 24-27; PX 612 at 2; PX 610 at 2; Dmgs. Tr. 175:5 – 177:16 (Brumbaugh); Dmgs. Tr. 2331:12-21 (Hargett); Dmgs. Tr. 2891:14 – 2892:7 (Hamm); Liab. Tr. 205:22 – 206:12 (Nocella); Liab. Tr. 209:1-8 (Nocella); Dmgs. Tr. 1569:23 – 1570:12 (Gough); Liab. Tr. 2872:19-23 (Valinote).

Second, the IMA provided no protection against a liquidity crisis, a real risk *See* PX 15 at 21, 31. FDIC documents confirm that in the months following the merger Western had massive deposit outflows. PX 33 at 9; PX 676 at 1; Dmgs. Tr. 3585:8 – 3585:24 (Hamm).

Third, the IMA provided only partial protection against interest rate risk. *See* Answer to Question 12.

Fourth, the MAA virtually guaranteed operating losses, because the IMA aimed only at break-even interest income (limited to the notional asset balance) and the income on the government's \$112 million note would not defray G&A expenses. *See* Answers to Questions 65-66; Dmgs. Tr. 2989:7-18 (Hamm); PX 854 (Brummett Report) at Ex. A line [5] (at 1% of deposits, WSFS annual G&A expense ranges from \$22 million to \$25.7 million, 1983 – 1989); PX 1001 (estimated income from the \$112 million note between \$4 million and \$14 million).