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Status Report to the Congress on the Receivership of  
United States National Bank

Statement by

Frank Wille, Chairman  
Federal Deposit Insurance Corporation

before the

Subcommittee on Bank Supervision and Insurance  
Committee on Banking and Currency  
House of Representatives

December 12, 1974

## INTRODUCTION

This statement is in response to the Subcommittee's request for a current status report of the receivership of the United States National Bank, San Diego, California ("USNB") and supplements the initial report I gave the Subcommittee a year ago. The receivership is, of course, still in progress and the bottom line of FDIC's collection efforts will not be known for many years. Even with that caveat, however, it appears likely that this one failure will result in a final net loss to the federal deposit insurance fund substantially greater than the aggregate of all losses resulting from the failure of all other FDIC-insured banks since 1933.<sup>\*/</sup>

USNB was declared insolvent by the Comptroller of the Currency on October 18, 1973, and the Federal Deposit Insurance Corporation was immediately appointed Receiver thereof pursuant to law. Under the terms of the Purchase and Assumption Agreement entered into on the same date (the "Agreement") between FDIC, as Receiver, and Crocker National Bank, San Francisco, California ("Crocker"), Crocker

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<sup>\*/</sup> From January 1, 1934, to date, 506 FDIC-insured banks have closed, including USNB and Franklin National Bank, New York. This statement assumes a final net loss to the federal deposit insurance fund of approximately \$75 million for the 501 bank failures prior to USNB and a significantly smaller figure for the 4 bank failures that have occurred so far in 1974.

was required to assume virtually all of USNB's deposits and other non-subordinated balance sheet liabilities (other than a secured \$30 million "window" loan from the Federal Reserve Bank of San Francisco to USNB which the Receiver paid in full prior to consummation of the Agreement) and to purchase in exchange offsetting assets less the \$89.5 million price it bid for the overall transaction. Excluded from the transaction, however, for the reasons stated in my testimony last year, were all assets, deposits and other liabilities related to USNB's control shareholder, Mr. C. Arnholt Smith, his business associates and their various affiliated interests (referred to in the Agreement as the "Designated Group"). The FDIC as Receiver in turn retained responsibility for working out such Smith-related assets and liabilities, and since this arrangement produced a substantial shortfall in the USNB assets which Crocker could acquire to offset the USNB liabilities it assumed, FDIC as Receiver agreed to make up any such shortfall in cash. The Agreement also provided that Crocker could return to FDIC as Receiver up to \$15 million in non-Smith-related loans for any reason and receive cash therefor in a corresponding amount.

Under this Agreement, with all figures reflecting post-closing adjustments made to date, Crocker assumed the liability to pay approximately \$924 million in USNB deposits and approximately \$201 million

in other USNB nonsubordinated balance sheet liabilities, including standby letters of credit issued by USNB aggregating \$47.7 million in principal amount which FDIC as Receiver determined in June of this year represented direct interbank loans or deposits between the original holder of the letter and USNB. Crocker has received off-setting assets of approximately \$1,036,000,000 consisting of: USNB cash and due from banks of approximately \$121 million, non-Smith-related loans of approximately \$265 million, securities worth \$331 million, bank premises and equipment appraised at approximately \$20 million, other USNB assets of approximately \$18 million and balancing cash from the Receiver of approximately \$281 million.

Under the FDIC's invitation to bid on the Agreement, Crocker or its parent holding company was also given an option to place a five-year \$50 million note with FDIC in its corporate capacity, at 7 1/2 percent per annum. This option, which was promptly exercised, was designed to enable the successful bidder to increase its capital account immediately upon consummation of the Agreement so as to support the very large expansion in its deposit liabilities which would occur by virtue of the purchase and assumption transaction. The note issued by Crocker's parent is to be retired whenever Crocker finds market conditions favorable for raising more permanent capital, but in no event later than October 22, 1978.

For convenience, the balance of this statement is divided into five sections:

- I. FDIC's Cash Advances to date and the Sources of Repayment
- II. Current Status of Certain USNB Standby Letters of Credit
- III. An Overview of FDIC's Collection Efforts
- IV. A Specific Example: Westgate-California Corporation
- V. Litigation By and Against the Receivership Estate

I. FDIC's Cash Advances to date and the Sources of Repayment

The FDIC Board of Directors to date has authorized cash advances from the federal deposit insurance fund of approximately \$372 million in connection with the USNB failure. Fifty million dollars of this total amount represents a direct obligation of Crocker National Corporation on account of the 7 1/2 percent five-year note it issued to FDIC last October in order to increase Crocker's capital accounts by a like amount. FDIC expects repayment in full of this amount not later than October 22, 1978. The remaining \$322 million has been advanced to the receivership estate to provide: the \$281 million in cash needed by Crocker to balance the liabilities it assumed, the \$30 million necessary to pay off the window loan which the Federal Reserve Bank of San Francisco had extended to USNB as of the time of closing, approximately \$9 million subsequent to USNB's closing to protect

receivership assets and the balance for a variety of miscellaneous settlement adjustments required by the Agreement and for certain liquidation expenses. As of last Friday, December 6, 1974, the Receiver had collected about \$28 million on receivership assets and had repaid about \$19 million to the insurance fund. Thus, the balance owing from the receivership estate to the federal deposit insurance fund now stands at slightly more than \$300 million.

To repay this \$300 million, the Receiver currently holds USNB assets having an approximate book value, net of realized losses, of \$438 million. In addition, there are unbooked claims on which the Receiver may be able to realize significant amounts, such as its claims for fidelity losses under USNB's blanket bond and its litigation against former USNB directors.

The book value figure of \$438 million in receivership assets is misleading, however, since it reflects USNB's least attractive and least collectible assets. About \$345 million of this total represents indebtedness in one form or another of Smith-related borrowers, while the balance includes such items as undesirable non-Smith-related loans returned by Crocker, loans charged off or assets not booked by USNB prior to its closing, municipal securities for which there is no ready market, foreign time and demand deposits which have been offset

against unpaid letters of credit, prepaid USNB expenses of little value to the Receiver, and long-term purchase obligations held in connection with the sale of borrowers' assets. While many of these receivership assets have some value, we currently estimate aggregate recoveries far below not only the book value of these assets, but far below the remaining \$300 million in FDIC advances to the receivership estate.

Last January, based on developments in the receivership through year-end 1973 and our very preliminary appraisals of the assets then held, the FDIC Board of Directors established a reserve for loss on account of the USNB receivership of \$48.3 million. Subsequent events, including the payment of \$47.7 million in disputed letter of credit claims and the return by Crocker of approximately \$35 million in Designated Group loans not previously identified as such, with the resulting receipt of assets in exchange which added little in value to the Receiver's anticipated recoveries, indicate that a substantial addition to this reserve will be required at the end of January 1975 based on developments in the receivership through this coming year-end. While it is premature to estimate the addition to last year's reserve which the FDIC Board of Directors will consider appropriate under all the circumstances, it is likely to fall between \$50 million and \$100 million. Whatever the total reserve established, it will be subject to further

adjustments in the years ahead as more accurate appraisals become possible on both the asset and liability side of the receivership's books. As the existence of any FDIC reserve for loss would imply, I see little chance of recovery even in part for USNB shareholders or debenture holders unless they succeed in overturning their subordinated status or in making recoveries from former USNB officers and directors through litigation.

## II. Current Status of Certain USNB Standby Letters of Credit

In my testimony before this Subcommittee last November, I reviewed for you FDIC's position and the actions taken by FDIC up to that time with regard to certain standby letters of credit issued by USNB. In brief, prior to its closing last October, USNB had outstanding letters of credit in the principal amount of approximately \$91.3 million which were carried on its books as standby letters of credit issued to guarantee the obligations of account parties affiliated with or closely related to C. Arnholt Smith, the so-called "Designated Group." Because these letters of credit, and the related obligation of the account party, appeared to be among USNB's Smith-related assets and liabilities, they were retained in the receivership. Shortly after USNB was closed, a number of the 39 holders of these retained letters of credit advised FDIC that, in their opinion, the obligations evidenced thereby were not USNB

guarantees of customer loans, but rather USNB direct obligations for deposits in or loans to USNB by the holder. FDIC thereupon asked each of the holders of these standby letters of credit to file a proof of claim outlining its version of the transaction, and by January 1974 virtually all of them had filed detailed claims. I also advised you that FDIC itself was in the process of conducting an extensive investigation into the facts underlying the issuance of these standby letters of credit.

Between January when all known records were gathered and June 1974, the FDIC staff reviewed each claim to determine whether the letter of credit issued by USNB represented USNB's guarantee of an obligation due from the account party to the beneficiary, as FDIC at first believed and as USNB's records indicated, or whether it evidenced a direct deposit or loan transaction between USNB and the beneficiary as many of the holders claimed. To make this determination, the FDIC staff relied on information obtained from interviews with brokers, former USNB officers and account party officers, as well as all of the documentation surrounding the transactions, including the files of USNB, the files kept in C. Arnholt Smith's private offices (which frequently contained information different from that found in USNB's files), and correspondence among USNB, the beneficiaries, the account parties and the brokers. Where available, records of the account parties were also reviewed. Many of the letters of credit which were outstanding at

the time USNB closed appeared to evidence transactions which were rollovers of prior transactions between USNB and the beneficiaries. In order to determine the initial intention of the parties at the time transactions between them were first begun, it was necessary to review not only the information contained in open files but also the information contained in files pertaining to prior transactions.

All told, information was reviewed regarding 59 standby letters of credit issued by USNB and still outstanding at the time it closed. In a number of cases, it was necessary to request further information from the holders of letters of credit regarding apparent inconsistencies between documentation in FDIC's possession and information provided by the claimants.

It is impossible to generalize about these letter of credit claims, as virtually each transaction was different. However, the basic purpose of the review was, as indicated, to attempt to determine whether the transactions were two party deposit or loan transactions involving only USNB and the beneficiaries (and thus the type of obligations assumable by Crocker under the Agreement) or whether they were guarantee or typical standby letter of credit transactions involving three parties, one of whom was a member of the Designated Group. As a result of this review, it appeared that in 37 of the 59 letter of credit transactions aggregating \$47.7 million in principal amount, the holders of the letters

of credit had no privity of contract, and no contact, or at most minimal contact, with the account parties; further, the account parties' records reflected loans from USNB rather than USNB-guaranteed loans from the beneficiaries. Correspondence with the brokers involved in some of these transactions verified that the beneficiary had been asked to, and in fact intended to, make a deposit with or loan money directly to USNB. USNB, on the other hand, had indicated in its records and on its books that a loan had been made not by the beneficiary to USNB but by the beneficiary to the account party, and that USNB had issued its letter of credit to guarantee the loan. In other words, while USNB's records reflected a three-party transaction, the records of the beneficiaries and brokers reflected a two-party transaction between the beneficiaries and USNB. At the same time, the records of the account parties reflected another two-party transaction between the account party and USNB. Apparently what USNB had done in these 37 transactions was to borrow money from the beneficiary and issue a so-called "clean" letter of credit to evidence the loan. USNB then used the loan proceeds to make a loan to the account party named in the letter of credit. Having issued a "letter of credit" to evidence its primary obligation, USNB booked the letter of credit as a contingent liability or guarantee rather than as a primary obligation and did not book the offsetting loan to the

account party at all, thus avoiding statutory lending and borrowing limits, reserve requirements and a direct balance sheet liability. <sup>\*/</sup>

At the time USNB closed, of course, FDIC had available to it only that information contained on USNB's books and in the Comptroller's Reports of Examination. Only after reviewing all of the records and files available did we learn the true nature of these transactions. In view of these findings, FDIC's Board of Directors determined that, had the true facts of these 37 transactions been known at the time USNB closed, USNB's liability to the beneficiaries on the letters of credit would have been assumed by Crocker under the terms of the Agreement. In June 1974, FDIC arranged for this assumption to take place under reimbursement by FDIC.

As a result of this review, FDIC also determined that 22 of the letters of credit in question (aggregating approximately \$42.4 million in principal amount) were, in its opinion, properly booked by USNB as three-party guarantee transactions. That is, the letters of credit themselves, viewed together with the correspondence and other evidence surrounding the transactions, indicated that the beneficiary of the letter of credit intended to and did make a loan to a Designated Group member, with

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<sup>\*/</sup> Rulings adopted by the Comptroller of the Currency August 9, 1974 in respect of standby letters of credit would tend to frustrate a similar result today.

the letter of credit it received being USNB's guarantee of that loan. The holders of the letters of credit not transferred to Crocker for payment were advised of this decision and that, to the extent allowable by law, they had claims against the receivership. They were further advised that FDIC was willing to cooperate with them in their attempt to collect from the account party, the party primarily liable on the obligation. The actions taken by FDIC are reviewed in greater detail in two press releases issued on June 19 and July 2, 1974, copies of which have been submitted to the Subcommittee for its convenience.

Subsequent to these determinations, the FDIC staff has been working with a number of the beneficiaries of these letters of credit to assist them in collecting the amounts due them from the various account parties. In each case the account party also owes substantial sums of money to the FDIC as Receiver of USNB. Agreements are being negotiated between FDIC and some of the beneficiaries regarding such matters as the priority of future claims against these account parties and the maximization of the recovery of the Receiver and the beneficiaries.

A number of the holders of letters of credit which were not transferred to Crocker have advised FDIC that they disagree with FDIC's findings and have filed with us additional information regarding their transactions with USNB. The FDIC staff and one or more members of the FDIC Board of Directors have met with these claimants regarding

their requests for reconsideration. Each of these claimants will be advised in due course of the disposition of its particular request for reconsideration and of the status of its particular claim.

In addition, a number of persons holding letters of credit which Crocker paid have claimed that they are owed additional sums for interest from the date of the maturity of the letter of credit until the date of actual payment. With regard to these claims, FDIC has taken the position that payment of such post-maturity interest would be improper at this time and under the circumstances present in these cases.

Concurrently with the review of the letter of credit claims filed by the various holders, two court actions have been filed alleging, in substance, that FDIC in both its capacity as Receiver of USNB and in its corporate capacity acted improperly with respect to their claims. The first of these suits, a class action, was filed on November 21, 1973, on behalf of International Westminster Bank and others whose claims were not assumed by Crocker (this suit was referred to in my testimony before this Subcommittee last November). This suit sought to have the Agreement declared illegal on the theory that it violated the provisions of 12 U.S.C. § 194 which calls for the payment of ratable dividends to all creditors of an insolvent national bank whose claims have been proved to the satisfaction of the Receiver or adjudicated in a court of

competent jurisdiction. Subsequent to my prior testimony, the District Court for the Southern District of California dismissed the suit holding that it was filed prematurely and that it failed to state a cause of action upon which relief could be granted. An appeal from that dismissal is presently pending before the United States Court of Appeals for the Ninth Circuit. As of this date, no decision has been handed down by that Court.

A second suit was filed in the District Court for the District of Columbia by Banque Francais du Commerce Exterieur and four other letter of credit holders. It sought a declaration that both the FDIC and the Comptroller of the Currency acted illegally with respect to the USNB transaction. This suit is substantively similar to the International Westminster complaint although it seeks a somewhat different form of relief. The District Court ruled that venue in the District of Columbia was improper and ordered the case transferred to the United States District Court for the Southern District of California. That decision was affirmed by the United States Court of Appeals for the District of Columbia and the case has now been transferred to California. The course it will take will probably depend upon the ultimate decision of the Court of Appeals for the Ninth Circuit in the case presently before it.

An early resolution of these law suits is unlikely, and further litigation may be expected from holders of letters of credit.

### III. An Overview of FDIC's Collection Efforts

About 30 FDIC employees are currently engaged full time in San Diego in the collection activities of the USNB receivership. They are aided by several West Coast law firms retained as special counsel for various aspects of this receivership, and the total operation is supervised and coordinated by members of the FDIC liquidation staff in Washington and by the FDIC Board of Directors. Over the next ten years, which we anticipate to be the minimum life of this complex receivership, we expect our personnel requirements and direct liquidation costs to decline gradually. To date, our direct salary, operating and legal expense has approximated \$2 million.

The receivership contains approximately 4,400 assets not counting unbooked causes of action, but 3,600 of these are relatively small claims, aggregating only \$24.9 million in book value. As I have previously indicated, the bulk of the receivership assets (approximately \$345 million) represents indebtedness in one form or another of Smith-related borrowers. Our Liquidation Office believes that this indebtedness may be broken down as follows, although particular borrowing groups may allege, for reasons to which I will refer shortly, that some other group is responsible for at least part of the indebtedness attributed to them.

BCIC and related companies	\$126.7 million
Hollis Roberts and related companies	79.2 million
Westgate-California Corporation and related companies	44.2 million
San Luis Rey Development Project <sup>*/</sup>	47.3 million
M. J. Coen and related companies other than BCIC	19.9 million
J. A. Smith and related companies	7.9 million
Miscellaneous loans related to the above	<u>20.5</u> million
Total	\$345.7 million

In each of the six major lines first listed, there appears to have been a close relationship between C. Arnholt Smith and one or more of the principals involved, although at the present time we do not know the full extent of that relationship. There also appears to have been significant and recurring relationships between the different groups, in addition to

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<sup>\*/</sup> The San Luis Rey line does not represent loans to a group called San Luis Rey, but rather loans secured by property in a portion of California called San Luis Rey. This is approximately 60 miles north of San Diego and includes approximately 2,457 acres under various deeds of trust now held by the receivership. These deeds of trust relate to land owned by 22 different companies. The property appears to be part of a speculative venture on the part of those who borrowed money from USNB to invest in this area. Many borrowers included in other groups are also borrowers in this line.

their separate relationships with USNB. Suffice it to say, however, that this receivership is unusual from the standpoint of the concentration of very large loan lines in the hands of only a few individuals, or in the hands of companies they once controlled, all of whom seem to have had a close working relationship with C. Arnholt Smith.

While the number of controlling individuals originally involved in these six lines may be small, the number of corporate entities encompassed within each line is substantial. Organizationally, BCIC, for example, can be grouped into five major headings totalling 26 companies: boat companies, operating companies, real estate holding companies, shell companies, and miscellaneous other companies. Each of the boat companies, of which there are eight, owns or has owned in the past a tuna fishing boat. Two of the operating companies own shopping centers and one operates an airline terminal and service facility. The five real estate holding companies either own real estate in the San Luis Rey area or in the Kern County area, and one of them owns nothing but shares of Westgate-California common stock. There appear to be four companies which were simply shell companies and were used for manipulation of assets by the control group, only one of which has any assets at the present time. The miscellaneous other companies remaining in the BCIC group own furniture and fixtures, four small airplanes, real

estate in Chino, California, and Ontario, stock in Westgate-California Corporation and a commercial property in Beverly Hills. Even where these corporations own assets, their net worth is frequently so small and their operations so minimal that there is little likelihood that sufficient funds can be generated to repay their obligations in full. The same pattern is present in the other five major lines.

The collection efforts of the USNB receivership are compounded by the necessity of following numerous specific transfers of assets, liabilities, ownership rights, debt, and security interests among and between this large number of companies. Loans which on the books of USNB at closing might appear to be the responsibility of Company X turn out to be, in reality, the responsibility of Company Y or Individual A after the receivership has traced the passage of loan proceeds from company to company or individual to individual. While we feel that we have unraveled some of this complexity and have begun litigation to assert claims we have uncovered, we are not yet sure that we know all the facts about the multiple manipulations that have occurred. Some persons who could shed light on this area, such as C. Arnholt Smith himself, have refused to answer our questions, pleading their constitutional right against self-incrimination. These are matters that will be sorted out, if at all, only over time as our tracings are completed, new information is discovered, or litigation progresses.

It would be too time-consuming at this point to go into great detail on the collection strategy that the Receiver is adopting with respect to each of these six major lines. Likewise, to reveal that strategy or to reveal our estimates of specific anticipated recoveries might in some cases compromise negotiations currently under way with some of the debtors. To give the Subcommittee some idea of the nature of the problems being encountered, however, we have included in the next section of this report a rather full description of our collection efforts with respect to one of the six major lines, i.e., Westgate-California Corporation and its related companies.

#### IV. A Specific Example: Westgate-California Corporation

Westgate-California Corporation is a large conglomerate whose affiliates and subsidiaries can be grouped into eight groups: seafood, surface transportation, air transportation, real estate, hotel/resort, produce, leasing, and insurance. At the time of USNB's failure, these eight groups included eleven separate companies. Five of the companies are involved in the tuna business, owning three canneries, four tuna boats, and a leased terminal with docking facilities and warehouse. Two of the companies own control of taxi cab companies and operate commuter airline routes. They also lease and own three commercial jets. Several companies own real estate.

Westgate-California Corporation and its subsidiaries (collectively referred to herein as "Westgate-California") now has debt of approximately \$44 million on the books of the receivership, a reduction of \$24.4 million since USNB failed.<sup>\*/</sup>

Shortly after USNB failed, Westgate-California, represented by a president and board of directors appointed by the Court a few months earlier following compromise and settlement of litigation brought by the SEC, requested from the FDIC a \$500,000 cash advance to meet payrolls due in Westgate-California and to pay premiums on directors' liability insurance policies. Westgate-California told the Receiver that advances were needed because USNB had been Westgate-California's bank, that it was not able to acquire quickly other bank lines, and that if the advances were not forthcoming the members of Westgate-California's board of directors would resign and the company would be placed in voluntary bankruptcy. Westgate-California also requested an additional \$6 million on a short-term basis for working capital to permit its seafood companies to purchase tuna during the first two or three months of calendar 1974.

In order to permit the receivership time to analyze the operations of Westgate-California, and to permit other banks and insurance companies

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<sup>\*/</sup> This reduction resulted from the application of \$7.2 million in cash payments, \$200,000 in offsets made with USNB deposits, and the transfer of approximately \$17 million to purchasers of assets who assumed Westgate-California's related debt to USNB or substituted their own obligations for such debt.

which had been financing the operations of that conglomerate on both a short and long-term basis time to make their review of the situation, the Corporation advanced \$500,000 on November 29, 1973. That \$500,000 advance was subsequently repaid on May 6, 1974.

A few weeks later, the FDIC Board of Directors rejected Westgate-California's request for an additional \$6 million advance following extensive analysis and meetings, both in Washington and in San Diego, on the grounds that it could not satisfy itself that any advance beyond the \$500,000 previously transferred would serve to protect the total assets in the receivership estate attributable to Westgate-California. This judgment was supported by the decision of the banks and insurance companies which had been long-term creditors of Westgate-California not to make further loans to the conglomerate, and by the fact that commercial banks which had been financing Westgate-California's seafood operations had either withdrawn the lines outstanding or had limited the size of the lines then on their books.

Notwithstanding the Receiver's denial of the \$6,000,000 request, Westgate-California did not go into bankruptcy at that time. Rather, in an attempt to raise the needed working capital, Westgate-California made a corporate decision to sell the 1,823,566 shares of common stock of Golconda Corporation which it held and formally applied to the Court which was overseeing its affairs for the requisite permission.

Since the Receiver held substantial amounts of the Golconda stock as security for a loan of \$4,500,000 to Wescal Properties, Inc. (a wholly owned subsidiary of Westgate-California Corporation), and since the Receiver claimed an interest in any additional proceeds that might be realized from the sale of the stock on a constructive trust theory, negotiations between Westgate-California and the Receiver were undertaken to see whether some amicable agreement for the distribution of the proceeds of the sale of the Golconda stock could be reached.

Westgate-California claimed, among other things, that there was substantial question whether Wescal Properties, Inc. had ever received the benefits of the \$4,500,000 debt shown on the books of the Receiver, and, therefore, whether it in fact owed \$4,500,000 to the USNB receivership. It further argued that any additional claim in the proceeds beyond \$4,500,000 was totally without foundation. It claimed in fact that there was substantial doubt that Westgate-California had obtained the benefits of a large portion of the other loans due from its subsidiaries on the books of the receivership, and suggested that it was prepared to litigate extensively, in bankruptcy if necessary, to prove the point. Finally, it claimed that the entire proceeds of the sale of the Golconda stock were needed to provide working capital for Westgate-California, and that without it, Westgate-California would collapse and

the collection of the entire debt owed by Westgate-California to the receivership would be jeopardized. The situation was complicated by a lien which the Internal Revenue Service had obtained on all assets of Westgate-California, including the Golconda stock, for the purpose of insuring payment by Westgate-California of a tax claim for \$4,200,000 allegedly owed the United States by Westgate-California.

Following extensive negotiations, Westgate-California made a formal request to the Receiver on February 13, 1974 that the Receiver: (1) defer all principal payments on the debt owed by Westgate-California to some unspecified date, (2) cancel any interest now due or to accrue on that debt, (3) waive the Receiver's security interest in the stock of Golconda Corporation, and (4) waive the Receiver's rights to any proceeds of the contemplated sale of Golconda stock. As consideration, Westgate-California offered to confirm and not contest all debt owed by Westgate-California to the Receiver (in amounts to which the two parties might agree based on information then known) and all collateral purportedly held by the Receiver as security therefor. As a further inducement, Westgate-California also submitted financial projections which it claimed showed that, upon agreement by the Receiver to its offer, Westgate-California would be able to pay the principal amount of the debt to the Receiver at some unspecified time in the future.

In due course, the Receiver rejected that proposal since, upon analysis, it was clear that acceptance of the proposal would not have led to a greater recovery for the receivership estate and, in fact, might have led to a lesser recovery for the estate. Negotiations continued with Westgate-California, but no agreement was reached until the parent Westgate-California Corporation and its subsidiary Wescal Properties, Inc. voluntarily went into a Chapter X proceeding on February 26, 1974.

The Receiver was unable to reach an accommodation with Westgate-California prior to its bankruptcy petition, since in all cases the offers made by Westgate-California contemplated the serious weakening of the Receiver's position vis-a-vis other creditors, actual or prospective, and offered as consideration only the prospects of long-term partial repayment that was speculative at best. Westgate-California seemed to feel that the receivership had a continuing interest, as a successor bank, to fund its operations, and that Westgate-California's repayment of debt already in default was secondary to protecting the equity interests of Westgate-California's capital noteholders and shareholders. Its arguments were supported only by unaudited figures, and these seemed to change significantly with each request. Upon analysis, none of the figures showed that the receivership would benefit from the requests being made.

The prevailing attitude of Westgate-California had been, until the appointment of a Trustee in Bankruptcy, that the conglomerate should be run as if it was an untroubled and bankable business, and that no part of the conglomerate should be liquidated (with the possible exception of certain real estate it owned in downtown San Diego). The Receiver's analysis was that none of this was possible unless the Receiver surrendered substantial rights and interests it held, a surrender which showed no promise of ultimate repayment. In direct contrast to this approach, the new Trustee, Mr. Curvin Trone, suggested to the Board of Directors of the FDIC in a meeting held in Washington, D. C., on March 15, 1974, that there should be an orderly liquidation of some parts of the Westgate-California operation. He also suggested that the FDIC, as well as other creditors, had some repayment due them and consideration should be given to them as well as to employees, stockholders, and debenture holders of Westgate-California.

The Trustee had filed a petition under Chapter X claiming that it could reorganize Westgate-California successfully. Even though the Receiver formally objected to that petition, claiming that any reorganization would be unsuccessful, the Receiver felt that with the changed attitude reflected by the new Trustee it could properly begin negotiations to see if there was some way to reach an accommodation

which would permit the proceeds from the sale of the Golconda stock to be distributed to the benefit of the Internal Revenue Service, the Receiver, and the Trustee, and permit him a period of time to apply his skills and business experience to Westgate-California's pervasive problems.

The Receiver considered it essential to insure that its position vis-a-vis the Trustee, other creditors of Westgate-California, and equity holders of Westgate-California would not be diminished by any agreement reached with the Trustee, and that the Westgate-California assets did not diminish in value. Likewise, IRS found itself hard pressed to accept anything but full cash payment for the \$4,200,000 allegedly owed it by Westgate-California. Westgate-California, on the other hand, needed a significant part of the proceeds of the sale of Golconda stock for working capital or it was meaningless for it to enter into any agreement. Since the proceeds of the sale of the Golconda stock amounted to only \$9,752,985.50, it was clear that all parties could not be satisfied completely. In due course, a compromise agreement for the distribution of the proceeds of this sale was entered into on April 9, 1974.

The agreement is lengthy and detailed, but from the standpoint of the Receiver, it seemed desirable since (1) the Receiver immediately received \$3,500,000 from the sale of the Golconda stock without litigation, (2) the Trustee agreed systematically to use his best efforts to

liquidate in an orderly fashion companies in Westgate-California other than those in the seafood division, within the following two years, (3) payment was committed to the Receiver of amounts obtained from the sale of certain subsidiary companies even though no loan outstanding to such companies then appeared on the Receiver's books, (4) the Trustee agreed to a schedule of debt repayment which would allow repayments made to be applied at the discretion of the Receiver (which meant such repayments could be applied first to unsecured or poorly secured loans thereby keeping the Receiver's good security intact), and (5) the Trustee gave the Receiver security for loans or bankers acceptances that were unsecured at the time. Most importantly, the agreement reflected that one of the purposes of the Trustee in reorganization was to pay creditors of Westgate-California.

From the standpoint of Westgate-California, and indirectly from the standpoint of the receivership, the agreement provided a means whereby Westgate-California could continue normal operations while attempting to sell certain assets and companies. Schedules which Westgate-California furnished at that time showed projections of income and cash flow which indicated that it could and would pay the receivership approximately \$4.5 million by the end of 1974, some of it from the proceeds of liquidation and some from current earnings.

Since April 9, there has been some deterioration in the cash flow and income results of Westgate-California's operations vis-a-vis the forecasted results, but there has also been substantial reduction of debt. While it appears at this time that Westgate-California will not be able to pay directly any part of the \$4,500,000 projected for 1974, and that the Trustee has failed to meet some of the target dates established for selling certain of the assets in the conglomerate, the Receiver nevertheless believes that there have been substantial benefits accruing to the receivership from the April agreement. Westgate-California has been able to operate in a normal manner and has not been forced to liquidate assets at distressed prices. These conditions made it possible to reach a favorable sale of the downtown San Diego block containing the Westgate Plaza Hotel in the summer of 1974. Similarly, an additional \$2,070,280 was paid to the Receiver from the proceeds of the Golconda sale when the IRS released some of its claims earlier this summer, bringing to \$5.5 million the total amount realized by the Receiver in this transaction without litigation. We further believe that the April compromise has probably increased our likely net recovery in the whole Westgate-California line.

At the present time, the Receiver is considering a request by Westgate-California's Trustee to restructure the debt from Westgate-California to the Receiver on a long-term basis and to provide an

additional \$5 million of working capital on a short-term basis. We are in the midst of analyzing that request at the present time and have not yet reached any conclusions with respect to it.

V. Litigation By and Against the Receivership Estate

Every receivership involves the FDIC in litigation, and there is obviously more of it when the receivership is as large and as complex as the USNB receivership. The principal litigation efforts in which we are currently engaged include the following:

Attacks on the Purchase and Assumption Agreement with Crocker.

In addition to the two lawsuits filed by holders of USNB standby letters of credit to which I have previously referred in Part II of this statement, a more recent case has been filed which also attacks certain provisions of the Agreement between FDIC as Receiver and Crocker. This case, 340 Spring St. Co. v. FDIC, represents a cross-claim against FDIC by the owner of a building which USNB leased as a branch office. The building was occupied temporarily by Crocker, but the lease has since been terminated by the Receiver. The plaintiffs seek damages for alleged default on the lease and a declaration that the purchase and assumption transaction with Crocker was illegal to the extent it did not require full performance of USNB's lease obligations. This action was commenced just recently, and no answer has yet been filed by FDIC.

Bond Claims and Director's Liability Matters. FDIC personnel have been conducting a thorough examination of USNB's records since October 1973 with a view to developing and presenting substantial claims under USNB's bankers blanket bond. To date claims totalling \$153 million have been filed with the bonding company which wrote USNB's policy, although recovery would be limited to no more than \$10 million for each USNB officer shown to have committed independent violations of its terms which may as a practical matter limit total recovery to \$10 million.

The FDIC is also attempting to prosecute claims against former directors of USNB. These efforts have been complicated by reason of two actions filed against such directors by minority shareholders of USNB shortly after the bank closed. These complaints, Harmsen v. Smith, et al. and Hansen v. Smith, et al. (which have since been consolidated) sought recovery against certain directors of USNB for alleged violations of the Securities Exchange Act of 1934, for violations of the National Bank Act, and for breaches of their fiduciary duties. The FDIC believes that these actions are essentially derivative in nature and therefore has sought and received permission to intervene as USNB's Receiver. However, the FDIC has been denied the exclusive right to prosecute this claim and is in the process of making an interlocutory appeal of that ruling to the United States Court of Appeals for the Ninth

Circuit. As plaintiff in intervention, the FDIC has filed its own complaint against the directors which seeks recovery, among other things, for alleged violations of the National Bank Act and of the directors' common law duties of care and loyalty.

Franklin National Bank v. USNB. Shortly after USNB was declared insolvent, Franklin National Bank filed a suit requesting rescission and damages in connection with \$5 million in capital debentures it had purchased from USNB. The suit alleges violations of the federal securities laws and common law fraud. As of October 8, 1974, the date of Franklin National Bank's own failure, the action was involved in ponderous discovery efforts and had not yet proceeded to trial. However, in the wake of Franklin National Bank's closing and the appointment of FDIC as its Receiver as well, the case has been stayed. The FDIC is currently developing plans to deal effectively and fairly with its statutorily imposed responsibility for handling receivership estates with clearly divergent interests.

Westgate-California Proceedings. In addition to taking the protective legal steps in Westgate-California's Chapter X reorganization proceedings which led to the compromise agreement of April 9, 1974, the FDIC as Receiver instituted a suit in the United States District Court for the Southern District of California against four companies of

the Westgate-California conglomerate. This suit, against Westgate Life Insurance Co., South Plaza, Inc., Westgate Caribe, Inc., and Westgate-California Foods, seeks recovery of \$3.99 million. The complaint is based on the apparent practice of shifting the loan obligations of major Westgate subsidiaries to other entities with the result that the loans are still outstanding. The Receiver is currently preparing an amended complaint in this matter.

Additionally, the Receiver has filed substantial claims in Westgate-California's Chapter X reorganization proceedings. These claims seek recovery of \$48 million based on continuing guarantees by the parent corporation of subsidiary debts and further seeks recovery of \$110 million on the theory that the parent is indebted to USNB by reason of:

- (a) Moneys obtained from USNB on loans made under false pretenses and by misrepresentation as to the identities of the borrowers or users of such moneys, the uses of such moneys and the sources of repayment of such moneys, all of which moneys were in fact received and used by and for the benefit of the parent; and
- (b) The parent's assisting, agreeing, aiding and abetting C. Arnholt Smith, a director, officer and controlling

shareholder of USNB, in violating his fiduciary duties and duties of care to USNB by obtaining moneys in said amount from USNB for the use and benefit of Westgate-California, without approval of the board of directors or stockholders of USNB, in violation of 12 U.S.C. § 84, without regard to sound banking and credit practices and for the purpose of benefiting Westgate-California at the expense of USNB.

To date, Westgate-California Corporation's Trustee has not acted on these claims or any of the other claims filed against it by others which together aggregate approximately \$1.5 billion.

Other Litigation. There are, of course, many more cases both by and against the FDIC as Receiver of USNB. However, most of these cases were pending prior to the bank's closing and are routine insofar as they present legal questions not unlike those associated with normal banking operations. These cases involve such questions as violations of margin requirements by USNB, breaches of contract, general tort claims, etc. While there are approximately two hundred cases of all types pending in the USNB receivership, the matters discussed above relate to legal issues of special significance in the conduct of the receivership.