REPORT OF THE SPECIAL COUNSEL ON THE SAVINGS AND LOAN CRISIS

STATE OF MARYLAND

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January 8, 1986

The Honorable Harry R. Hughes
Governor, State of Maryland

The Honorable Melvin A. Steinberg
President, Maryland State Senate

The Honorable Benjamin L. Cardin
Speaker, Maryland House of Delegates

Dear Sirs:

I am hereby submitting the report of Special Counsel's investigation of the savings and loan crisis, pursuant to State Government, Section 9-1204 of the Annotated Code of Maryland.

Respectfully submitted,

Wilbur D. Preston, Jr.

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A. INTRODUCTION

"We unanimously concluded that the people who are currently operating First Progressive Savings and Loan Association should not be permitted to operate a savings and loan association."

This ominous conclusion appeared seven years ago in 1978 in a Division of Savings and Loan Associations' (Division) examination of First Progressive Savings and Loan Association (First Progressive). Two of the people to whom it referred were Jeffrey Levitt and Allan Pearlstein; Levitt was then a director, settlement attorney and secretary, and Pearlstein was a director for First Progressive. The examination report was a blueprint for the future of the industry in Maryland. Its prophetic warning was written by three examiners with combined experience of twenty-seven years of examining Maryland associations.

That it was not heeded is an understatement. To the contrary, both the Division and the Maryland Savings-Share Insurance Corporation (MSSIC) embraced Levitt and Pearlstein, "lionized" them and assisted them and their colleagues and competitors in establishing a subculture in the handling of the savings of their fellow men. Before the ultimate collapse in May of 1985, many others would contribute to the disaster in a variety of ways. This report traces and summarizes the contributing factors and causes of Maryland's savings and loan crisis. It is a history without heroes.

B. TASK OF SPECIAL COUNSEL

In May of 1985, during the Extraordinary Session of the General Assembly, the Administration and the General Assembly decided that an independent investigation should be conducted of the crisis declared by the Governor in his Proclamation of May 14, 1985. The Office of Special Counsel was created to conduct that investigation.

The duties of Special Counsel and other aspects of the office are described in State Government Article Section 9-1204, passed by the General Assembly during the First Special Session of May, 1985. In that legislation Special Counsel is instructed to:

> Investigate all aspects of the events related to the emergency declared by the Governor on May 14, 1985 at 4:47 p.m. including but not limited to, any act or omission:
>
> (1) By any official or employee of the State;
>
> (2) By any officer, director, or employee of any privately insured savings and loan association; or
>
> (3) By any officer, director or employee of the former Maryland Savings-Share Insurance Corporation.

Although the Office of Special Counsel does not terminate until March 1, 1986, Special Counsel is required, on or before January 8, 1986, to submit a complete report of his investigation, including all of the findings and recommendations, to the Governor and the members of the General Assembly. This document is that report.

In addition to the report due on January 8, 1986, Special Counsel is also instructed in the enabling legislation to make confidential reports to the Governor for referral to appropriate prosecutors of any alleged or apparent criminal violations found within the scope of the matters to be investigated by Special Counsel. Confidential reports pursuant to this section have been made prior to this report and it is anticipated that additional confidential reports will be made subsequent to this report. The enabling statute also instructs Special Counsel to report on a confidential basis to the Governor his findings relating to any other action that may be warranted as a result of his investigation. Subsequent to this report and prior to March 1 we shall recommend such other actions to the Governor. It is anticipated that we shall be recommending civil actions available to the State or its agencies which we believe have a reasonable chance of resulting in substantial recoveries for the State.

We have also prepared emergency regulations relating to the savings and loan industry, which the Governor has put into effect by Executive Order, and have sent to the Governor and the General Assembly a draft of proposed legislation which drastically changes Titles VIII and IX of the Financial Institutions Article of the Annotated Code of Maryland. All of this has been done with a view towards preventing any similar crisis from occurring in the future.

The Preamble of the legislation creating the Office of Special Counsel should also be considered by the reader of this report. It points out that during the consideration of this emergency legislation questions have arisen that call for an examination of the actions taken by State officials, State agencies, MSSIC and certain segments of the savings and loan industry. It further points out that the crisis involving privately insured savings and loan associations apparently involved many more aspects than the occurrence of alleged criminal acts at a single institution. The legislation states that the paramount questions raised by this crisis are why and how it occurred, who the responsible parties were, could it have been prevented or its impact decreased, and what can and should be done to prevent any similar crisis from occurring in the future. It is within the parameters of this legislation that Special Counsel has functioned and prepared this report for the Governor, the General Assembly and the people of the State of Maryland.

The reader should also keep in mind some things that this report does not claim to be. It is not infallible, nor are its authors. It involved a task far beyond the imagination of Special Counsel when this office was assumed. It does not claim to contain every relevant factor pertaining to the crisis. We have not discovered all relevant factors and neither time nor space permits the publication of all those that we have discovered. Few will be pleased and many will be displeased by our findings. Those who disagree with us are entitled to state their position and their position should be considered.. We believe, however, that we have performed the task required of us relative to this report and that its factual findings and conclusions are accurate and in the best interests of the State of Maryland and its citizens.

The reader should also remember that this report is admittedly based on hindsight. Hindsight has certain advantages that are not always apparent at the time of the contemporaneous act. We concede that. Our necessary use of hindsight results in criticism for various people which, for the most part, is intended to be criticism in a classical sense, designed to discern past mistakes so that they may be avoided in the future. Occasionally, however, our report surpasses criticism and censures certain acts where our investigation reveals such a judgment to be warranted. We hope that readers will recognize this distinction.

We believe that the most important aspect of our function is to have conducted an independent examination of all pertinent factors and causes. We can state absolutely that this has been accomplished. When Governor Hughes contacted Special Counsel and requested that he undertake this position, the Governor volunteered that the job would include an investigation of <u>all</u> parts of the State's government in any way related to the crisis. He specifically stated "that includes the office of Governor." Neither he nor any other official of the State has tried to hinder us in any way. They have all encouraged us to press forward regardless of who may be involved. Not only has the Governor taken this position but so has the Attorney General, the President of the Senate, the Speaker of the House and all other officials of the State government. They have been helpful and cooperative. They have provided all the necessary tools that we have requested to complete our undertaking.

In the course of preparing this report we have interviewed hundreds of witnesses, subpoenaed and reviewed thousands of pages of documents and subpoenaed and examined under oath several dozen witnesses. In performing our task we have had several handicaps. First and foremost is the time element. An investigation such as this is complete only when the investigator says it is complete. We recognize that it is necessary to have a prescribed completion date given the circumstances faced by the General Assembly, but it did hinder our work. There are enumerable ways to hinder any investigation for some period of time and this is particularly effective when the investigator is known to have a limited life-span such as the Office of Special Counsel. Some areas we simply had to go over very lightly because of a lack of time. Indeed, we stopped some of our investigation in mid-stream to prepare this report. Other problems we confronted were persons who have exercised their Constitutional privileges under the Fifth Amendment and assertions that documents were similarly protected. Despite these factors, we believe the report is sufficiently complete for the purposes for which it was intended.

The Office of Special Counsel could not have completed its task without the assistance of many people. We first express our gratitude to the State itself for providing a totally independent and unbiased atmosphere for the completion of our job. No one has tried to influence our conclusions or our factual findings. Every State agency has cooperated in supplying information and other requested assistance. We are especially grateful to the Maryland State Police. At the beginning of our job we requested their help and they responded by assigning to us Sergeant R. Lee Caple. His skillful and dedicated investigation into complex financial transactions has been invaluable. We also are especially grateful to F. Carvel Payne, Director of the Department of Legislative Reference, and his staff who provided invaluable assistance and advice in gathering information and publishing this report.

The Federal Home Loan Bank Board has been unstinting in their support of our investigation. Senior Vice President Lamar Heath of the Federal Home Loan Bank in Atlanta has met with us and supplied vast quantities of helpful information. John Amick of the Maryland office of the Federal Savings and Loan Insurance Corporation (FSLIC) examiners and his colleagues have given us their support. Officials at the Federal Reserve at its headquarters in Washington, D.C. and at the Federal Reserve Bank in Richmond, Virginia have never refused any of our requests. General Counsel Mike Bradfield and Wellford Farmer are among those with the Federal Reserve who have helped.

Most of all Special Counsel would like to thank the lawyers and supporting staff who have made the completion of this task possible. They are Ward B. Coe, III whose skill as a lawyer and organizational ability have kept the complexities of our undertaking manageable. Steven I. Batoff has served as our expert on regulatory, statutory and historical matters germane to our investigation. Like Ward Coe, Steven Batoff is a partner in the firm of Whiteford, Taylor & Preston. Attorneys Carl R. Gold and John V. Church have rounded out our legal staff. Their energy and investigative skill have both been outstanding. Our multitude of records, documents, news clippings, financial data and assorted miscellaneous records have been managed by para-professionals Karen Quine and Marie Berkner. Legal assistants Kathleen Hughes and Vikki Harris have helped in ways too numerous to mention. All have the heartfelt thanks of Special Counsel.

C. SUMMARY OF THE CAUSES OF THE CRISIS

A summary of the causes of the crisis must begin with an understanding of the crisis itself. The crisis was not limited to the loss of confidence in Maryland's private deposit insurance system, MSSIC, which was triggered by the problems in Ohio. Maryland's savings and loan industry was on a collision course with disaster. The Ohio crisis merely accelerated the collapse. If it had not been for the problems in Ohio, Maryland surely would have faced a more serious and disastrous financial catastrophe a year or two hence.

The crisis in Maryland was not just the loss of confidence in MSSIC associations but the fact that the industry, through lack of regulation and gross mismanagement, had deteriorated to the point where it could not stand the scrutiny of a free and independent press. The crux of the crisis was that savings and loan associations that held approximately fifty percent of the MSSIC association insured deposits were so unsafe and unsound that they were either completely unable to qualify for FSLIC insurance or were unable to qualify without extraordinary financial assistance created by the State of Maryland. Veteran federal examiners have advised us that they have never seen a group of associations concentrated in a geographic area that have been operated in such an unsafe and unsound way as those mentioned in this report.

We believe that the three major causes of the crisis were: a total absence of regulation of savings and loan associations; individuals in the industry who took advantage of that absence of regulation to expropriate depositors' money for their own use, in violation of the law; and a hopelessly flawed system which permitted the industry to make and enforce its own rules. Many people contributed to these major causes.

MSSIC and the Division completely failed to regulate the industry. As a result, each association was only as good or as bad as those who controlled it. Insider deals, excessive fees, diversions of corporate opportunities and even criminal acts were tolerated. Both MSSIC and the Division have claimed that they were powerless. Although additional statutes and regulations would have been helpful, both had ample power to regulate the savings and loan industry. Both, however, chose not to exercise their substantial authority.

For example, MSSIC's powers included the ultimate sanction of expulsion of a member who violated MSSIC's rules and regulations. Intermediate steps included the ability to require an association to cease and desist from unsafe and unsound practices and the power to remove an officer or director of a noncomplying association. MSSIC was also authorized to require a member who was in violation of its rules and regulations to enter into an "insurance agreement." Pursuant to an insurance agreement, MSSIC could require virtually any provision it wanted, including requiring an association to submit all new transactions to MSSIC for prior approval. MSSIC also had the power to order an audit of an association at the association's expense, to fine noncomplying associations and to order associations to reduce or change their advertising. Each association that joined MSSIC was aware of these provisions and by accepting MSSIC's offer of insurance agreed to abide by them.

The Division Director also had substantial regulatory powers. Pursuant to Section 8-401 of the Financial Institutions Article of the Annotated Code of Maryland, he could issue orders to compel an association to comply with its charter or bylaws, any applicable law, or any rule or regulation issued by the Board of Savings and Loan Association Commissioners (Board of Commissioners) - the practical equal of MSSIC's cease and desist power. He also had the ultimate economic power over savings and loan associations because all requests for approval of insider transactions, applications for membership in MSSIC, mergers, conversions and new branches had to be approved by him. Additionally, the Board of Commissioners had the power to seek conservatorship or receivership for a noncomplying association.

Although both the Division and MSSIC frequently discussed using some or all of these powers, they rarely, if ever, did. Both were crippled by ineffective leaders and top management who were little more than industry captives. The MSSIC Board was totally dominated by the savings and loan industry and was obsessed with protecting the industry rather than protecting the safety of the deposits. Although the Board of Commissioners was comprised of three members from MSSIC insured institutions, two members from federally insured institutions and four public members, it too saw itself as a protector of the industry. Its operation was greatly hindered by the refusal of the Division staff to impart its most pertinent examination results to the Board of Commissioners. Our investigation has disclosed that the MSSIC Board received more direct information of violations from its staff than the Board of Commissioners received from the Division staff.

MSSIC also was damaged by ineffective legal advice. A striking example of this occurred in 1976 when the MSSIC Board sought an opinion from its general counsel with regard to the limits of its insurance coverage. For the prior fourteen years (1962-1976) of MSSIC's existence, it had interpreted its charter as limiting the amount of insurance coverage for <u>each depositor</u> so that it would "not exceed by more than the sum of $10,000 the amount of prevailing insurance available from the Federal Savings and Loan Insurance Corporation or its successor instrumentality from time to time." MSSIC sought and obtained from its counsel an opinion that MSSIC's insurance limits could be based on a <u>per account</u> basis as opposed to a <u>per depositor</u> basis. This meant that if one depositor had five separate $100,000 accounts in a MSSIC insured institution in May of 1985, the entire $500,000 would be insured. The practical effect of MSSIC's adoption of this opinion was to make MSSIC's insurance of deposits unlimited. We believe that MSSIC's action in 1976 was contrary to the provisions in MSSIC's charter.

The result of this change in coverage is difficult to quantify. An example of its effect is that for Old Court Savings and Loan Association (Old Court), approximately $76,000,000 would not have been covered by MSSIC if MSSIC had correctly interpreted its charter. More than half of this $76,000,000 came from multiple accounts outside the State of Maryland and some came from other countries.

The private law firm that served as MSSIC's general counsel also furnished legal services to persons who regularly violated or caused the violation of MSSIC's own rules and regulations. Beginning in 1982 Jeffrey Levitt and Old Court were discussed at many MSSIC Board meetings, which were attended by MSSIC's counsel. Both Old Court and First Progressive were controlled by Levitt and were classified as "habitual rule violators." From 1982 through 1985, MSSIC's lawyers also represented on a regular basis, Old Court, its subsidiaries, Levitt, Pearlstein, and Jerome Cardin. The members of the MSSIC Board interviewed by the Office of Special Counsel have testified and stated that they had no knowledge of their law firm's simultaneous representation of "habitual violators" of their rules.

Like his counterpart at MSSIC, the Division Director knew for years of the multitude of unsafe and unsound practices, including criminal conduct, engaged in by certain members of the savings and loan industry. The Director failed to carry out regulatory responsibilities to control this conduct because he too saw himself as a protector of the industry. Although the Director was appointed to his position by then Governor Marvin Mandel, he was the chosen candidate of the industry. As a result, he was too willing to listen to the pleas and excuses of poorly and criminally managed savings and loan associations. His staff lacked confidence in his abilities and individual examiners kept their own records of examinations out of a fear that they would be blamed if industry problems were ever made public. Although the examiners could have been better trained, equipped and paid, our investigation has disclosed that time and again they presented ample evidence of wrongdoing, including criminal misconduct, to the Director and his deputy. Almost without exception the Director took no action, paralyzed by the fear that regulatory sanctions of any major association would result in publicity that would denude the industry he felt bound to protect, leading to a loss of public confidence and the industry's demise.

The second major cause of the savings and loan crisis was the flagrant violation of state laws and regulations, including criminal conduct, of certain savings and loan officers, directors and controlling persons. Instead of protecting their depositors' money pursuant to their fiduciary duties, they used the deposits for their own personal gain. Although the vast majority of small neighborhood associations retained their identity as sponsors of thrift and home ownership, other industry members used associations to engender their own wealth and the fortunes of their families and friends. They were operated as commercial real estate investment corporations fueled by depositors money. An incestuous relationship developed between controlling persons of different associations. No distinction was made between the money of depositors and of directors; "fiduciary duty" was an unknown term.

These activities were frequently facilitated by association lawyers, accountants and appraisers. Association lawyers assisted association insiders in taking advantage of opportunities that belonged to the association. Despite the restrictions of Maryland law regulating association loans to officers, directors and controlling persons, certain associations systematically loaned millions of dollars to these individuals and to entities they controlled. These transactions were regularly approved by the association's board of directors. On the infrequent occasions when they were presented to the Division Director for his approval, as required by Maryland law, his approval was almost automatic.

The Division and MSSIC relied on certified audits from independent accounting firms which associations were required to furnish annually. We doubt the "independence" of some of the auditors and we also believe that some of the certified audits allowed accounting practices which overstated the profitability of certain associations. As a result, the regulators were misled.

Similarly, MSSIC and the Division regularly relied on purportedly independent appraisals of properties securing association "loans." In many associations, board members, officers or directors would do the appraisals or have the appraisals performed by companies they owned. Additionally, certain so-called "independent" appraisers rendered appraisals that greatly exaggerated the worth of the appraised property. These appraisals served as a basis for association contentions that "loans" were made in compliance with MSSIC and Division regulations. Both MSSIC and the Division regularly accepted these appraisals, without question.

A third major cause of the crisis was the totally unrealistic and impractical insurance and regulatory system for savings and loan associations in Maryland. The system was conceived in the early 1960's to insure small neighborhood associations primarily concerned with encouraging thrift and home ownership. Over the next twenty years the savings and loan industry in Maryland dramatically changed. With the advent of financial institution deregulation two classes of savings and loan associations emerged. The first consisted of the traditional associations that MSSIC was designed to insure. These were generally mutual associations controlled by the depositors. The second consisted of aggressive, commercial investors who sought deposits nationwide. These were primarily stock associations. The aggressive business tactics of the second group and industry domination of MSSIC's Board soon outstripped MSSIC's ability to regulate the industry and resulted in MSSIC's insuring more than $7,000,000,000 in deposits as of May, 1985. The industry-dominated Board of Commissioners also adjusted to the new economic environment primarily by making it easier for the industry to operate rather than by increasing protection for depositors and the public.

A final cause of the crisis, not as significant in our opinion as the three major causes, was the failure of State government at all levels to discover the gross regulatory failure and the criminal conduct of certain industry members. The legislature consistently enacted legislation created by industry dominated boards or commissions and often bowed to the influence of special interest groups representing the savings and loan industry. For example, in the savings and loan reorganization bill of 1980 where the entire savings and loan regulatory framework was revamped, the flexibility of the industry received more attention than the safety of depositors. The commission that drafted the 1980 legislation was chaired by the secretary of the savings and loan industry trade association and was totally dominated by persons who represented the industry.

The Office of the Attorney General provided legal representation to the Division. It has been the stated policy of the Attorney General that the role of his assistants was both to provide legal representation to their regulatory clients and to ensure that the regulators were doing their jobs. The Assistant Attorney General assigned to the Division did not fulfill that role.

The failings of the executive branch were in large part due to deficiencies in the Division. The Director failed to notify his superiors, including the Secretary of the Department of Licensing and Regulation and the Governor, and in fact actively misled them, concerning the status of the savings and loan industry. Nevertheless, the Governor's office did not have sufficient staff to independently examine and judge the effectiveness of the Division. When concerns of misconduct in the industry were brought to the Governor's attention by a reliable source, his staff failed to appropriately follow up. Additionally, there was no meaningful required reporting system from the Division, through channels, to the Chief Executive, although as our report shows, there is no assurance that the reports would have been informative.

D. THE CRISIS BEGINS

On May 14, 1985, at 4:47 p.m. Governor Harry Hughes issued a Proclamation stating among other things. . . "THAT A STATE OF PUBLIC CRISIS AND EMERGENCY EXISTS WITHIN THE STATE OF MARYLAND;. . ." The crisis and emergency involved the State chartered-savings and loan associations insured by MSSIC.

The immediate events leading up to the Governor's proclamation have been well documented in the press. They will be reviewed here only to set the stage, for although they may have "triggered" Maryland's crisis, they did not cause it. Indeed, we believe they caused our State to finally seek a cure before the illness became fatal.

Prior to March, 1985, most of MSSIC's high flying savings and loan associations maintained the veneer of success, at least to the general public. Advertisements in newspapers, magazines and on television spoke of "the Old Court advantage" and that "Merritt did it first." MSSIC and the Division joined in the campaign, answering all inquiries, whether they came from the government or from the private sector, with absolute assurances about the safety of MSSIC associations both individually and collectively. MSSIC had its own television campaign aimed at getting deposits for its member associations and featuring its misleading emblem intended to look like the State seal with the word "INSURED" emblazoned across it. Most, if not all, MSSIC associations had a MSSIC published pamphlet available as a "hand-out" for customers. It was entitled "Questions About Protection Of Your Savings? We Have The Answers." One of the questions it asked was: "What high standards protect savings in member associations?" The answer was in four parts, one of which stated: "By requiring through its rules and regulations, that members maintain high standards of operation." Added to all of this was the cold, hard fact that MSSIC associations were paying among the highest interest rates in the nation.

Maryland became a favorite locale for brokered deposits and "jumbo CD's" (certificates of deposit of $100,000 or more). Brokers and other large depositors across the nation (and in some foreign countries) were also attracted by MSSIC's representation that each separate account was insured for $100,000 under the provisions of its charter. Under this interpretation John Doe would be insured for any amount deposited in a MSSIC association so long as it was divided into separate accounts not exceeding $100,000.

In this scenario deposits soared. The MSSIC "high-flyers" headed for the stratosphere. Assets at Old Court approached one billion dollars and other MSSIC associations showed phenomenal growth, doubling and tripling and more in a year or two.

In late 1984 and early 1985, however, nagging questions about MSSIC and its associations began to arise. More sophisticated depositors wondered how Old Court could pay such high rates and questions about some of its loans began to surface. An uninsured private bank in Nebraska failed and was featured in a "60 Minutes" telecast. Two friends of Attorney General Stephen H. Sachs were concerned when they noted Old Court investments or loans in Florida and mentioned it to him. He requested an assistant to begin a survey of MSSIC and the Division. Attorney George Liebmann concluded two separate deals for clients with Merritt Commercial Savings and Loan Association (Merritt) and Old Court and expressed his general concern in a letter to Governor Hughes. The banking industry, itself, was or should have been alarmed. Growth at the rate experienced by the MSSIC associations is usually an early warning sign of trouble, particularly when you are paying the highest rates of interest in the nation. Old Court seems to have been so desperate to do something with the millions it was obtaining in deposits that almost any proffered deal had a chance of acceptance and this was no secret in the community.

Despite these scattered storm clouds the money machine known as MSSIC steamed through February with few visible signs of trouble. Old Court alone obtained more than $100,000,000 in deposits in February. Then came the collapse of Home State Savings Bank of Ohio. On March 15, Governor Richard F. Celeste of Ohio declared a bank holiday for that State's savings and loan associations insured by Ohio's counterpart of MSSIC. This event triggered the reversal of the cash flow with MSSIC thrifts. The run had started.

Media interest in the first parts of the run was non-existent. There were no lines of depositors seeking withdrawals. But the "smart money," the brokered deposits and others with some insight of the Maryland system began a quiet and orderly withdrawal of deposits. As a result of a call from the Governor of

Ohio, Maryland officials began to monitor withdrawals from MSSIC associations. Ejner J. Johnson, Governor Hughes' Staff Director, directed this effort. The legislature was in session and its leaders inquired of Charles C. Hogg, III of MSSIC and Charles H. Brown, Jr. of the Division if Maryland faced any danger. They received the same absolute assurances they had always received, that there were no problems with the MSSIC associations. Indeed, it appears from our investigation that the President of the Senate and the Speaker of the House were not made aware of the impending crisis until early May. The reason for this was the slim hope of those in the Executive Branch that confidence could be restored and that to accomplish this there could be no publicity of the secret run. The theme was to involve as few people as possible.

Towards the end of March, President Hogg of MSSIC contacted Donald Beason of North Carolina's private deposit insurance company. He learned that the Board of the North Carolina company (unlike MSSIC it was not an industry dominated board) had decided to go out of business and had instructed their thrifts to obtain coverage from FSLIC. This was discussed by MSSIC directors although it does not appear in official minutes. Obviously it was not a viable consideration for MSSIC because so many of its associations were known to be "uninsurable" by FSLIC standards. Meanwhile, the silent run continued through March and April.

Back in February of 1985 MSSIC's Board had finally decided to take some long overdue action against Old Court. In interviews, most Board members told us that they had voted for a "Cease and Desist Order" as provided in Section 3-222 of MSSIC Rules and Regulations. Instead what they got was a "Management Agreement" with Old Court that was not signed until April 23, 1985. They keystone of the Agreement, which Special Counsel believes to have been inadequate for several reasons, was that John D. Faulkner, Jr., former president of Community Savings and Loan Association, would replace Levitt in the day to day management of Old Court. In fact Levitt and Old Court had hired Faulkner as a "consultant" in January before the MSSIC resolution. He was Levitt's choice and not MSSIC's.

By mid-April, 1985 the out-flow was now up to $375,000,000. Five associations had already borrowed over $100,000,000 from the Federal Reserve. Without the aggressive support of the Federal Reserve, the liquidity of MSSIC thrifts would have been exhausted. A series of crisis meetings commenced which were attended by federal and state officials including Governor Hughes, Attorney General Sachs, Johnson, Maddux, Hogg, Brown and Federal Reserve officials. Federal officials recognized that an all-out run was inevitable and suggested that contingency plans should be under way. The basic topic of the meetings was a consideration of how to deal with the crisis and with certain associations, especially Old Court and Merritt. These meetings are described in detail in Section IV of this report. From mid-April until the First Special Session of the General Assembly on May 17, 1985, when one crisis meeting ended, another began.

The media reports of the change of management of Old Court and announcement of a criminal investigation into its management on May 8 and 9 brought the run into the open. Special Counsel believes that both announcements were appropriate and in the public interest. A report of MSSIC's critical letter to Merritt caused the run to spread on May 10. Last minute meetings to save Old Court were held on Saturday and Sunday, May 11 and 12, but proved futile. A conservator was appointed for Old Court at 1 a.m. on May 13, 1985 at the residence of Judge Martin B. Greenfeld. Merritt followed into conservatorship on May 14, 1985.

The Governor was forced to cut short his trip to Israel, returning on May 13, 1985 and immediately entering meetings with legislative leaders, the Attorney General, attorneys Lowell Bowen and Roger Redden, staff attorneys from the Attorney General's office, representatives of the Federal Home Loan Bank Board, Federal Reserve officials and a variety of other executive department personnel. The enormity of the problem was beginning to become known. From the very inception of the crisis, Johnson was haunted by the fact that deposits in MSSIC institutions exceeded the entire State budget.

The State considered declaring a "bank holiday" closing the savings and loan associations but a telephone call from Chairman Paul Volcker of the Federal Reserve discouraged this.

By May 14 there was a consensus that the State should hold harmless all depositors in MSSIC associations. Legislation accomplishing this was to follow at the First Special Session commencing on May 17. Attorney General Sachs has pointed out the irony of this: Maryland through MSSIC did not regulate the savings and loan industry as it had promised; but it did guarantee the deposits as it had not promised. On that same day, May 14, the Governor proclaimed "THAT A STATE OF PUBLIC CRISIS EXISTS" and limited withdrawals in MSSIC institutions to $1,000 every thirty days.

Before going on to the important task of reporting in-depth as to the causes of the "crisis," a few observations about the hectic meetings of April and May are in order. Given the fact that Maryland should not have found itself in this mess in the first place, we think that the leaders of the State acquitted themselves well. They made some tough decisions under extreme pressure. The bond legislation, apparently the brainchild of Federal Reserve General Counsel Bradfield, was particularly helpful. In our interviews with General Counsel Bradfield and William Taylor of the Federal Reserve, they praised the cooperation between the Governor and the leaders of the legislature that resulted in the prompt enactment of necessary legislation to begin dealing with the crisis. Our function, however, is to report on the causes of the crises and so we do not go beyond May 14, 1985 in expressing opinions about any State action.

All of this frantic action did have a bizarre taint caused by the then unknown regulatory problems existing in the MSSIC associations. One of those problems that we shall detail in this report was the total domination of the regulatory process by the very people it was supposed to regulate. This continued right through the "crisis meetings" of April and May.

The Baltimore law firm of Venable, Baetjer and Howard (VB&H) had been general counsel to MSSIC since 1974 or 75. Since the Spring of 1981, a VB&H lawyer attended virtually every meeting of the MSSIC Board. That lawyer was usually Terry Hall. For many years VB&H has performed legal work for Cardin. We have not seen the files but have been assured by VB&H that they did not involve any savings and loan matters. The firm first represented Levitt as a separate client in 1979 and Pearlstein in August, 1980. It had represented a partnership involving Levitt as early as 1975. Old Court was first represented by the firm on a regular basis in the Fall of 1982, after Levitt and Pearlstein took control of it, although VB&H had represented it in two isolated matters in the sixties. The representation of Levitt, Pearlstein, and Old Court was substantial and persisted into 1985 apparently ending, if at all, only because of the Old Court problems. The representation of Cardin and his family continues to date. Despite almost monthly discussions of Old Court and Levitt at MSSIC Board meetings, all of the MSSIC directors whom we have interviewed deny any knowledge at all of the VB&H representation of Old Court, Levitt, Pearlstein and Cardin. Hall of VB&H participated in all but one of the MSSIC Board meetings during its last years but never disclosed his firm's representation at the meetings, at least not so far as any MSSIC director can recall. Hall says he disclosed the representation of Old Court and Levitt in a phone call to Hogg on January 11, 1983. Hall claims he told Hogg at that time that VB&H was going to represent Levitt in non-Old Court related transactions, that they would not represent Old Court or Levitt in transactions involving insider deals, and that they were going to represent Old Court in non-Levitt transactions. (For a more complete history of Hall's testimony on this subject see Section IIIB). Hogg has denied under oath that this phone call ever occurred. He says that he knew nothing of VB&H's representation of Old Court or any of its principals except for a brief face to face conversation with Hall not earlier than April of 1984 when Hall told him that VB&H partner Gerald M. Katz would be doing some personal tax work for Levitt. Hogg says that Hall seemed displeased to tell him this but offered no explanation or alternatives.

VB&H lawyers attended all or most of the crisis meetings of April and May about Old Court. They were there as MSSIC's lawyers. Some of the meetings were in their office. None of the officials of Maryland had any idea that the MSSIC lawyers at those meetings also represented the principal topics of discussion -- Old Court and Levitt. They have uniformly expressed astonishment on the subject.

That lawyers whose firm also represented Old Court, Cardin, Levitt, and Pearlstein attended these meetings is surprising. But VB&H lawyers were not the only Levitt connection at the crisis meetings. The other is truly incredible and also typifies the failure of the industry dominated regulatory system to distinguish between the regulators and those to be regulated. This attendee was Dr. Huell E. Connor, Jr., a psychiatrist, and a friend of Hogg of MSSIC. Hogg seems to have pictured Levitt as a super-successful person whose principal problem was dealing with his own success. He just could not get organized. Hogg says that he knew that Connor specialized in helping these victims of their own wealth learn how to handle it. Sometime in January of 1985 Hogg introduced Dr. Connor to Levitt. Subsequently, Dr. Connor was placed on the Old Court payroll to help Levitt deal with the tragedy of being a millionaire. He also specialized in various corporate organizational problems, so both Levitt and Old Court had the advantage of an "in house" psychiatrist. When the Governor of Maryland and other high officials were discussing what to do about Old Court, Dr. Connor was there, brought by Hogg. His contribution and his respect for the regulatory process is best described by his own handwritten note for a meeting with Old Court's stockholders on the same day. The first thing on his note pad said -- "neutralize AG." Dr. Connor has testified that he thought the Attorney General was too aggressive towards Old Court although the notation leaves little doubt of his opinion. Whatever else this might demonstrate, it is clear that it is not a text book example of the regulation of financial institutions.

The regulators of the future must be someone other than those to be regulated.

Our report will analyze the causes of the crisis in detail. Section II describes the legislative history and framework for saving and loan regulation in Maryland and its implementation. In Section III we set forth the manner in which certain associations systematically violated those regulations, and describe how the Division and MSSIC responded. Section IV describes how the various governmental departments dealt with their opportunities to ward off the impending crisis.

II. LEGISLATIVE HISTORY OF MARYLAND'S SAVINGS AND LOAN ASSOCIATIONS AND SAVINGS AND LOAN REGULATION*

A. LEGISLATIVE HISTORY

"What happened, of course, was that a few unscrupulous operators engaged in a profitable legal larceny. That this situation will never happen again is little balm for the wronged; it may give comfort to those who have been more fortunate."[1]

Introduction

Maryland's savings and loan associations trace their roots to 1837 when the General Assembly first authorized the chartering of mutual savings societies created to assist members in purchasing homes.[2] The first Maryland associations were patterned on the plan of "benefit building societies" originally recognized by the British parliament.

In 1852 these groups, then only partnerships, were permitted to incorporate in Maryland, under Chapter 148 of the Act of 1852. These groups were self-liquidating and neither engaged in building nor made loans. All of the members of an association subscribed to shares and agreed to pay for them in installments until their "par value" was reached. When this was

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* Unless otherwise provided, all references to the "Code" in this Report shall mean the Financial Institutions Article of the Annotated Code of Maryland.

1 From address by Richard W. Case delivered before the Downtown Kiwanis Club on April 5, 1962.

2 For an in-depth discussion of the history of the savings and loan industry in Maryland from 1852 to 1961, see Sause, Associations "for the meretoricus purpose of. . . Mutual Benefit' A Chronicle of the Building and Loan Industry in Maryland from 1852-1961," 22 MD. L. Rev. 1 (1962).

accomplished the corporation was dissolved. If a member wished to purchase a home, he could obtain an "advance" on the money he would ultimately receive upon the liquidation of the corporation. A mortgage was given to insure the payment of future installments, and the member usually had to pay interest on the sum advanced to him. When the pre-determined par value was reached and the corporation terminated, all mortgages, whether paid in full or not, were released.

A problem with these early "building and loan associations" was with their self-liquidating nature. Various attempts were made to provide alternatives to the terminating plan. For example, in 1872 the General Assembly permitted "non-participating" associations to overcome the difficulties of a terminating plan in order to achieve perpetual existence. The purpose of the 1872 Act was to expand the Act of 1852.[3] Nevertheless, non-participating associations were a failure. Another variation of the terminating plan was the permanent association, where each individual member of the association had a separate termination date.

The "permanent association" developed as a solution to the drawbacks of the terminating plan. This type of association attracted individuals who otherwise would not be able to join an association after it was formed, and thereby brought about a constant flow of new money to the association. Furthermore, this

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[3] The Act of 1872 repealed Section 92 of Chapter 471 of the Act of 1868 relating to corporations formed for the purpose of loaning money, and re-enacted similar provisions with modifications.

plan provided an inducement to savers, in that a shareholder was entitled to withdraw from the association prior to the time when a subscription was fulfilled and could receive dividends that had been credited to his account.

Until 1929 there was little, if any, regulation by the Maryland state legislature of building and loan associations. In 1929, probably as a reaction to the stock market crash, the General Assembly began to regulate the nature and character of investments made by building and loan associations.[4] Attempts to regulate the industry in areas other than investments, however, were not successful. In the early 1940's various bills were presented to the General Assembly from time to time, but each one was aborted before being enacted into law. On the other hand, the building and loan association lobby experienced no difficulty in effecting passage of bills which it favored, such as the expansion of permissible investments that could be made by the association.

Until the late 1950's most building and loan associations traced their origins to the small local associations designed to serve the encouragement of thrift and the promotion of home ownership. Historically, ethnic and other neighborhood groups provided impetus for the development of these associations. They were conservatively managed and efficiently run. Most of these "neighborhood associations" were located in the City of Baltimore.

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[4] Ch. 226 of Act of 1929 § 165 (1929).

Although many associations retained their traditional place within the financial arena, others changed in response to changes in the economy. Associations were stimulated by the increased prosperity and the home building boom that followed the second World War. These associations grew into imposing institutions with substantial assets and customers.

Proposals for regulation of building and loan associations were heard as early as 1890. However, the demands for supervision of these associations sprang from competitors of the associations. For example, in the 1920's the Maryland Bankers' Association led a campaign for closer scrutiny of these associations. Often the legislators who were being petitioned, unsuccessfully, to pass regulatory laws were active in the affairs of state-chartered associations.

Promoters were attracted by the combination of unregulated operations and speculative real estate investment opportunities. As a result, new associations were formed and older ones were taken over and enhanced. Frequently, these associations were controlled by out-of-state interests. Before state regulation was enacted, it was simple for an individual to obtain a new charter and start an association, or takeover an existing association and expand its business.

This, in part, brought about the 1960 savings and loan crisis. In the late 1950's and early 1960's unregulated associations in Maryland ran into trouble.[5] Large sums of money poured

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[5] Approximately 46,000 depositors with funds in 28 troubled Maryland associations lost money during this period. From press (footnote continued)

into associations by depositors in order to receive valuable "gifts" and promotion items. Apparently in order to get better "promotions" depositors shifted their money from one association to another. Furthermore, some of the state-chartered associations claimed that their deposits were insured in order to compete favorably with banks and federal associations. This claim led to the first investigation of a building and loan (by now, also called "savings and loan") association. In 1958 Senator Glenn Beall questioned the claim of a Silver Spring

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(footnote continued from previous page)
reports, the average refund to depositors was from 30% to 40% of their accounts with the association. The number of associations went from more than 700 to 345. According to Richard W. Case, the losing depositors themselves should not be overlooked as scapegoats. Case noted that the age old quest of something for nothing -- or the receipt of the "top dollar" -- surely found its presence in these cases. Some of the associations that were placed in receivership during the early 1960's are still in the process of being liquidated today.

Dishonest practices in Maryland's financial institutions have not been limited to savings and loan associations or to the modern era. One of the most famous Supreme Court decisions, McCulloch v. Maryland, 17 U.S. (44 Wheat.) 316 (1819), grew out of unsecured insider dealing by some of Maryland's leading citizens, who controlled the Baltimore branch of the Bank of the United States. Today the case is best known for the phrase "the power to tax is the power to destroy." McCulloch v. Maryland also described the framework from which "destroyers of widows and orphans" preyed upon the people of Maryland. IX Md. Law Forum No. 4, Bogen, The Scandal of Smith and Buchanan: The Skeletons in the McCulloch v. Maryland Closet (1985), quoting letter from Anna Boyd to John McHenry, August 6, 1819 (McHenry papers, manuscript, Maryland Historical Society).

Similar activities, again by the leading citizens of the day, led to the closing of the Bank of Maryland in 1834, and the resulting "Baltimore Bank Riot of 1835." See D. Grimstead, Democratic Rioting: A Case Study of the Baltimore Bank Mob of 1835, at 125 (W. O'Neill ed. 1973). In rioting fueled by depositors who could not get access to their funds, five were killed and over twenty wounded. Finally, in 1838, over four years after the bank closed, all debts were paid in full plus a dividend. Most of the poor who had savings at the bank, however, already had been forced to sell their credits to investors at far less than face value.

association whose insurance turned out to be provided by a Panama corporation whose assets were stored in the association's own vault and precipitated an investigation.

The insurance on deposits in many cases proved to be illusory. Postal inspectors looked into activities of Federated Swiss Insurance Underwriters, a company based in Tangier, Moracco, and the American Savings and Loan Indemnity Company of Panama, which were advertised as insuring building and loan deposits. As a result of investigations, bills were introduced at the 1959 session of the General Assembly to prevent an association from claiming deposit insurance unless it was obtained from FSLIC or a private company approved by the State Insurance Commissioner. These bills died in committee. As another result of the investigations, several associations were placed into receivership, uninsured depositors lost millions of dollars, the Speaker of the House of Delegates, A. Gordon Boone, went to jail and two Congressmen were convicted of obstructing a federal investigation.

Robinson Commission

The first legislative response to the savings and loan crisis was the creation of the Robinson Commission in 1959.[6] The commission was a subcommittee of the Budget and Finance Committee of the Legislative Council and consisted of Chairman Jerome Robinson, W. Randolph Harrison, W. Dale Hess, Edward S. Northrop

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6 Report to the General Assembly of 1960 -- Proposed Bills -- Special Committee Reports -- Legislative Council of Maryland.

and George B. Rasin, Jr. The principal purpose of the subcommittee was to determine the extent of the change in the operations of savings and loan associations. In December 1959 when the subcommittee issued its "interim report," it submitted one bill for consideration, which prohibited a savings and loan association from advertising that it was insured if it did not carry federal insurance or insurance with a commercial company approved by the state insurance department. They believed that this legislation was badly needed in light of advertisements by savings and loan associations using insurance carriers that were not subject to state regulation which displayed an emblem strongly resembling the FSLIC emblem. The subcommittee also recommended that it continue its study of the savings and loan industry in Maryland. The proposed legislation was never enacted by the General Assembly.

In the 1960 session of the General Assembly, Joseph D. Tydings, then a Harford County delegate, introduced a bill which provided for a state licensing and regulatory authority for savings and loan associations. The Tydings bill passed the House of Delegates and swept through the Senate. After a public hearing, however, Governor J. Millard Tawes vetoed the bill, indicating that it was too weak to be effective. The Governor also announced his intention to appoint a commission to study the regulatory problem.

With the demise of the Tydings Bill, the law relating to the savings and loan industry was almost where it started over 100 years before. Any three people with thirty dollars among them could start an association. No person or agency was vested with authority to check into the identity of the incorporators, who were to become the trustees of the public's savings. No initial capital was required to commence business. There was no provision for reserves. No state officer could examine an association's books. There was no regulation of advertising. No state agency could police the meager restraints on investments that associations might legally make.

Savings and Loan Study Commission-Case Commission

After the 1960 session, the General Assembly appointed the Savings and Loan Study Commission, known as the Case Commission, after its chairman, Richard W. Case. Samuel W. Borden, J. Calvin Carney, Leslie J. Clark, Shirley Brannock Jones, John-Clarence North, Edward S. Northrop, Charles E. Orth, Jr., Jerome Robinson, William C. Rogers, Sr., Robert L. Stocksdale, Joseph D. Tydings, Harry B. Wolf, Jr., T. Hammond Welsh and John P. Zebelean, Jr. were also on the Commission.

The Case Commission met from June to December of 1960 to discuss and draft legislation.[7] It used the Savings and Loan League "Model Act," as well as the law of other states, especially Massachusetts, for guidance in drafting. The commission held a public hearing on the proposed legislation on December 21, 1960.

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[7] The minutes of these meetings indicate that at the outset, the Commission could not agree on anything including where to meet, who would be vice-chairman and what legal assistance to use.

The Case Commission Bill was introduced in the Maryland Senate by Senators North and Northrop on February 1, 1961 as Senate Bill 254.[8] The bill was amended separately in the House in the 1961 session of the General Assembly, before it was passed with Governor Tawes' support, becoming the first comprehensive regulatory law for savings and loan associations in the State of Maryland.[9]

The "Case Act"[10] stated that it was the policy of the State of Maryland to promote and foster the business of savings and loan associations and to assure their financial stability. The savings and loan business was to be supervised as a business affecting the economic security and general welfare of the citizens of Maryland.[11]

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[8] See ExhibitII1.

[9] Although the Case Act was approved by the General Assembly, it was challenged by referendum. Under the State Constitution, laws petitioned to the ballot do not take affect until ratified. While required signatures were being filed for the referendum, a special session of the General Assembly was held, at which the bill was passed again as an "Emergency Act," as Sections 160A-160KK of Article 23 of the Annotated Code of Maryland. As an emergency measure, the bill could not be subject to a second referendum attempt. The Case Act was ultimately ratified by the voters at the general election held on November 6, 1962. The General Assembly had provided that the Emergency Act, as passed in the special session, should not be construed as repealing what was enacted during the regular session, and that legislation enacted during the special session would terminate at such time that the Case Act was ratified.

[10] Md. Ann. Code Article 23, §§ 161A to 161KK (1973 Repl. Vol.). The first regulations promulgated under these sections of the Code were effective October 10, 1963.

[11] This section suggests that there is a public interest in fostering healthy competition among associations, as long as it does not become suicidal. County Federal Savings and Loan Association v. Equitable Savings and Loan Association, 261 Md. 246, 274 A.2d 363 (1971).

The Case Act established a Board of Building, Savings and Loan Association Commissioners (Board of Commissioners) to be selected from the industry.[12] The powers and duties of the Board were to advise and make recommendations to the Department Director on any questions within the scope of the authority of the Director. In addition, the Board was to submit to the Governor proposed amendments to the savings and loan law. The Board was also to establish the methods and standards to be used in making examinations of associations, for the valuation of assets of associations, and for advertising and promotional activities by associations. Finally, the Board was to promulgate rules and regulations to carry out provisions of the law applicable to savings and loan associations.[13]

The Case Act also established the Department of Building, Savings and Loan Associations.[14] The head of the department, with the general powers of administration, was to be

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[12] The Board consisted of five members, each appointed by the Governor with the advice and consent of the Senate. Each member of the Board was to have been an officer, director, or an attorney for a building and loan association for at least five years prior to the year of appointment. The Board later became known as the Board of Savings and Loan Association Commissioners.

[13] See 47 Op. Att'y Gen. 52 (1962), which discussed the scope of authority to enact regulations under the savings and loan regulatory acts. The general rule is that statutory provisions control with respect to what rules and regulations may be promulgated as well as with respect to what fields are subject to regulations. The opinion noted that the power given under the savings and loan acts, the Case Act as well as the Emergency Act, was "comparatively broad." The general rule-making power granted in both acts extended to such rules and regulations as were reasonable and necessary to carry out the provisions of the law and to define the terms as they related to or affected associations.

[14] Later called the Division of Savings and Loan Associations.

a Director.[15] The powers of the Director included issuing orders to compel any association to comply with its charter, constitution, and bylaws, the laws of the State of Maryland, and regulations adopted by the Board of Commissioners.[16]

If the Director found that an association was violating the laws of Maryland or any order, he could direct the discontinuance of such violation and require the association to conform with all of the requirements of the law. If the association failed or refused to carry out any final order, the Board of Commissioners could petition to the appropriate court for the appointment of a conservator. A court was authorized under the statute to appoint a conservator if it found that the association was in an impaired or insolvent condition, or was in substantial violation of any applicable law or regulation, was concealing any of its assets, books or records, or was conducting an unsafe or

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[15] The Director was required to have five years experience as an attorney, officer, or director of a savings and loan association, or to have been an employee of the department for at least five years. In addition, the Director had to be a resident of Maryland for five years prior to being appointed Director.

[16] Stock associations were not permitted under the Case Act, except stock associations that were in existence on or before January 1, 1962. The charters of these grandfathered associations became valuable. For example, Alvin Lapidus has informed the Office of Special Counsel that he owned, with others, the stock of Pimlico Savings and Loan Association, the charter of which was sold for $5,000 to Melvin Berger. Pimlico later became Chevy Chase Savings and Loan Association. Lapidus sold the charter of First Republic Savings and Loan Associton to Jay Fitzgerald for $25,000. First Republic later became Community Savings and Loan Association. Similarly, Lapidus arranged for the sale of the charter of Manhattan Savings and Loan Association to a family in Silver Spring, Maryland. Manhattan later became Friendship Savings and Loan Association.

unsound operation. The conservator, upon recommendation of the Board of Commissioners, also could remove any director, officer or employee.

If the irregularities complained of in a final order were not corrected, or if the irregularities complained of in the petition for the appointment of a conservator were not corrected, or if there were "an emergency," the Board of Commissioners could apply to an appropriate court for the appointment of a receiver. The court was authorized to appoint a receiver based on the same findings as in the case of appointing a conservator.

The Case Act established new requirements for entry into the state-chartered savings and loan industry, including initial capitalization of $50,000 (in a locality where there were more than 100,000 inhabitants), a general reserve fund and an expense fund. The Board of Commissioners was granted the authority to investigate the character, responsibility, and general fitness of the incorporators to determine whether the association would be honestly and efficiently run.

The Case Act required that the association have prepared an annual financial statement which was to be filed with the Director. It also prohibited certain transactions which constituted conflicts of interest. Loans to an officer, director, or employee of an association, or to any corporation or business in which they or a member of their family owned an interest of ten percent or more were prohibited. Loans upon the security of the individual's home or free share account in the association were excepted from the prohibition. In addition, there was a general exception for loans approved by a two-thirds vote of the board of directors of the association and appraised by a disinterested appraiser appointed by the Director, if the loan was approved by the Director.

Associations were authorized to make investments permitted under Section 150 of Article 23 (Corporations) of the Annotated Code of Maryland and to invest in real estate related to the transaction of their business.[17] They were prohibited from accepting real estate or leasehold property as security for a loan if it was outside the State of Maryland or outside a fifty mile radius of the principal Maryland office of the association.

Finally, the statute also set forth specific rules with regard to reserves. If the reserves of an association were less than six percent of the aggregate withdrawal value of the association's free share accounts, ten percent of the profits or such lesser portion as would increase the reserve to the required total amount had to be allocated to the reserves. The provision for the apportionment of profits in the new law required that there first be a proper allocation made to the reserve fund before any other apportionment of profits.

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[17] Each association had the power to invest in such real estate reasonably anticipated to be necessary or convenient for the transaction of its business, real estate purchased at auction sale, public or private, judicial or otherwise, upon which the association had a lien or claim, real estate accepted by the association in satisfaction of any obligation, real estate acquired by the association in exchange for real estate owned by the association, real estate acquired by the association in connection with salvaging the value of property owned by the association, and chattels and equipment necessary to conduct its business. Section 150 of Article 23 was repealed by the Acts of 1968 ch. 65. For a similar provision see § 161Z of Article 23 (1973 Repl. Vol.).

Although the Case Act provided for regulation of savings and loan associations, it did not provide for or regulate the insurance of accounts, one of two major problems encountered in the 1960 crisis. As a consequence, the General Assembly established the Shriver Commission to study the insurance problem.

Commission to Study the Establishment of a State System of Insuring Deposits of Savings and Loan Associations - Shriver Commission

The 1961 General Assembly in Joint Resolution 22 appointed a commission to study the establishment of a state system of insuring deposits of savings and loan associations in Maryland. The Commission was chaired by John S. Shriver and consisted of David R. Cohan, James O'C. Gentry, John D. Hospelhorn, Marvin Mandel, George V. Parkhurst, F. Douglass Sears, Harry B. Wolf, Jr. and John B. Zebelean. They conferred with representatives of the Maryland savings and loan industry, officials in Massachusetts (from the Co-operative Central Bank) and Ohio (from the Ohio Deposit Guarantee Fund), which were the only states at that time that had private or state insured savings and loan associations. As a result of its deliberations the Commission set forth its conclusions in its report to Governor Tawes, proposing legislation to create MSSIC.[18]

The Commission believed that it was desirable to establish a system for insuring the accounts of state-chartered savings and loan associations. The insurance was to be provided

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[18] See Exhibit II2.

through a fund financed by the insured associations with the state not pledging its full faith and credit. Participation in the new system, while encouraged, was voluntary.[19] The Commission concluded that the supervision of the participating savings and loan associations by a state regulatory agency was essential. Finally, it noted that an exemption from federal income taxation was essential to the success of the insurance fund.[20]

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19 When MSSIC was established, uninsured associations were still permitted. Since July 1, 1973, however, all state-chartered associations have been required to have deposits insured through either MSSIC or FSLIC. The 1973 requirement in effect gave MSSIC the power to control state-chartered associations by threatening to discontinue insurance if its directions were not followed, since the loss of insurance for associations that could not qualify for federal insurance meant loss of the ability to do business under state law. See Article 23 § 150A (1973 Repl. Vol.), which was repealed by Acts 1980, ch. 33, § 1, effective July 1, 1980. See Md. Fin. Inst. Code Ann. § 9-901 (1980) for provisions similar to those of repealed § 150A.

20 Section 501(c)(14)(B) of the Internal Revenue Code of 1954 grants an exemption from the payment of taxes to organizations similar to MSSIC, but only if they were organized before the cutoff date provided in the statute. MSSIC instituted an action to recover federal income taxes, attacking the constitutionality of the September 1, 1957 cutoff date. The District Court allowed recovery. On direct appeal, the United States Supreme Court reversed, holding that the cutoff date was not arbitrary or unconstitutional. Maryland Savings-Share Ins. Corp. v. United States, 308 F. Supp. 761 (D. Md.), rev'd on other grounds. 400 US 4 (1970).

It is interesting to note that in this case MSSIC argued unsuccessfully that it was an instrumentality of the State, and hence entitled to exemption from federal taxation under the doctrine of intergovernmental immunity.

In 1963, Bill HR3297, 88th Cong. 1st Sess. (1963), which would have moved the cutoff date forward to January 1, 1963 for the benefit of MSSIC, passed in the House, but was never reported out by the Senate Finance Committee. See Hearing on H.R. 3297, before the Senate Committee on Finance, 88th Cong. 2d Sess., 9-10 (1964), where testimony before the committee indicated that continued forward movement of the date might lead to proliferation of state insurers that could hinder the operations of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation.

The 1962 session of the General Assembly passed the Shriver Commission's bill with no significant amendments and MSSIC was created.

Its primary purposes were to insure the accounts of member associations, to promote elasticity and flexibility of the resources of member associations, and to foster the liquidity of member associations by providing a central reserve fund.[21] In furtherance of these purposes, MSSIC was given the power to create a reserve fund and an insurance fund, invest its funds, incur indebtedness, lend money, deal with real and personal property subject to certain limitations, and exercise all corporate powers granted to Maryland corporations. Under no circumstances, however, could MSSIC pledge the faith or credit of the State of Maryland. In addition, the provisions of the Insurance Code were not to be applicable to MSSIC, its member associations, or persons owning accounts in member associations.

MSSIC went into operation on November 1, 1962. Each depositor's account in a member association in 1962 was insured to $20,000. A total of 149 associations were accepted by the MSSIC Board of Directors out of 230 associations that applied for membership.[22] Associations were initially required to deposit with MSSIC one percent of their outstanding free-share accounts.

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[21] Maryland Savings-Share Insurance Corp. v. United States., 400 US 4.

[22] Eighty-one associations were rejected because of serious shortcomings in their financial structure.

Richard W. Case critiqued the Shriver Commission bill in a memorandum to Governor Tawes. In his memorandum, Mr. Case noted that it was possible to convert the Shriver plan into one that would provide state insurance which, according to Mr. Case, would not jeopardize the credit position of the state nor would it involve financial loss to the state except in "remote circumstances." Case recommended a plan which would be an insurance plan similar to FSLIC which he believed would restore public confidence in the savings and loan industry more than the Shriver plan. Case believed that, because the state would control the corporation, which was not the case under the Shriver plan, the state would be able to "screen" associations. In addition, if the corporation were a "state authority," the problem of whether it would be subject to federal income taxation would be eliminated. Case recognized that the disadvantage of his plan would be the exposure of the state to losses in the event of a major economic crisis. In addition he believed there might be some objection by representatives of the savings and loan industry that the plan would involve additional costs and regulation for the smaller associations.

1980 Revision To Title IX (House Bill 1008)

The Case Commission in 1961 recommended that the operational provisions in the savings and loan law, regarding the internal operations of associations, be left untouched because the smallest change could create nightmares of litigation. There was insufficient time to complete a comprehensive review of the operational provisions because the problems were complex. In 1967, the Department of Savings and Loan Associations requested a committee, chaired by William C. Rogers, Jr., to rewrite the savings and loan law. A draft was prepared by the committee, but at the request of Governor Spiro T. Agnew, a bill was not introduced in the General Assembly.

In 1979 the General Assembly and the industry believed that there was a need for reorganization of the savings and loan law to remove obsolete, archaic, and contradictory provisions. The Committee on Economic Matters of the House of Delegates appointed a Savings and Loan Association Law Commission, rather than a legislative committee, to study the law and to prepare a substantive revision to be introduced in the 1980 session of the General Assembly. The staff of the Commission to Revise the Annotated Code also recommended to Governor Harry R. Hughes that a commission, rather than the legislature, rewrite the law relating to savings and loan associations. The substantive revision contemplated required a thorough knowledge of savings and loan law and an understanding of the savings and loan industry. The Commission consisted of Chairman Charles H. Kresslein, Jr., Lowell R. Bowen, Charles H. Brown, Jr., Jerome S. Cardin, R. Terry Connelly, Thomas Costantini, Nathaniel Exum, W. Thomas Gisriel, Franklin Goldstein, James D. Laudeman, Dennis C. McCoy, Donald F. Munson, William C. Rogers, Jr., Ellen R. Sauerbrey, Robert L. Stocksdale, David H. Wells, Jr. and Harry B. Wolf, Jr. Kresslein was President of the Maryland Savings and Loan League, a trade association; Brown was Division Director; Cardin was the majority stockholder of Old Court and former Chairman of the Board of MSSIC; Costantini was a former Division Director and a savings and loan executive; Gisriel was Chairman of the Board of Commissioners; Goldstein was an attorney and lobbyist; Laudeman was an attorney for a savings and loan association; Rogers was an attorney for a savings and loan association; Stocksdale was an attorney for a savings and loan association; Wells was deputy director of the Division and Wolf was Chief Operating Officer of MSSIC. McCoy and Sauerbrey were members of the General Assembly, presumably placed on the Commission to represent the interests of the general public. They did not attend any of the Commission's meetings.

The Commission began work on May 21, 1979. The new law was based on former Maryland savings and loan law, the Model Act produced by the U.S. League of Savings and Loan Associations, federal law, as well as the law of other states. The final report was presented to the House Economic Matters Committee on December 15, 1979. The Chairman of the Economics Matters Committee introduced House Bill 1008 on February 1, 1980. The recodification as Title IX of the Financial Institutions Article was effective July 1, 1980.

Committee comments indicated that the law was intended to be remedial - aimed at correcting problems in the present system - rather than prospective - heading off anticipated problems. The introductory comments to Title IX also show that specifics were intentionally left to the regulatory authorities because they were "better suited" to handle the rapidly changing industry. Some of the legislation was drawn from federal law in order to permit state-chartered savings and loan associations to compete favorably with federally-chartered associations. There was concern over the situation of the home mortgage market and the restrictions in the law at that time. The Commission believed that the original law needed to be modernized to keep the state-chartered savings and loan industry viable; that numerous changes taking place within the federal system necessitated changes in state-chartered associations in order to maintain competitive equality. Therefore, the basic thrust of the bill was to permit more flexibility. It was frequently noted, however, that the changes made by the commission were within the overriding context that savings and loan associations remain a "heavily regulated industry."

The "statement of purpose" was simplified and broadened. Under the old law the purpose of savings and loan associations was stated as accepting free share accounts and making loans to members. The rewrite provided conformity to the current business of financial institutions, which was receiving funds and making loans. The Commission did not recommend a change to the formation of savings and loan associations in general.

Capitalization provisions were revised by combining diverse references throughout the predecessor law to make a list of all the capital needed to organize a savings and loan association including initial subscriptions for savings and loan associations, initial general reserve fund and expense fund. The

Commission, upon recommendation of the Board of Commissioners, advised increasing the amount required for initial subscriptions for savings and loan associations from $100,000 to $500,000.

Also on the advice of the Board of Commissioners, the Commission increased the minimum amount for the initial subscription for capital stock from $100,000 to $200,000. They removed a provision permitting the Board of Commissioners to require a stock association to pay an additional amount of money as paid-in surplus, believing that it was unnecessary. Therefore, the amount allocated to paid-in surplus became purely a matter of internal accounting and business judgment.

The Commission revised the annual statement provision, which had specified that the annual statement be on a form required by the Division Director. The Division Director advised the Commission that this statement was not significant in the Director's view because quarterly audited statements were received by regulation.[23] In the current regulations governing savings and loan associations there is no such regulation.

The Commission refined the conflict of interest provision to clarify what is meant by a "member of the family" and deleted employees from the conflict rule. It also added the phrase "directly or indirectly" for the purpose of <u>tightening</u> the

[23] The Commission also recommended that annual statements be available at all offices, not only the principal office of the savings and loan association.

provision by applying the conflict of interest prohibition to loans made through other entities for the benefit of officers and directors.[24]

The "controlling persons" conflict of interest provision was also revised to provide that the restrictions did not apply to compensation for services rendered, thus creating an opportunity for controlling persons to receive various fees from their associations. To approve a loan to a controlling person, the Commission also changed the vote required from a two-thirds vote of disinterested directors to a simple majority.[25]

The Commission's desire to provide more flexibility was evident in its revision of reserve requirements and requirements for the allocation of profits. On advice of the Division Director and Board of Commissioners, specifics with regard to reserves and allocation of profits were deleted from the statute, leaving both to the Board of Commissioners to regulate.

On the advice of the Board of Commissioners and the Division Director, investment provisions were collected into one section of the law and revised. The Commission's intent in revising the investment provision was to give savings and loan associations more flexibility within their corporate powers and, within the context of being a "heavily regulated industry," to use their best business judgment to invest in such endeavors that

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[24] Compare the Committee Comment to § 9-307 which indicates that this phrase was added for clarity.

[25] This should be compared to the required two-thirds vote of the board of directors in the case of a loan to an officer or director.

would return funds to the association for lending. They created a "laundry list" of authorized investments subject to regulation of the Board of Commissioners. The Commission believed that, because of the inflationary economy, the market rather than statutes should dictate investments. They noted that flexibility was additionally disciplined by the fact that in order to qualify for treatment as a savings and loan association under the Internal Revenue Code, associations had to maintain eighty percent of their funds in residential mortgages.[26]

All previous restrictions concerning the geographic area in which savings and loan associations could invest were deleted. A prohibition against holding a second mortgage unless the association also held the first mortgage was deleted and participation interests in mortgages were deregulated. Secured or unsecured consumer loans were authorized up to a limit of ten percent of savings liability of the association. For example,

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[26] This may not be a correct statement of the Internal Revenue Code. Under Internal Revenue Code § 7701(a)(19), a savings and loan association must, in order to qualify as such, have at least 60% of its total assets consist of "qualifying assets." "Qualifying assets" include certain certificates of deposit, loans for residential real property, loans relating to real property in an urban development area, loans for health, education and welfare institutions, and student loans. Pursuant to § 593(b) of the Internal Revenue Code, a mutual institution generally is permitted to compute its bad debt reserves by use of the "reduced percentage of taxable income method." The amount determined under this method is 40% of the association's taxable income less the amount added to the reserve for losses for nonqualifying loans. The percentage of income method is subject to a percentage of "qualifying assets" test. To take the full percentage deduction (of 40%), an association is required to have at least 82% of its funds in "qualifying assets." If less than 60% of an association's assets are in "qualifying assets," the percentage of taxable income method may not be used.

Subsection 419(a)(20) of the Code[27] provides that the association can invest in any other investment authorized by the Board of Commissioners. Subsection 419(a)(20) does not set forth any guidelines for the Board of Commissioners leaving the nature of the investment and its size in relation to the association's assets completely to the Board's discretion.[28]

The Commission also recommended adding a new provision to the Code concerning alternative mortgage instruments. It noted that it was the opinion of the attorney general that mortgage instruments must set forth a stated rate of interest, which mechanically prohibited certain of the more attractive alternative mortgage instruments. It was the opinion of the Commission that the standard mortgage instrument was not suitable in an inflationary economy and that other types of mortgages would permit more home buyers to purchase homes, since they can be designed to current circumstances while anticipating future circumstances.

Committee comments indicated that in order for the associations to carry on their basic purpose of home financing, the investment provisions were drafted in order to insure

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[27] Prior to July 1, 1982, this subsection was Subsection 419(a)(19).

[28] The former section prohibited the Board of Commissioners from permitting investments by an association in mortgages outside the state, except under certain conditions. This restriction was removed upon recommendation by the Commission.

A concern with permitting investments outside of the state, is the burden on the Division Director to physically inspect such property in conjunction with the examination of any particular loan made out of state.

flexibility. Changes were made with the contemplation that the new flexibility would be supervised and regulated by the Division Director and the Board of Commissioners.

To summarize, the Commission, which was dominated by the savings and loan industry, revised the Code to accomplish significant deregulation. Prior investment restrictions were abandoned and the Board of Commissioners, also dominated by the industry, was given blanket authority to expand authorized investments even farther. Conflict of interest prohibitions were diluted. Reserve and profit allocation provisions were liberalized. The rapidly changing economy had created pressures on the industry which threatened their future and the Commission responded with a Code revision which greatly increased the options available to savings and loan management. The General Assembly enacted their recommendations into law.

B. CHANGES IN FEDERAL LAW AFFECTING SAVINGS AND LOAN ASSOCIATIONS; REACTION BY MARYLAND

The nation's savings and loan system has a dual avenue of chartering and supervision. Federal savings and loan associations are chartered under the Home Owners' Loan Act [29] and are subject to the supervision of the Federal Home Loan Bank Board (FHLBB). State-chartered savings and loan associations are chartered under state statutes and are examined and supervised by their respective savings and loan departments. In addition, there are a number of state-chartered savings and loan associations which have obtained "insured institution" status under FSLIC.[30] As part of the insurance contract, insured state-chartered associations agree to conduct their operations in accordance with the rules and regulations of FSLIC. Thus, although state-chartered associations derived their existence in corporate power from state law and are supervised by state authority, insurance of accounts covered by FSLIC subjects them to additional supervision and regulation by FSLIC.

Three major pieces of federal legislation since 1933 which affected the operation of savings and loan associations were the Interest Rate Adjustment Act, the Depository Institutions Deregulation and Monetary Control Act, and the Garn-St. Germain Depository Institutions Act.

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[29] 12 U.S.C. § 1461 (1933).

[30] FSLIC was created under the National Housing Act. 12 U.S.C. § 1724 (1934).

The Interest Rate Adjustment Act [31] gave the FHLBB the power to set interest rate ceilings for savings and loan associations and the authority to confer with the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) in order to coordinate the ceilings for banks and savings and loan associations, so that the savings and loan associations would be given higher ceilings, or what was known as the interest rate differential.[32] This coordination was accomplished by the creation of the Inter-Agency Coordinating Committee.

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was signed into law on March 31, 1980.[33] The key feature of the DIDMCA was a six-year phaseout of deposit rate ceilings (Regulation Q) and the thrift interest rate differential. DIDMCA also provided the authority for federal savings and loan associations to offer NOW[34] accounts. In addition, DIDMCA included authority for federal savings and loan associations to engage in credit card activities; to invest up to twenty percent of their assets in consumer loans, commercial paper, corporate debt securities; to offer trust services; to issue mutual capital certificates; and to make first or second mortgages without regard to size or geographic restrictions. In

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31 P.L. 89-597 (1966).

32 Limits were first proposed for banks in 1933 in response to the number of bank failures but were not extended to savings and loan associations and savings banks, collectively known as "thrifts," until 1966.

33 P.L. 96-221 (1980).

34 Negotiable order of withdrawal.

addition, DIDMCA provided that the limitation on the maximum investment in a "service corporation" by a savings and loan association was increased from one percent to three percent. For the first time, DIDMCA granted thrifts equal access to Federal Reserve System services and the Federal Reserve discount "window" for borrowing purposes in emergency situations, even if they were state-chartered and privately insured.

Congress had several reasons for enacting DIDMCA. First, the high rates of inflation and related market interest rates during the period meant that savers were being heavily penalized. Therefore, saving at depository institutions was being discouraged with less money to finance capital expenditures. If interest rate ceilings were maintained, it was feared that there would have been a failure of numerous savings and loan associations, because they would not have been able to compete with other financial institutions. Therefore, in effect, high interest rates led to the deregulation. In addition, deregulatory efforts in other sectors of the economy were deemed as having favorable results, and therefore legislators were less fearful about the consequence of deregulating the savings and loan industry. Finally, money market mutual funds were being established and had effectively eliminated the significance of interest rate ceilings.

In order to accomplish the phaseout of ceilings by December 31, 1986, the DIDMCA created the Depository Institutions Deregulation Committee (DIDC). The DIDC consists of the Chairman of the Federal Reserve Board, FDIC, FHLBB, the National Credit

Union Administration Board, as well as the Secretary of Treasury as voting members, and the Comptroller of Currency as a nonvoting member. It was also the responsibility of the DIDC to approve new saving instruments to stop the outflow of deposits from the savings and loan industry and to attract new deposits which could be used profitably.

Although DIDMCA gave some greater lending flexibility to savings and loan associations, it did not go to the root of the industry's problem, namely, the requirement to keep the majority of savings and loan associations' assets in long-term mortgages. Consequently, the record-setting interest rates during 1981 drove up the savings and loan association's costs of funds to the point where they passed the point of return on their assets. The situation resulted in a dramatic increase in the number of savings and loan associations that were becoming insolvent.

Congress reacted by enacting the Garn-St. Germain Depository Institutions Act (Garn-St. Germain).[35] Garn-St. Germain expanded even further the deregulation of the savings and loan industry on both the asset and liability sides. Garn-St. Germain expanded the investment authority of federally-chartered thrift institutions beyond the traditional residential and related real estate financing to enable the thrift industry to compete with all regulated and non-regulated financial institutions.

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[35] P.L. 97-320 (1982).

While Garn-St. Germain addressed a wide variety of banking issues, its most significant provisions were those contained in Title III that deal with the thrift industry. One of the primary purposes of Title III was to give federal thrifts greater freedom to choose their form of organization and to generate capital. Prior law heavily biased thrifts toward the mutual form of ownership, making it very difficult for those institutions to tap the capital markets. Garn-St. Germain allowed the creation of new federal associations, whether on a de novo or a conversion basis, whether in the mutual or stock form, anywhere in the United States, and allowed any federal association to convert from the mutual to the stock form, or the reverse, also without geographic restriction.

One of the more salient features of Garn-St. Germain was its clear authorization for the formation of service corporations. A service corporation is owned by a financial institution to perform specific services for that institution. A service corporation may perform accounting or statistical functions, but only for the depository institution. It is also free to engage in investment advising, leasing, and data processing services.

From the investment standpoint, one of the most significant features of Garn-St. Germain was its bestowing to federal associations the authority to make secured or unsecured loans for commercial, corporate, business, or agricultural purposes. As of January 1, 1984, federal associations could invest up to ten percent of their assets in such loans.

Garn-St. Germain also authorized federal associations to offer demand accounts to persons or corporations with which the association has a corporate, commercial, business, or agricultural loan relationship. In addition, federal associations were authorized to invest up to forty percent of their assets in loans secured by liens on nonresidential real estate. Commercial real estate lending authority previously was limited to twenty percent of assets, and was subject to a first-lien requirement. Furthermore, commercial-type lending authority under Garn-St. Germain allowed inventory and "floor-plan" financing to be made in connection with an association's consumer loan basket, which, including these new activities, was increased to thirty percent of total association assets. Before Garn-St. Germain, consumer lending power was limited to twenty percent of assets, and could only be used to provide direct consumer credit between individuals.

Historically, the federal system of savings and loan associations was developed to create a national system that would incorporate the best practices used locally by state thrift institutions in the provision of mortgage finance. State legislative experimentation relating to the structure and operation of financial institutions had produced viable approaches worthy of adoption by the federal system. For example, the variable rate mortgage loan was conceived in California prior to adoption by the federal government. The NOW account was tested in the Commonwealth of Massachusetts prior to December 31, 1980, when DIDMCA authorized NOW accounts for all depository institutions.

While there has been some attempt in Congress to override the states in a host of areas, these attempts for the most part have failed because advocates of the dual system argued that state-chartered institutions act as theaters for innovation and experimentation. Despite the dual system in which the states serve as a laboratory for maintaining a dynamic financial system, financial markets that were once insulated by geography have long since become tightly inter-connected not only in the United States, but also throughout the world. Thus, as will be seen later, unsuccessful regulation in one section can have a significant impact in others.

In deference to the dual federal-state thrift system in which state legislatures established the operational parameters for their own state-chartered thrifts, direct investment activity by state-chartered savings and loan associations was left untouched by Congress. This was applicable to state-chartered savings institutions that elected to be insured under FSLIC as well as state-chartered institutions that are insured under state or private insurance systems, such as MSSIC.

The state-chartered savings and loan association had to keep pace with the amended federal statutes through legislative innovation on both the asset (loan) and liability (deposit) sides.[36] The deregulation of investment limitations resulting from federal legislation was accompanied by additional pressures

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36 For example, in California the state legislature enacted legislation in 1982 which permitted its own state-chartered institutions to place up to 100% of assets in subsidiary service corporation activities and therefore to make unlimited direct equity investments in any type of enterprise.

on federal and state-chartered associations, including those in Maryland, to pay higher rates to compete for deposits. Moreover, the market for insured deposits had become nationwide due to the proliferation of "deposit brokers" - third parties that have enabled institutions to instantaneously have access to and deploy huge amounts of funds. In effect, the brokered funds were providing a continuous life support to savings and loan associations.[37]

In part as a result of federal deregulation, savings and loan associations in Maryland created substantial pressure on the General Assembly to effect further state deregulation, arguing for a "level playing field." For the most part, they were successful. Changes in Maryland savings and loan laws since the 1980 recodification are discussed in Section IIE.

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[37] The problem with deposit brokers was and is not unique to state or privately insured associations. For example, in 1983 California granted all its state-chartered savings and loan associations the authority to engage in virtually any activity imaginable regardless of the risk to FSLIC. Deposit brokers began to pump billions of dollars into state-chartered institutions such as Beverly Hills Savings and Loan Association, whose deposits were insured by FSLIC. Beverly Hills, infused with broker deposits, invested in risky investments. By mid-1983 it was placing virtually all of its assets into real estate investments. In the summer of 1985, Beverly Hills failed and was taken over by FSLIC.

C. SAVINGS AND LOAN ASSOCIATIONS - SUMMARY OF PURPOSE, STATUTES AND REGULATIONS*

The following is a summary of the savings and loan laws and regulations as they existed in Maryland at the time of the 1985 crisis. The purpose of this summary is to set forth the powers that were available to regulatory authorities to deal with the practices of certain associations which created the crisis.

Board of Savings and Loan Association Commissioners and Division of Savings and Loan Associations

Title VIII of the Financial Institutions Article sets forth the structure of the Board of Savings and Loan Commissioners and the Division of Savings and Loan Associations. The policy of the state, as set forth in this Title, is to have savings and loan associations supervised as a business affecting the economic security and general welfare of the people in the State of Maryland, and to promote and insure the business and financial stability of savings and loan associations.[38] In order

* This section of the report will also provide, primarily by way of footnote, a comparison of the regulation of savings and loan associations with the regulation of Maryland banks and other states' savings and loan associations where there is a private or state insured system. Except as otherwise noted, citations to Maryland law are as they existed prior to the First Special Session of the 1985 General Assembly.

[38] Md. Fin. Inst. Code Ann. § 8-102 (1980).

to further the legislative policies of Title VIII, the provisions are to be liberally construed to promote the purpose of savings and loan associations.[39]

A Division of Savings and Loan Associations is established in the Department of Licensing and Regulation.[40] The head of the Division is the Division Director, who is appointed by the Secretary with the approval of the Governor. The Secretary appoints the Division Director from a list of three nominees submitted by the Board of Commissioners.[41] The Director is required to have been, for at least five years, an officer or director of, or attorney for, a savings and loan association, or be an employee of any state or federal regulatory or supervisory agency for financial institutions.

The Division Director serves at the pleasure of the Secretary of Licensing and Regulation and is provided a salary as set forth in the state budget. He is responsible for the general supervision of savings and loan associations in Maryland.[42]

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39 Id. § 8-103.

40 Id. § 8-301. See Id. § 2-101, which establishes the Maryland State Bank Commissioner in the Department of Licensing and Regulation.

41 Id. § 8-302. See Id. § 2-102, where the Bank Commissioner is appointed by the Secretary of Licensing and Regulation with the approval of the Governor who, unlike in the case of the Division Director, must receive the advice and consent of the Senate in the appointment of the Commissioner.

42 Id. § 8-303. Cf. N.C. Gen. Stat. § 54B-55 (1982 Repl. Vol.), where in North Carolina the Administrator of the Savings and Loan Division is given specific guidance as to his power and the discharge of his duties with regard to the promulgation of regulations. The Administrator, for example, as a by-product of his statutorily derived powers, has promulgated a regulation (footnote continued)

Although the Division Director, deputy director and examiners may not be officers, directors, employees, or agents of, or attorneys for any savings and loan association, they may have savings accounts.[43] There is no provision requiring the Division Director to report the operations of his office to the Governor. By statute, the Bank Commissioner reports to the Governor on June 30 of each year on the operations of his office and to recommend amendments to the banking law.[44]

Title VIII also establishes the Board of Savings and Loan Commissioners as part of the Department of Licensing and Regulation.[45] The Board of Commissioners consists of nine

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requiring a stock association to obtain the approval of the Administrator prior to the declaration or payment of any form of dividend. N.C. Administrative Code § .0005 (1984). In Pennsylvania, the supervision and regulation of savings and loan associations falls within the Department of Banking. 7 Pa. Cons. Stat. Ann. § 6020-2(7) (Purdon 1985 Supp.). In Massachusetts the Bank Commisioner regulates co-operative banks, virtually the equivalent to Maryland's savings and loan associations, and has the same power and duties which he has with respect to banks. Mass. Gen. Laws Ann. ch. 170, § 41 (West 1984). The Superintendent of Savings and Loan Associations in Ohio has the power to see that the laws relating to savings and loan associations are executed and enforced. Ohio Rev. Code Ann. § 1155.01 (Page 1984 Supp.). See also Md. Fin. Inst. Code Ann. § 2-105 (1980), where the Bank Commissioner exercises powers and performs the duties of his office subject to the authority of the Secretary of Licensing and Regulation.

[43] Md. Fin. Inst. Code Ann. § 8-306 (1980). See Md. Fin. Inst. Code Ann. § 2-111 (1980), where the Bank Commissioner and the employees of the Bank Commissioner's office may not own stock in any institution that is subject to examination or supervision by the Bank Commissioner. There is no similar statutory provision that applies to the Division Director or his staff.

[44] See also Ohio Rev. Code Ann. § 1155.14 (Page 1968), where the Superintendent is required to report annually to the Governor.

[45] Md. Fin. Inst. Code Ann. § 8-201 (1980). See Id. § 2-201,
(footnote continued)

members appointed by the Governor with the advice of the Secretary and with the advice and consent of the Senate. Three of the members are to be industry members who have been officers or directors of, or attorneys for, MSSIC insured associations for at least five years prior to appointment. Two of the remaining nine are to be industry members who were officers or directors of, or attorneys for, Maryland savings and loan associations insured by FSLIC for five years prior to appointment. The remaining four members are to be public members who have not served as an officer or director of, or attorney for, a savings and loan association during the year preceding appointment, nor while the member is serving on the board. Thus, by statute, the Board is controlled by the industry, a feature which does not exist in North Carolina, Pennsylvania, Ohio or with the Maryland Banking Board.

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which establishes a Banking Board in the Department of Licensing and Regulation. See also 7 Pa. Cons. Stat. Ann. § 6020-223 (Purdon 1985 Supp.), where there was created a Savings Association Board which consisted of nine members, one of whom was the Secretary of Banking and the remaining eight members were appointed by the Governor. This Board was terminated in April 1984. In Ohio the Building and Loan Advisory Board was repealed effective July 26, 1963. Ohio Rev. Code Ann. § 1155.01 (Page 1968).

In North Carolina there is a Savings and Loan Commission that consists of seven members appointed by the Governor. At least two members must be persons who are managing officers of state-chartered associations. Four members are to represent the public and cannot be employees or directors of any financial institution. The Commission is to review, approve, disapprove, or modify any action taken by the Adminstrator of the Savings and Loan Division. N.C. Gen. Stat. § 54B-53 (1982 Repl. Vol.).

The Board of Commissioners has the authority to adopt rules and regulations to carry out the provisions of the Financial Institutions Article to the extent it relates to savings and loan associations. Therefore, it has regulatory power and is not purely advisory.[46] The Board may advise and make recommendations to the Division Director and may recommend changes in the laws governing savings and loan associations. In addition, the Board has authority to determine procedures and standards for examinations, the valuation of assets, and advertising and promotional activities. A member of the Board may not participate in any hearing before the Board or rule on any order that affects any savings and loan association in which the member has an interest or any connection as a stockholder, member of the association, director, mortgagor, borrower, attorney or otherwise.

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[46] The function of the Banking Board is advisory. The Banking Board consists of eight members. One is the state comptroller and the remaining seven are appointed by the Governor. Of the seven appointed members, one is to represent the Baltimore Clearing House, one is to represent the Maryland State Bankers' Association, one is to be an economist, one is to be a certified public accountant, and two are to be public members. The economist and the certified public accountant may not be employed by a bank. The Board's duties include giving the Bank Commissioner advice on (1) approval or disapproval of applications, (2) how to protect the interest of the general public and depositors and stockholders of banking institutions, and (3) any other matters relating to the business of banking. Members of the Banking Board are not entitled to receive compensation but are entitled to reimbursement for expenses. Md. Fin. Inst. Code Ann. §§ 2-202 and 2-203 (1985 Supp.). In addition to the Banking Board, there was a Bank Regulations Board in the Department of Licensing and Regulations. The Bank Regulations Board was repealed by Acts 1981, ch. 753, § 1, effective July 1, 1981.

Orders

The Division Director may order a savings and loan association to comply with its charter or bylaws, and any applicable law or any rule or regulation of the Board of Commissioners. An order, however, is not effective until the savings and loan association has been given an opportunity for a hearing before the Division Director. After the association has been given a hearing, the Division Director may issue the order and it becomes a final order if the savings and loan association does not file an appeal with the Board of Commissioners. If an appeal is filed, a hearing is held before the Board of Commissioners. After the hearing, the Board can either sustain, reject, or modify the order, or issue a final order. The association then has the right to appeal the order to the circuit court for the county where the association has its principal business office in Maryland.

Prior to July 1, 1985 there was no specific provision in Title VIII permitting the Division Director to issue "cease and desist" orders, although the Division Director could issue an order to compel a savings and loan association to comply with rules or regulations.[47] Effective July 1, 1985, pursuant to

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[47] _Cf_. N.C. Gen. Stat. § 54B59 (1982 Repl. Vol.), where the Administrator may issue a cease and desist order if a person or association is engaging in any unsafe or unsound practice or violation of any law, rule, or regulation. A hearing must be held before the order is issued _unless_ it can be shown that immediate corrective action is needed, and then the Administrator may issue an immediate temporary order. _See generally_ Ohio Rev. Code Ann. § 1155.02 (Page 1984 Supp.), where the Superintendent may issue a cease or desist order if an association or person is engaging in an unsafe or unsound practice, or has violated any (footnote continued)

legislation enacted during the 1985 regular session of the General Assembly, the Division Director was granted authority to order any savings and loan association to cease and desist from an unsafe or unsound practice, a practice that is injurious to the public interest, or a violation of a law or of a rule, or regulation of the Board of Commissioners.[48]

Also effective July 1, 1985, authority was given to the Division Director to send a written warning to any director or officer that the Director finds has engaged in an unsafe or unsound business practice. If the Division Director finds that the director or officer has continued to engage in the unsafe or unsound practice, the Division Director, with the advice of the Board of Commissioners, is to report this action to the Secretary of Licensing and Regulation and the Attorney General.[49] After giving the officer or director the opportunity to be heard by the Board of Commissioners, if the Board finds that the unsafe or unsound practice continues after the warning, it may remove the

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provision of the savings and loan law. The Superintendent may issue a summary cease and desist order without a prior hearing. If an order has been violated the Superintendent may request the attorney general to take appropriate action. In Pennsylvania, the Banking Department can order an association to discontinue any violation of law or unsafe or unsound practice. 7 Pa. Cons. Stat. Ann. § 6020-224 (Purdon 1985 Supp.).

[48] Md. Fin. Inst. Code Ann. § 8-402.1 (1985 Supp.). Similar legislation was introduced in the 1984 session of the General Assembly but was not enacted and was referred by the House Economic Matters Committee and the Senate Economic Affairs Committee for an interim study to the Joint Subcommittee on the Savings and Loan Industry. The report of the Joint Subcommittee was submitted to the General Assembly on August 15, 1984. See Section IIE.

[49] Md. Fin. Inst. Code Ann. § 8-402.2 (1985 Supp.).

officer or director, with the approval of the Secretary of Licensing and Regulation.[50] There is no provision to remove the officer or director immediately and give the officer or director an opportunity to be heard before the Board of Commissioners at a later date.[51] The new cease and desist and removal powers granted to the Division Director are similar to those granted to the Bank Commissioner.[52]

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[50] Similar legislation was introduced in the 1984 session of the General Assembly in Senate Bill 576. An unfavorable report was issued and the matter was referred for an interim study to the Joint Subcommittee on the Savings and Loan Industry. See footnote 48, supra.

[51] Cf. N.C. Gen. Stat. § 54B-69 (1982 Repl. Vol.), where the Adminstrator can remove any director, officer, or employee who has violated the savings and loan law or any other rule, law, order or regulation, or participated in any unsafe or unsound business practice or insider loan not authorized. If the Administrator believes that the situation requires immediate corrective action, the order to remove may be issued prior to a hearing. See generally Ohio Rev. Code Ann. § 1151.18 (Page 1984 Supp.), where the Superintendant can remove a director or officer for violating certain savings and loan laws or any unsafe or unsound business practice but only after a hearing. Pending a hearing, however, the director or officer cannot act for the association. In Pennsylvania, the Banking Department can remove, after a hearing, a director, officer, employee, or attorney if there is a continuing violation of the law or unsafe or unsound practice. 7 Pa. Cons. Stat. Ann. § 6020-224 (Purdon 1985 Supp.).

[52] See Md. Fin. Inst. Code Ann. § 5-808 (1985 Supp.), where the Bank Commissioner, since 1981, has had cease and desist powers. See also Md. Fin. Inst. Code Ann. § 5-801 (1980), where the Bank Commissioner also has had authority, since 1957, to remove a director or officer who is engaging in an unsafe or unsound banking practice.

Formation and Operation of Savings and Loan Associations

Title IX of the Financial Institutions Article sets forth the operational laws for savings and loan associations. The title begins with a definition section which is followed by general rules on incorporation.

Five or more individuals may act as incorporators to form a state-chartered savings and loan association in Maryland.[53] A written application must be submitted to the Board of Commissioners along with executed copies of the articles of incorporation and a copy of the proposed bylaws as well as any other exhibits that the Board requires. The filing fee for organizing an association in Maryland is $750. After receipt of the aforementioned items, the Board of Commissioners publishes a notice of the filing of the application and holds a public hearing.

The Board of Commissioners then investigates the character, responsibility, and general fitness of the incorporators, directors, and managing officers of the proposed association. The Board of Commissioners was not required to investigate the directors or managing officers until July 1, 1984.[54] Fur-

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53 Id. § 9-202 (1980). See Id. § 3-201, where the same is true for forming a bank or trust company in Maryland.

54 Id. § 9-207 (1985 Supp.). See Senate Bill 103, which was introduced on January 11, 1984 by Senator Connell on behalf of the Department of Licensing and Regulation. The bill added directors and managing officers to § 9-207. Cf. Id. § 3-203 (1980), where the Bank Commissioner who, when determining the approval of the bank, investigates the character, responsibility, and general fitness of the incorporators and directors to determine if they command the confidence and warrant belief that the bank would be conducted honestly and efficiently.

(footnote continued)

thermore, the Board of Commissioners, unlike the Bank Commissioner, is not required to investigate whether the proposed association will promote public convenience and is expedient and desirable.

The business affairs of a savings and loan association are to be managed by directors who must be United States citizens and either a member of the association or holder of a savings account of the association. Unless the charter or bylaws provide otherwise, each member of the mutual association has one vote and each member of the capital stock association has one vote for each share of capital stock that the individual owns. Directors are elected by the members.[55]

(footnote continued from previous page)

See generally N.C. Gen. Stat. § 54B-12(a)(6) (1982 Repl. Vol.), where the Adminstrator investigates the initial board of directors of the association, and in the case of a stock association, the initial stockholders.

Pennsylvania law requires the Department of Banking to investigate the director and the proposed officers of the proposed association. The Department is also to ascertain whether the proposed association will have sufficient personnel with adequate knowledge and experience to administer the business of the association. 7 Pa. Cons. Stat. Ann. § 6020-26 (Purdon 1985 Supp.).

[55] Md. Fin. Inst. Code Ann. § 9-305 (1980). See Md. Fin. Inst. Code Ann. § 3-401 (1980), where the business and affairs of a bank are managed under the direction of the board of directors. Each director of a bank is required to take an oath to perform diligently and honestly the duties of his office and not to violate knowingly or permit knowingly a violation of any law that relates to the bank. No oath is required of a director of a savings and loan association.

A majority of the directors of a bank is a quorum. Each director is required to attend at least one-half of the scheduled board meetings that are held during his term. If the director fails to attend the required number of board meetings he is disqualified from being a director for the succeeding term unless the Bank Commissioner waives a disqualification based upon good cause for failure to attend the meetings. Md. Fin. Inst. Code Ann. §§ 3-408 and 3-410 (1980).

Capitalization

A capital stock association, in addition to establishing an initial subscription for savings accounts, initial general reserve fund, general reserve fund and expense fund, must have subscriptions for capital stock of not less than $200,000, or such greater amount as determined by the Board of Commissioners in order to conduct a safe and sound operation.[56] The Board of Commissioners has not promulgated regulations requiring a greater amount of subscription for capital stock. Capital stock associations may use paid-in-surplus if the expense fund is not sufficient to pay organizational and operating expenses.[57]

Reserves

A savings and loan association is required to maintain a reserve fund as determined by the Board of Commissioners.[58]

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56 Id. § 9-221. Cf. N.C. Gen. Stat. § 54B12(b)(1) (1985 Supp.), where the Administrator can only approve a capital stock association with at least $1,500,000 of subscriptions for capital stock.

57 Md. Fin. Inst. Code Ann. § 9-222 (1980). See Md. Fin. Inst. Code Ann. § 3-209 (1985 Supp.), where the initial capital requirements for commercial banks (in a location where there are more than 50,000 inhabitants) is capital stock of at least $1,500,000 and a capital surplus of at least 20% of the bank's required capital stock. This amount has been increased to $3,000,000 by (unwritten) regulation according to Margie H. Muller, the current Bank Commissioner, in an interview with the Office of Special Counsel. See Md. Fin. Inst. Code Ann. § 3-212 (1985 Supp), where before the Bank Commissioner gives approval for a bank, the bank must go through an examination to determine whether the authorized capital stock and surplus are paid in full and whether the bank has complied with all applicable banking provisions. There is no comparable provision applicable to Maryland savings and loan associations.

58 Id. § 9-327 (1980).

Maryland law does not give the Board specific guidance as to the percentage of reserves required to be maintained by an association.[59] Former statutory amounts were deleted by the Committee on Economic Matters of the House of Delegates in the 1980 recodification of the Financial Institution Article upon advice of the Board of Commissioners, apparently to provide flexibility. The Committee viewed the amounts to be allocated to reserves as a matter of business judgment to be decided by the savings and loan association subject to regulations by the Board of Commissioners. The Board has set forth the requirement that an association maintain reserves which exceed three percent of its savings liability.[60]

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59 See also Ohio Rev. Code Ann. § 1151.33 (Page 1984 Supp.), where the same is applicable to the Superintendent of Savings and Loan Associations in Ohio. But cf. North Carolina law in footnote 60, infra.

60 Md. Admin. Code Tit. 9 § 05.01.40-1 (1985). See N.C. Gen. Stat. § 54B-216 (1982 Repl. Vol.), where the North Carolina Code provides that every state association is to establish and maintain a general reserve for the sole purpose of covering losses. The amount of the reserve is to be established pursuant to rules and regulations prescribed by the Commission. However, unlike Maryland law, the statute provides specific guidance to the Commission. The reserve is to be maintained at a level set by the Commission based on assets. The Commission is to evaluate the risk attributable to various types of assets and is to establish percentages for each type of asset based on its level of risk rather than a uniform percentage applying to all levels of risks as in the case under Maryland regulations. For example, under North Carolina regulations the level of reserves to be maintained against assets that are relatively "safe" investments, such as stock in the Federal Home Loan Bank of Atlanta or FSLIC secondary reserve, is zero. The level of the reserve account to be maintained against commercial loans, secured consumer loans, and investments in service corporations is five percent. The level of the general reserve account is increased to eight percent against assets that are invested in unsecured loans, real estate, and certain long term commitments in excess of six months at the time of issuance.

(footnote continued)

The board of directors of any savings and loan association is to allocate profits of the association, at least annually, or such time as stipulated in its bylaws.[61]

(footnote continued from previous page)

North Carolina provides that the failure of an association to maintain the required level of reserves set by the Commission may be grounds for action by the Administrator of the Savings and Loan Division. Section 9-327 of the Code does not provide for any action by the Division Director in the case of failure of an association to abide by the reserve requirements as set forth by the Board of Commissioners. An "order" could be issued to the association pursuant to § 8-401 of the Code, demanding compliance with the reserve regulation.

See also 7 Pa. Cons. Stat. Ann. § 6020-132 (Purdon 1985 Supp.), where under Pennsylvania law, every association is required to maintain general reserves to be used solely for the purpose of absorbing losses. Whenever the reserves of an association are not equal to at least eight percent of the association's savings accounts, and whenever the net worth of an association is not equal to at least 10% of such savings accounts, the association is required under the statute to credit to its general reserves each year an amount equal to not less than five percent of its net profits for the year. Alternatively, in lieu of complying with these reserve requirements, an association may elect to have such reserves as required by FSLIC.

Under Massachusetts law, co-operative banks, when earnings are distributed, must transfer five percent of the net profits to a guarantee fund to be used to meet losses until the fund is at least equal to 10% of the assets of the co-operative bank. If at any date of distribution of earnings, the fund and any surplus account total at least 11% of the share liability of the co-operative bank, such transfer is not required. In addition, each co-operative bank is required to maintain at all times a minimum reserve for liquidation purposes to meet withdrawals from accounts and loans on accounts, of an amount equal to not less than 6-1/2% of its share liability, plus an amount equal to its liability upon "club accounts" and payments held for the payment of taxes on mortgaged real estate. Mass. Gen. Laws Ann. ch. 170 §§ 38, 39, 40 (West 1984).

See also Md. Fin. Inst. Code Ann. § 3-607 (1985 Supp.), where Maryland banks must at all times have reserves equal to at least 15% of their demand deposits and three percent of their time deposits. The Bank Commissioner, with the advice of the Banking Board, may change these requirements. Regulations promulgated by the Commissioner may increase the demand deposit reserves to 30% of those deposits and may increase the time

(footnote continued)

Authorized Investments

Subsection 9-419(a) of the Code sets forth the investments authorized for state-chartered savings and loan associations. These investments are subject to regulation by the Board of Commissioners. With some exceptions,[62] specific limitations are not set forth either with regard to the percentage of the association's assets or net worth in a particular type of investment, or the amount of an association's net worth or assets that may be invested with or loaned to one individual or entity.[63]

The Code allows an association to make any investment permitted a Maryland banking institution.[64] Furthermore,

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deposit reserve to six percent of those deposits. Margie H. Muller has informed the Office of Special Counsel that the Commissioner's office refers to Federal Reserve Board regulations for guidance regarding the reserve requirements for Maryland banks. Md. Admin. Code Tit. 9 §§ 03.06.05 and .06 (1985).

61 Md. Fin. Inst. Code Ann. § 9-328 (1980).

62 See Id. Subsections 9-419(a)(6) (1980), (16) (1980) and (a)(18) (1985 Supp.), where general obligations of any other state are limited to not more than five percent of the association's savings liability, secured and unsecured loans cannot exceed 10% of the savings liability of an association, and an obligation of the State of Israel may not exceed 20% of the association's net worth.

63 The Ohio Code sets forth specific limitations regarding real estate loans, consumer loans, commercial paper, corporate debt securities, and commercial loans. See also, 7 Pa. Cons. Stat. Ann. §§ 6020-159, 161, and 163 (Purdon 1985), which sets forth specific limitations.

64 Md. Fin. Inst. Code Ann. § 9-419(a)(19) (1985 Supp.).

Subsection 9-419(c) of the Code provides that a state-chartered association is not prohibited from making any investment that is permissible for a federal savings and loan association.[65]

Subsection 9-419(a) of the Code states that the Board of Commissioners is to regulate the percentage of an association's total assets that may be invested in a specific type of investment. By regulation, not more than ten percent of the assets of an association may be concentrated in any one person, partnership, company, firm, or corporation.[66] In addition, an association may not make any one loan that exceeds 100% of its net worth as of the date the loan is made.[67]

The composition of an association's mortgage loan[68] portfolio is subject to the following limitations:

1. The aggregate outstanding balance of all loans owned by an association on residential property of a homeowner must be in excess of fifty percent of the association's total assets.

2. The aggregate outstanding balance of all loans owned by an association on improved residential property that is owned by a non-homeowner may not exceed fifty percent of the total assets of the association.

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65 See Section IIE.

66 Md. Admin. Code Tit. 9 § 05.01.30 (1985).

67 Id.

68 A mortgage loan is a loan upon the security of real or leasehold property.

3. The aggregate outstanding balance of all other loans owned by the association may not exceed forty percent of the association's total assets subject to the following additional limitations: (a) the aggregate outstanding balance of all loans secured by improved commercial property may not exceed twenty percent of the association's total assets; (b) the aggregate outstanding balance of all loans secured by unimproved property may not exceed fifteen percent of the association's total assets; (c) the aggregate outstanding balance of all land development loans may not exceed ten percent of the association's assets; (d) the aggregate outstanding balance of all construction loans may not exceed forty percent of the association's total assets.

A savings and loan association is to give priority to first mortgages for owner-occupied residences in the State of Maryland.[69] There is no specific statutory requirement, however, that a certain percentage of the association's investments be in first mortgages for owner-occupied residences in Maryland.

Insider Loans; Conflicts of Interest

A savings and loan association and its subsidiary may not make a loan directly or indirectly to any officer or director of an association, or any corporation or business in which a ten percent or more interest is owned by the officer or director of the association, or member of the immediate family of the officer

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69 Md. Fin. Inst. Code Ann. § 9-419.1 (1980).

or director.[70] A loan is not prohibited, however, if it is (1) secured by the borrower's principal residence, (2) secured by the borrower's savings account up to the withdrawal value of the account, or (3) approved by two-thirds vote of the board of directors of the association, approved by the Division Director and secured by collateral appraised by a disinterested appraiser approved by the Division Director.[71]

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[70] Id. § 9-307. For purposes of this section of the Code, "member of immediate family" means a spouse, child, parent, sibling, grandparent, or grandchild. Maryland law is not necessarily lenient as it relates to loans to directors and officers. Most states do not require approval of the supervisory agency.

[71] See N.C. Gen. Stat. § 54B-154 (1985 Supp.), which provides that a loan to any director, officer, member of the immediate family of such person, or company controlled by such person shall be limited to certain categories. Regulations promulgated under this section provide that a full disclosure of the transaction must be made to the members of the Board of Directors of the institution and that the loan must be approved by a majority of the directors with no director interested in the loan proceeds having a vote. Furthermore, no officer, director, etc. can enjoy an improper advantage with respect to loan transactions beyond those advantages enjoyed by other loan applicants. The regulations also provide that each loan made under the insider loan limitation regulations must be made in the ordinary course of business of the association and must not involve more than the normal risks of collectibility or impose unfavorable features to the association.

Under Pennsylvania law, a director or officer as well as an employee or attorney of an association cannot contract with the association upon terms less favorable to the association than is offered by any other corporation or person. Therefore, under the Pennsylvania law an 11% first mortgage on a director's primary residence would not be permissible even if the transaction is otherwise authorized under state law if the current interest rate for a similar loan to a disinterested party is 13%. 7 Pa. Cons. Stat. Ann. § 6020-70 (Purdon 1985 Supp.).

In Massachusetts, a co-operative bank is only required to report annually to the Banking Commissioner any loan or extension of credit made to officers and directors. Mass. Gen. Stat. Ann. ch. 170 § 42A (West 1984).

Directors and officers of a savings and loan association are fiduciaries and therefore may not directly or indirectly engage in any business transaction that would result in a conflict of interest with the association in a manner that would be detrimental to the association.[72] Regulations enumerate areas that may <u>not</u> be deemed to be conflicts of interest including business transactions that are conducted in good faith and that are fair, honest, and reasonable to the association. Regulations also set forth certain restrictions governing the conduct of the directors and officers of the association. For example, a director may not receive remuneration as a director other than reasonable fees for services. The director can also serve, however, as an officer, employee, attorney, appraiser, or accountant or provide a service to the association and receive reasonable compensation for such services rendered in that capacity. A director, officer or employee may not solicit or accept, directly or indirectly, for any person other than the association, compensation or any personal benefit in connection with the procurement of any loan made by the association or its subsidiaries. The penalty for violating the regulation is that the violation <u>may</u> be

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[72] Md. Admin. Code Tit. 9 § 05.01.43 (1985). <u>See also</u> 92 Op. Att'y. Gen. 804 (1977), where an officer and director of a state-chartered savings and loan association also has a fiduciary duty not to usurp a corporate opportunity in which the association has an interest or expectancy.

considered an unsafe and unsound practice necessitating the issuance of an order by the Division Director pursuant to Section 8-401 of the Code.[73]

Furthermore, a "controlling person" may engage in a transaction with a stock association if a full disclosure, including the nature of the person's interest, is made to the board of directors, the transaction is approved by the vote of the disinterested directors, and the profits of the controlling person are not at the association's expense and do not prejudice its interest.[74] A stock association may make a loan to a

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[73] Md. Admin. Code Tit. 9 § 05.01.43 (1985).

[74] Md. Fin. Inst. Code Ann. § 9-323 (1980). "Controlling person" means any individual or legal entity, acting directly or indirectly, individually or in concert with one or more other individuals or legal entities, or through one or more subsidiaries who owns, controls, or holds with power to vote, or holds proxies to vote, more than 20% of the voting shares of the capital stock association, or controls in any manner the election of the majority of the directors of the capital stock association. This section does not apply to compensation paid to a controlling person for services.

See Md. Fin. Inst. Code Ann. § 5-212 (1980), where, as a general rule, the following may not borrow directly or indirectly from a bank in Maryland: (1) director, officer, or employee of the bank; (2) partnership of which the director, officer, or employee is a member; (3) any corporation which the director, officer, or employee is an officer or owns a majority interest. This restriction, however, does not apply to the director of a bank, unless the director is also an officer or employee of the bank; a partnership in which the director is a member, unless an officer or employee of the bank is also a member of that partnership; or the corporation which the director holds any interest, unless an officer or employee of the bank is an officer or owns the majority interest in that corporation. Otherwise, a loan to a director, officer or employee of a bank can be made only if the loan has been approved by the board of directors of the bank. See also Md. Fin. Inst. Code Ann. § 3-601 (1980), where there are certain maximum loans that may be made to a specific individual. There is no statutory or regulatory requirement for receiving loan approval by the Bank Commissioner or the Bank Board. Likewise there is no requirement of reporting (footnote continued) controlling person only if the loan is approved by a majority of disinterested directors, the security is appraised by a disinterested appraiser, and approved by the Division Director.

Service Corporations

A savings and loan association may also invest in a service corporation, subject to certain limitations. A service corporation is a corporation where all stock is owned by a state-chartered savings and loan association or a federally-chartered savings and loan association. The outstanding investment in service corporations and subsidiaries of service corporations cannot exceed two percent of the association's assets.[75] The activities of a service corporation are limited to the following: (1) originating, purchasing, selling and servicing loans, and participation in loans secured by first liens upon real estate; (2) originating, purchasing, selling and servicing educational loans; (3) making any investment as specified in Section 9-419 of the Code; (4) performing certain services primarily for the association itself, such as accounting and data processing services; (5) purchasing unimproved real estate lots for the purpose of development or subdivision, *etc.*; (6) the

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the loan to the Commissioner or Bank Board. Notwithstanding, Bank Commissioner Margie H. Muller has informed the Office of Special Counsel that all loans to officers, directors, or shareholders must, by (unwritten) regulation, be reported in the minutes of the Board of Directors' meetings, which are reviewed by the Commissioner's office when a bank is examined.

[75] Md. Admin. Code Tit. 9 § 05.01.34 (1985).

development and construction of improvements for sale or rental on real estate; and (7) conducting a real estate brokerage business.

There are three conditions for an investment in a service corporation. First, an association may not invest in a service corporation unless there is a written agreement with the Board of Commissioners that the service corporation will permit and pay the costs of an examination of the corporation by the Division Director or by a certified public accountant. Second, annual financial statements of the service corporation must be prepared and "submitted" with the annual financial statements required under the Code.[76] Finally, if a service corporation exceeds the limitations proposed by statute or regulation as to an investment, the corporation must dispose of the investment.[77]

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[76] Md. Fin. Inst. Code Ann. § 9-306 (1985 Supp.).

[77] Md. Admin. Code Tit. 9 § 05.01.34 (1985). Cf. Md. Fin. Inst. Code Ann. § 5-403 (1985 Supp.), where a banking institution may not have an affiliate unless the Bank Commissioner, with the advice of the Banking Board, approves the affiliate. The affiliate may only be approved if it offers to the public a financial, fiduciary, or insurance service. The affiliate would be approved only if the Bank Commissioner determines that such approval is required to protect the welfare of the general economy of the state and of the banking institution and would not be detrimental to the public interest or to the banking institution. In addition, the approval by the Bank Commissioner imposes the same conditions the federal law requires or permits as to national banking associations. The Bank Commissioner has the same authority to examine the business of the affiliate as it does with a banking institution.

See generally N.C. Gen. Stat. § 54B-194 (1982 Repl. Vol.), where an association in North Carolina may establish service corporations. The maximum investment in a service corporation in North Carolina is 10% of the association's total assets. A service corporation in North Carolina is subject to audit and examination by the Administrator of the Savings and Loan Division. The cost of the examination is to be paid by the

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Examination; Audit and Reports

Savings and loan associations are required to have an examination at least once every two years.[78] The association does not pay a fee to the Division Director for the examination. The examination can include a "service company" or subsidiary of a savings and loan association.[79]

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service corporation. The permitted activities of the service corporation are set forth in rules and regulations promulgated by the Administrator. Under the statute, a service corporation may engage in activities which are approved by the Federal Home Loan Bank Board for service corporations owned solely by federal associations, unless these activities are prohibited by the Administrator. Under regulations promulgated by the Administrator, a service corporation may engage only in activities which are approved by the Federal Home Loan Bank Board for service corporations owned solely by federal savings and loan associations and investments authorized for state-chartered savings and loan associations in North Carolina.

Under Ohio Rev. Ann. Code § 1151.344 (Page 1984 Supp.), an Ohio savings and loan association may invest 15% of its assets in a service corporation. If no association holds more than 50% of the stock of a service corporation, then the corporation may provide services compatible with the purposes, powers, and duties of Ohio savings and loan associations. In addition, the service corporation may provide mechnical, clerical, and recordkeeping services subject to written approval of the Superintendent of Building and Loan Associations. If an association owns more 50% of the service corporation stock, the service corporation may provide only such services as the Superintendent of Building and Loan Associations authorizes. The Superintendent may authorize services which he determines to be related to the business of building and loan associations. The Superintendent is to consider whether the performance by a service corporation can be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound practices.

In Ohio the Superintendent may, at anytime, examine the affairs of a service corporation. Whenever the service corporation fails to meet the requirements of the law, all loans to, or investment by an association in a service corporation are deemed unauthorized investments.

[78] Md. Fin. Inst. Code Ann. § 9-502 (1980).

No regulations have been promulgated with regard to the examination process conducted by the Division. Generally speaking, the chief examiner of the Division decides which examiner is to examine an association. He selects the examiner in charge and the other field examiners. Then a supervisor,

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79 Id. § 9-501. The term "service company" is not defined in the Financial Institutions Article. Cf. Id. § 5-201 (1985 Supp.) where, in the case of a Maryland bank, an examiner is to examine each banking institution at least once every twelve months. For each examination of the bank, the institution must pay the Bank Commissioner $250 plus five cents for each $1000 of assets of the institution over $50,000. The purpose of the examination, which is specifically set forth in the statute, is to determine the condition of the institution and whether it is complying with the law. No similar purpose is set forth in the parallel statute applying to the examination of Maryland savings and loan associations.

In Massachusetts at least once during each calendar year, and more frequently if required by the Bank Commissioner, each co-operative bank is to have an examination and audit made of its books and records. The examination and audit is to be in the form described by the Commissioner, except that a cooperative bank having assets over $10,000,000 is to have the examination and audit by a certified public accountant not connected with the co-operative a bank. Mass. Gen. Stat. Ann. ch. 170 § 41 (West 1984).

See N.C. Gen. Stat. §§ 54B-56 (1982 Repl. Vol.) and 54B-57 (1985 Supp.), where under North Carolina law, the Administrator of the Savings and Loan Division may at any time examine and investigate anything relating to the busines of a savings and loan association or a savings and loan holding company. If the association willfully delays or obstructs the examination, it is guilty of a misdemeanor. The association pays the examination fees. See also N.C. Gen. Stat. § 54B-58 (1982 Repl. Vol.) where the Administrator may conduct an extended audit or examination of the association or revaluation of any assets or liabilities of the association.

In Ohio at least once every 18 months the Superintendent of Building and Loan Associations is to make an examination into the affairs of each building and loan association. The expenses of the examination are paid by the state. The Superintendent can establish different schedules of examination for different associations. Ohio Rev. Code Ann. § 1155.09 (Page 1984 Supp.). The Superintendent may also make "special" examinations of building and loan associations and the expense of such examination is to be paid by the association. Ohio Rev. Code Ann. § 1155.10 (Page 1984 Supp.).

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usually an "Examiner Grade V," will prepare a pre-exam analysis. The pre-exam analysis consists of using the audit of the association prepared by the certified public accountant and the accountant's management letter as guidelines.[80] On rare occasions, the examiner in charge will be called in to talk with the chief examiner or a supervisor about the assignment. The examiner in charge then takes a copy of the last examination as well as the examination "kit" with him.[81] The examiner uses the kit to compile information from the association's financial statements. He prepares "work papers" which are used to support his opinions as to various aspects of the examination. A good deal is left to the discretion of the examiner in charge, since other than the kit, there are no guidelines for the examiner to follow. Based on the "work papers" and the examiner's comments, a report is prepared and submitted to the Division. The report is then reviewed by review examiners and a letter from the Director is forwarded to the association with a copy of the examination. The reviewer does not give any feedback to the examiner who does not receive a copy of the letter sent to the association. In addition, the examiner is neither informed of

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<u>See generally</u> 7 Pa. Con. Stat. Ann. § 6020-221 (Purdon 1985 Supp.), where in Pennsylvania the Department of Banking is to examine the association at least once a year <u>and more frequently as it deems necessary</u> to protect the members or creditors of the association. The Department may examine <u>any person</u> who is performing services for the association. The provisions of the law regarding <u>banking</u> apply to the examination process.

80 <u>See</u> Exhibit II3.

81 <u>See</u> Exhibit II4.

any editing of his report nor the response by the association to any letter sent to it.[82] There is no penalty for violation of the examination process.

The Division Director may require savings and loan associations to be audited annually.[83] By regulation, if the association has assets exceeding $5,000,000 it is required to have, at its own expense, an audit at least once a year by a certified public accountant. An association whose assets are $5,000,000 or less can have its annual audit made by the board of directors of the association. The requirements under this alternative provision are set forth in regulations.[84]

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[82] The examiners receive no formal training. The Division attempts to send examiners to a federally sponsored training school, such as the New Extension Training School (NETS). The only guidelines that the examiner has in conducting his exams are Titles VIII and IX of the Financial Institutions Article of the Code and promulgated regulations.

[83] Md. Fin. Inst. Code Ann. § 9-502(b) (1980).

[84] Md. Admin. Code Tit. 9 § 05.01.06 (1985). Cf. Md. Fin. Inst. Code Ann. § 5-205 (1980), where a bank is required to have an audit by a certified public accountant at least once every five years. In addition, at least twice a year the Bank Commissioner is required to ask every bank to submit a financial report that shows in detail the assets and liabilities of the institution as of the close of a business day specified by the Bank Commissioner. Within 45 days after the institution receives the request for the financial report, it must publish a summary of the report and submit proof of publication of the summary to the Bank Commissioner. The form of the report is to conform as closely as possible to the forms used by federal banking authorities. This report must be submitted within 30 days after the institution receives the request for the financial report. In addition, the Bank Commissioner may request a bank to submit a "special financial report" in accordance with § 5-207 of the Code.

See Md. Fin. Inst. Code Ann. § 5-208 (1980), where if a banking institution fails to make any required report, it is subject to a civil penalty of $50 for each day the report is overdue. Instead of making an examination, the Bank

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Conversions and Mergers

A mutual association may convert to a capital stock association if its members approve, if its charter is amended, and if the Division Director approves.[85] In order to convert to a capital stock association, a mutual association must deliver to the Division Director an application for conversion, a certified copy of the resolution of board of directors that authorizes the conversion, the proposed amended charter and bylaws amendments, the proposed notice of the meeting to consider conversion, and the time and manner in which the notice will be given to members, the proposed property statement, and the proposed plan of conversion.[86]

The Division Director is to review the application for the conversion and also is to determine whether the plan is fair to members of the converting association and that insurance of accounts will remain in effect after the conversion.[87] An application for conversion will not be approved by the Division Director if the plan does not comply with governing regulations

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Commissioner, pursuant to § 5-204 of the Code, may accept a copy of a report of a recent examination by a federal banking authority.

Compare Md. Fin. Inst. Code Ann. § 9-306 (1985 Supp.), where a savings and loan association must prepare an annual statement of financial condition which is to be submitted at the association's annual meeting with Ohio Rev. Ann. Code § 1151.88 (Page 1968 Repl. Vol.), where each deposit association is required to file semi-annual financial reports with the Superintendent of Savings and Loan Associations.

85 Md. Fin. Inst. Code Ann. § 9-601 (1980).

86 Id. § 9-602.

87 Id. § 9-604.

on conversions or if it would result in a taxable reorganization under the Internal Revenue Code.[88] Regulations have been promulgated by the Board of Commissioners which set forth the required provisions for the proposed conversion.[89]

A savings and loan association may consolidate with, merge into, or transfer its assets to any other savings and loan association or any savings bank as long as it complies with Title III of the Corporations and Associations Article and the Division Director approves the plan.[90] A Maryland corporation having capital stock may consolidate with one or more Maryland corporations having capital stock to form a new consolidated corporation. It may also merge into another Maryland corporation having capital stock or have one or more such corporations merge into it. Finally, it may merge into a Maryland business trust having transferable units of beneficial interest, or it may have one or more such business trust merge into it.[91] It is questionable whether a stock association can merge with or be merged into a mutual association. Under the Corporations and Associations Article, a non-stock corporation may consolidate or merge only with another non-stock corporation.[92] However, it is not

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[88] Md. Admin. Code Tit. 9 § 9.05.01.21B (1985).

[89] Id. § 05.01.21B(2).

[90] Md. Fin. Inst. Code Ann. § 9-627 (1980).

[91] Md. Corporation and Associations Code Ann. § 3-102 (1982).

[92] Id. § 5-207. See also N.C. Gen. Stat. § 54B-35 (1985 Supp.), where a mutual association may only merge with another mutual association and a stock association may only merge with another stock association. In order for a mutual association to merge
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altogether certain, however, as to whether this section of the Corporations and Associations Article applies since only the general corporation law applies to a financial institution.[93]

A savings and loan association may effect a "statutory merger" into any other savings and loan association or any savings bank if the proposed statutory merger complies with Title III of the Corporations and Associations Article and is approved by the board of directors of both associations, the members of a transferor association, and the Division Director.[94]

To consolidate, merge, transfer assets, effect a statutory merger, reorganize, partially liquidate, or dissolve a savings and loan association, a proposed plan must be delivered to the Division Director. The Director is to examine the plan and determine if the successor association satisfies the requirements in Part II of Title IX relating to the organization of savings and loan associations, if the plan is fair, and if the implementation of the plan will promote the public interest. There may be an appeal if the Division Director does not approve of the plan.

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with a stock association, it must first convert to a stock association. N.C. Gen. Stat. § 54B-37 (1982 Repl. Vol.).

[93] Md. Fin. Inst. Code Ann. § 1-201 (1980).

[94] _Id_. § 9-628.

Conservatorship and Receivership

The Board of Commissioners may institute proceedings for the appointment of a conservator if the savings and loan association fails to comply with a final order, or if the Board of Commissioners considers the appointment of a conservator in the public interest.[95] Only the Board of Commissioners may institute proceedings for the appointment of a conservator. FSLIC or MSSIC,[96] as the applicable insurer, has the absolute right to be appointed the conservator of a savings and loan association insured by it.[97] Otherwise, the court may appoint the Division Director, deputy director, or an examiner from the Division as conservator. A conservator may be appointed if the court finds that the savings and loan association is in an impaired or insolvent condition, is in substantial violation of any law or regulation, is concealing any of its assets or records, or is conducting an unsafe or unsound operation. The conservator is to correct the irregularities in the operation of the association. The conservator has the powers, rights, and privileges of the officers, directors, and members of the savings

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95 Id. § 9-701.

96 The Maryland Deposit Insurance Fund (MDIF) Corporation since May 18, 1985.

97 Id. § 9-709.

and loan association. On the recommendation of the Board of Commissioners, by order of the court, the conservator may remove any director, officer, or employee of the association.[98]

The Board of Commissioners may institute proceedings to appoint a receiver if a savings and loan fails to comply with a final order, if irregularities giving rise to a conservatorship are not corrected, or if an emergency exists. In each case, the Board of Commissioners must consider the appointment of a

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[98] Id. § 9-702. Cf. Id. § 5-602, where in the case of a Maryland bank, if the Bank Commissioner finds that any bank is impaired, it may require the bank to correct the impairment, and if the bank fails to correct the impairment within three months, the Commissioner may take possession of the bank. If the reserves of the bank fall below the amount required, the Bank Commissioner can require the bank to correct the deficiency. If the bank fails to correct the deficiency within 30 days after it receives notice, the Commissioner may take possession of the bank.

Within reasonable time after the Bank Commissioner takes possession of the institution, he or she is to petition the court to take jurisdiction over the institution and appoint as receiver any examiner or the Federal Deposit Insurance Corporation (FDIC).

In North Carolina, the Administrator of the Savings and Loan Division, with prior approval of the Commission of Savings and Loan Associations, may take over an association if the association is being conducted in a fraudulent, illegal, or unsafe manner, or if the association is in an unsafe or unsound condition to transact business. In addition, if the officers, directors, or employees have assumed duties and have performed acts in excess of those permitted by law, the Administrator may also take over the association. If the association has experienced a substantial dissipation of assets or earnings due to any violation of law or due to an unsafe or unsound practice, the Administrator may also take over the association. If the Administrator has taken custody of an association and finds little or no likelihood of amelioration of the situation, he or she can then appoint a receiver for purposes of liquidating the association. N.C. Gen. Stat. § 54B-70 (1982 Repl. Vol.).

In Ohio, if the Superintendent of Savings and Loan Associations finds that an association is operating in an unsafe or unsound condition, that it is conducting its business contrary to law, or that its affairs are not being conducted for the best interest of its depositors, shareholders, or creditors, he or she may take possession of the business and property of the association. Ohio Rev. Code Ann. §§ 1157.01 through 1157.09 (Page 1968 Repl. Vol.).

receiver to be in the public interest.[99] Only the Board of Commissioners may institute proceedings for the appointment of a receiver. Subject to the priority of FSLIC or MSSIC as the insurer, the court may appoint a receiver if it finds that a savings and loan association is in an impaired or insolvent condition, is in substantial violation of any law or regulation, is concealing any of its assets or records, or is conducting an unsafe or unsound operation.

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[99] Md. Fin. Inst. Code Ann. § 9-708 (1980).

D. MARYLAND SAVINGS-SHARE INSURANCE CORPORATION (MSSIC) SUMMARY OF PURPOSE, STATUTE AND REGULATIONS*

Purpose

As a result of the general public mistrust of financial institutions after the Great Depression in 1929, the Federal Government created FSLIC to insure deposits in savings and loan associations.[100] Membership in FSLIC is available to both federal and state-chartered savings and loan associations. However, when a state-chartered savings and loan association becomes a member of FSLIC, it is required to abide by the federal insurance regulations that also apply to federally-chartered institutions.[101] Because this agency was not always sensitive to

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* This Section of the report will also provide, primarily by way of footnote, a comparison of MSSIC with FSLIC and other private or state insurers. Except as otherwise noted, citation to Maryland laws are as they existed prior to the First Special Session of the 1985 General Assembly.

100 See footnote 30, supra.

101 As a result of entering into the insurance contract with FSLIC, a state-chartered association is required to build and maintain loss reserves and to borrow funds only as prescribed by regulations. Furthermore, issuance of any securities must be approved in advance by FSLIC. An institution is also subject to various lending restrictions and is required to limit its lending area as prescribed by regulations. Advertising and sales methods must be in accordance with practices that have been approved by FSLIC. In addition, there are restrictions regarding sales commissions and other regulations regarding the sale of loans. There must be compliance with regulations regarding auditing and examinations, the bonding of employees, the solicitation of proxies, the making of reports to FSLIC at prescribed times and upon required forms, the establishment of minimum security devices and procedures, and the ownership of service corporations. 12 CFR § 563.1 et seq (1984).

Savers in an insured institution generally are insured in an amount not exceeding $100,000. A person may have various accounts in different capacities at the same association and have

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the needs of the state-chartered institutions, a few states opted to pass legislation enabling the formation of state or private associations which would be an alternative and sometimes a supplement to FSLIC.

In 1932, Massachusetts took the initiative to form the Co-operative Central Bank, which included the Share Insurance Fund. Ohio followed the lead and formed a state guarantee association in 1957. Since that time, three other states have created state guarantee associations: Maryland in 1962;[102] North Carolina, the North Carolina Savings Guarantee Corporation (NCSGC) in 1967, later the Financial Institutions Assurance Corporation (FIAC); and Pennsylvania, the Pennsylvania Savings Assurance Insurance Corporation (PSAIC) in 1979.

The principal reasons for the establishment of state private institutions were numerous. First, state associations were dissatisfied with FSLIC because some associations experienced difficulties in qualifying for membership in FSLIC. Furthermore, there was alleged discrimination by FSLIC against state-chartered institutions in a perceived overregulation by FSLIC. In addition, there was dissatisfaction with the limited

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(footnote continued from previous page)
separate insurance coverage of funds. For example, a person may have insured in the same association an individual account or joint account and an interest in an irrevocable trust account. His insurance protection under each grouping would be separate and apart from the insurance he would receive under the other groups.

[102] Chapter 6, Act 1985, 1st Sp. Sess., effective May 18, 1985, repealed former Md. Fin. Inst. Code Ann. §§ 10-101 to 10-117 which provided for MSSIC, and enacted present §§ 10-101 to 10-119 in lieu thereof. MSSIC was merged with MDIF, which became the surviving corporation.

liability of FSLIC insurance. These feelings of dissatisfaction with FSLIC were supplemented by the belief that state programs would be more responsive to the needs of both state-chartered institutions and the general public.

The purpose of these insurance corporations, as set forth in the statutes, are basically the same. The primary purpose is threefold: (1) to promote the elasticity and the flexibility of the resources of members; (2) to provide for the liquidity of members through a central reserve fund; and (3) to insure the savings accounts of members.[103]

MSSIC was established as a nonprofit, non-stock corporation whose members consisted of the associations that are accepted for membership under Title X of the Financial Institutions Article.[104] In addition to the general powers granted to a Maryland corporation under the Maryland General Corporation Law, MSSIC was granted the following powers: (1) to give financial assistance to members; (2) to buy and sell property; (3) to invest any of its funds; and (4) to borrow or secure credit;

Board of Directors

The powers of MSSIC are exercised by a Board of Directors. The Board consists of eleven directors, eight of whom are elected by member associations, and three who are appointed by the Governor with the advice of the Secretary of Licensing and

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103 See, e.g., Md. Fin. Inst. Code Ann. § 10-103 (1980).

104 Id. § 10-102.

Regulation.[105] Each director is to be a Maryland resident and registered voter. Not more than three directors of MSSIC at any one time may be directors or officers of associations that are insured by FSLIC. The Board of Directors is to elect from its members a chairman of the board and may appoint any officers and employees that it considers advisable.[106]

Membership

In Maryland, an association may become a member of MSSIC by satisfying three conditions. MSSIC's procedure for admission consists of an initial screening by the membership committee before the MSSIC Board approves or disapproves of the association. The application then is reviewed by the Division Director who must approve the financial affairs, solvency, management, and the board of directors of the association applying for membership.[107] Finally, the Board of Directors of MSSIC must approve the application. The Board may deny the application of an association only for good cause shown.[108]

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[105] Id. § 10-109. The Board of FSLIC is comprised entirely of Presidential appointees. For the composition of Boards of other insurers see Exhibit II5.

[106] Id. § 10-110. MSSIC Bylaws §§ 2-201, 2-202, and 2-203.

[107] Md. Fin. Inst. Code Ann. § 10-106(b) (1980).

[108] Id. Section 10-107(a)(2). Pennsylvania statutory language is similar to Maryland's in that it allows membership when the Secretary of Banking approves the quality and soundness of the association's financial affairs and certifies its solvency, management, and directorship. The Board of Directors of PSAIC must accept the association's formal application, except that the application may be denied for good cause shown regarding the soundness of the applicant's financial affairs, solvency,
(footnote continued)

Additional membership qualifications are enumerated in the MSSIC Bylaws. For example, MSSIC requires that any federally-chartered savings and loan association may not become a member unless it has its principal office in Maryland and has invested seventy-five percent or more of its total assets in accordance with the provisions of the Maryland Code.[109]

The bylaws include a provision requiring every association that applies for membership in MSSIC to abide by the rules and regulations of MSSIC.[110]

Capital Deposit Fund

The MSSIC Bylaws establish two funds, a Capital Deposit Fund (the "insurance fund") designed to insure the savings accounts of members, and a Central Reserve Fund (the "liquidity fund") intended to provide for the liquidity of member associations. Each association is required to contribute to the

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(footnote continued from previous page) management, or directorship. See PSAIC Rules and Regulations I §§ 1-4. See Exhibit II5.

109 MSSIC Bylaws § 2-501. In Pennsylvania, Rules and Regulations of PSAIC indicate that an association may not become a member unless it has its principal office in the Commonwealth of Pennsylvania and has invested 75% of its total assets in the Commonwealth. In addition, no applicant may become a member until its application has been approved by a majority vote of the entire board of directors of PSAIC. Any applicant whose application has been rejected by the board may, upon satisfying the requirements of the rules and regulations, have its application reviewed by the membership of PSAIC. See PSAIC Rules and Regulations I §§ 1-5.

110 MSSIC Bylaws § 2-502. Failure to abide by these rules and regulations or correct any default in a breach of the rules and regulations constitutes grounds for expulsion of the association from MSSIC. See MSSIC Rules and Regulations §§ 3-201 through 3-244.

insurance fund two percent of its free share accounts; in return, each receives a certificate of deposit from MSSIC.[111] MSSIC cannot require any additional capital deposits unless seventy-five percent of all members have agreed to such assessment.[112] In addition to the capital deposit, each association admitted to MSSIC after January 1, 1984, must pay a periodic adjustment charge.[113]

Central Reserve Fund/Liquidity

One of the purposes of MSSIC is to enhance the liquidity of its member associations. This purpose is critical because the financial structure of a savings and loan association is usually composed of short-term liabilities, such as savings and money market accounts, and long-term assets such as mortgages on owner occupied residences and, more recently, direct equity investments in commercial real estate. The bylaws of MSSIC provide for a certain amount of liquidity to be maintained by each association.[114]

A Central Reserve Fund was established by MSSIC and its member associations to provide for needed liquidity of a member association. Membership in the Central Reserve Fund is required

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111 MSSIC Rules and Regulations §§ 3-301, 3-302 and 3-303.

112 _Id_. § 3-304. _See_ MSSIC Rules and Regulations § 3-305, where if additional capital deposits are agreed upon, any association not voting in favor of the additional capital may resign.

113 _Id_. § 3-308.

114 MSSIC Bylaws § 2-701. The bylaws of FIAC and PSAIC also provide for a certain amount of liquidity.

for all member associations. Each association must purchase capital notes from MSSIC in accordance with a formula set out in MSSIC's rules and regulations. The capital notes purchased by the association are to be part of <u>its own</u> liquidity fund that is required to be maintained by the association. The Central Reserve Fund is <u>not</u> subject to the payment of insurance claims against MSSIC. Upon liquidation of the fund, each member is to receive its share after the deduction of any indebtedness due the fund. The fund also may make advances to member associations.

MSSIC requires that each member association maintain its own liquidity fund equal to six percent of its total free share accounts, less the unpaid balance due on loans secured by the accounts.[115] The MSSIC Board of Directors may waive any part

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115 MSSIC Rules and Regulations § 3-210. The liquidity fund is the sum of: (1) total cash and federal funds; (2) the lesser of cost or market value of any obligations of the United States or instrumentality which have a maturity of ten years or less; (3) GNMA-backed modified pass-through certificates with a maturity of more than 10 years, and such other instruments having a maturity of more than ten years which are guaranteed as to principal and interest by the United States, provided however that the aggregate not exceed 25%; (4) certificates of deposit issued by banks insured by FDIC, provided the total investment in certificates of deposit in any one bank does not exceed .4% of the total deposits of that bank or $100,000 whichever is greater, if the bank has an aggregate net worth of at least $5,000,000, and the certificates of deposit are negotiable or may be redeemed prior to maturity by the member association at its option; (5) bankers' acceptances discountable at the Federal Reserve Bank; and (6) Central Reserve Fund capital funds.

PSAIC requires an almost identical liquidity fund. Currently, it requires a fund equal to seven percent of an association's total savings accounts. In addition, PSAIC provides that 50% of the obligations of the United States may have a maturity of five years or less, while MSSIC allows a 10 year maturity date. PSAIC gives an association an opportunity, if it believes that there are appropriate existing circumstances, to present its case to the PSAIC Board and, upon showing good cause, have the requirements altered. PSAIC may order the member

(footnote continued)

of the liquidity rule.

Net Worth

MSSIC requires that its member associations have a total net worth equal to four percent of the aggregate withdrawal value of its free share accounts.[116] An association must notify MSSIC if its total net worth has declined to 3.75% at the end of any month. The association must also notify MSSIC at the end of any calendar year in which its total net worth is below that required by MSSIC regulations.

If an association fails to meet the net worth requirements, MSSIC has the option to (1) convene a meeting of the association's board of directors; (2) restrict or totally eliminate advertising by the association; (3) increase the association's liquidity and maintain such increased liquidity at specified levels; (4) limit the issuance or renewal of certificate accounts; (5) reduce the rate of earnings that may be paid on savings accounts or certificate accounts; (6) limit or cease granting new mortgage commitments and/or the purchase of mortgage loans or participation in those loans; (7) limit operation

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(footnote continued from previous page)
to refrain from investing its assets until it complies with the liquidity requirements. PSAIC Rules and Regulation II § 10.

116 MSSIC Rules and Regulations § 3-211. Each member association must increase its total net worth periodically by a certain percentage as set forth in MSSIC Regulations. Total net worth includes the general reserve funds maintained by an association for the purpose of absorbing losses, earned surplus and undivided profits, capital stock and paid-in surplus, subordinated debt, current net earnings, savings accounts pledged or hypothecated for or on behalf of a member association to MSSIC, and deferred fees.

expenditures to specified levels; and (8) take any other necessary action as MSSIC deems necessary or appropriate. If the total net worth declines to three percent, the association is required to enter into an assistance agreement with MSSIC. The MSSIC Board may waive the net worth requirements, except the three percent net worth rule, upon a showing of good cause.[117]

Insurance of Accounts

The statute forming MSSIC states that the corporation may set insurance limits in the bylaws, but those limits may never exceed the limits established by FSLIC by more than $10,000.[118] MSSIC adopted the exact statutory language in its

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[117] The net worth requirement for a FSLIC insured association is five percent of the association's total savings accounts. Members of FIAC are required to retain a net worth "as specified in the statutes or regulations of the state in which" they operate or whatever other amount is established by the FIAC Board of Trustees. The Trustees' decision is determined by whatever amount they deem adequate to protect the depositors of a member association and FIAC. FIAC Standards and Procedures Article III §§ 11, 13. For net worth requirements of other insurers see Exhibit II5.

[118] Md. Fin. Inst. Code Ann. § 10-105 (1980). See discussion of change in bylaws in Section IIF, infra. Massachusetts does not set specific limits as to the insurance of accounts. Massachusetts allows a member to become a member of FSLIC at the same time. The Massachusetts fund covers all deposits that are above the FSLIC limit.

The Pennsylvania statute makes no mention of the limit of PSAIC's liability. However, PSAIC's Bylaws indicate that the limit of liability, which PSAIC may be required to pay for each separate account, is to be the amount of the prevailing insurance available from FSLIC. PSAIC Bylaws Article VII § 2.

Just as with MSSIC, no payments can be made unless there occurs an "event of default." "Event of default" is defined as the taking possession of the association by the Department of Banking pursuant to the Banking Code.

FIAC insures members' accounts up to the FSLIC limit. IRA's, Pension and Keogh accounts are covered up to $250,000.
(footnote continued)

bylaws.[119] MSSIC requires an "event of default" as a condition precedent to its payment of insurance. "Event of default" means the association's adjudication in bankruptcy, the appointment of a conservator for its affairs, or the appointment of a receiver for its affairs.[120]

MSSIC may offer financial assistance to a member association in order to prevent default, preserve the financial integrity of the association, or restore the association in default to normal operations as an insured member.[121] MSSIC may also assist a troubled member by making loans, buying assets at book value, notwithstanding that it may exceed the market value, or making capital contributions to the member in an amount which MSSIC finds reasonably necessary to save the expense of liquidating an association or to pay the net loss of any account transferred to such association.[122]

(footnote continued from previous page)
FIAC Standards and Procedures Article VII §§ 1-12. Liability occurs in the event of a default or liquidation. "Default" is defined as "the inability of a member to satisfy its obligations" as determined by the president of FIAC. FIAC Standards and Procedures Article VII § 1(c).

119 MSSIC Bylaws § 2-702.

120 Id. § 2-703. See generally footnote 118, supra.

121 Id. § 2-707.

122 FIAC provides virtually the same method for assisting a member association. FIAC Standards and Procedures Article III § 7. See Exhibit II5. See also MSSIC Bylaws § 2-708, where MSSIC may also enter into a written agreement with a member and others for the purpose of adverting an event of default. Pursuant to such an agreement, MSSIC may financially assist any member association.

Investment Limitations

MSSIC regulations[123] set forth certain limitations with regard to permissible mortgage loans by a member association. A member association's commercial mortgage loan portfolio cannot exceed forty percent of the total savings of the member at any time. In addition, the outstanding principal balance of all construction loans may not exceed twenty-five percent of the member's total savings. Not more than five percent of the member's total savings accounts may be loaned to finance construction on any one development or project, regardless of the number of borrowers. A construction or permanent loan for the construction of a single family residence made to a borrower who intends to reside in the residence is excluded from these limitations. Furthermore, the total outstanding commitments and loans in process cannot exceed twenty-five percent of the association's total savings.

MSSIC regulations[124] permit an association to invest in "broker deposits." If an association's net worth exceeds four percent of the aggregate withdrawal value of its savings accounts, these brokered deposits cannot exceed ten percent of the association's total savings accounts. If the net worth of an association is four percent or less, the broker deposits cannot exceed five percent of the association's total savings

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[123] MSSIC Rules and Regulations § 3-217.

[124] MSSIC Rules and Regulations § 3-706.

accounts.[125] The MSSIC Board could grant an association a waiver for existing broker accounts exceeding the allowable percentages before October 1, 1985, if it found that compliance would result in "substantial adverse economic hardship" to the association, and if the association submitted to the Board of Directors a plan for compliance which was acceptable by the Board.[126] A MSSIC Policy Statement prohibits members from borrowing from an outside source in amounts exceeding fifteen percent of its savings accounts.

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[125] Under FSLIC regulations an association's net worth requirements must be met in order for the association to accept broker deposits, if the amount of aggregate broker deposits would exceed five percent of total deposits. 12 CFR § 563.4 (1984). North Carolina does not permit broker deposits. For broker deposit policies of other insurers see Exhibit II5.

[126] Under MSSIC rules and regulations, the term "brokered savings account" is used rather than "broker deposit." <u>See</u> MSSIC Rules and Regulations § 3-706, where "brokered savings account" means any savings account, any addition to an existing savings account, or any renewal of an existing savings account for which the association has paid a sales commission to any person other than an officer, director, or employee of the association.

Under FSLIC regulations, "broker deposit" is defined as any insured account obtained, or placed through or by, a deposit broker. An insured association under FSLIC that does not meet or exceed the net worth requirement may only accept the broker deposits if the amount of the deposits does not exceed five percent of the association's total deposits. The "net worth requirement" means the greater of: three percent of all liabilities of the association, or a minimum net worth requirement set forth under FSLIC regulations, or any net worth requirement imposed on the association by FSLIC as a condition to any consent granted by FSLIC or the Home Loan Bank Board to the association. 12 CFR Section 563.4(b) (1984).

Examination; Audit and Reports

A majority of the Board of Directors of MSSIC may require an examination of a member association.[127] The cost of the examination of an association's records and affairs, including an audit, is to be paid by the association. The examination provision set forth in the MSSIC rules has no affect on the examination required to be made by the Division Director pursuant to Section 9-502 of the Code.

An association having $3,000,000 or more in assets is required to file a general fiscal report with MSSIC for each month. If an association has less than $3,000,000 in assets, it is required to file a fiscal report with MSSIC as of the last day of each fiscal quarter. The report on MSSIC form SL200 is fed into MSSIC's computer and is the basic document used by MSSIC to monitor members.

A member association is required to file with MSSIC within thirty days after receipt, a copy of a certified statement, with accompanying management letters, prepared by a certified public accountant. In addition, the association is to file with MSSIC a copy of the annual audit made by the board of directors of the association thirty days after it is completed. Furthermore, an association must file other statistical reports and information as required by the MSSIC Board of Directors. If the association fails to submit the report by the due date, MSSIC may assess a penalty in accordance with a schedule set forth in

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[127] MSSIC Rules and Regulations § 3-202.

the regulations.[128] The reports, audits, and other documents received by MSSIC are confidential, except the Division Director may request and receive information from MSSIC. In addition, the Board may disclose any information contained in the reports, audits, and other documents, which it deems to be in the best interest of the association or MSSIC.

Under FSLIC, an association is examined "periodically" and at any time that FSLIC deems necessary. In addition, when deemed advisable, FSLIC may request appraisals at the time of the examination. The association or service corporation pays the cost of the examination fee, which includes a per diem rate, cost of travel and related expenses, as well as a portion of FSLIC's overhead. The insured association also must be audited once a year. In addition, the association may be audited, including appraisals, anytime FSLIC deems advisable. A copy of the audit must be filed with FSLIC. The appraiser is to be selected by FSLIC and paid for by the association. Under FSLIC regulations[129] an association must establish and maintain complete and accurate records to be available for the examination and audit.

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128 MSSIC Rules and Regulations § 3-203(E).

129 <u>See</u> 12 CFR § 563.17-1 (1984).

FSLIC regulations also set forth a list of requirements for the examination and audit.[130] FSLIC also requires various other reports.[131]

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[130] In connection with an examination of the assets of an association or service corporation, a FSLIC examiner may make a reevaluation. If the reevaluation discloses that any asset is overvalued, the association or service corporation is to make an adjustment of the book value of such asset, establishing a specific reserve in an amount equal to the overvaluation. 12 CFR § 563.17-2 (1984). For examination and audit requirements of other insurers see Exhibit II5.

[131] FSLIC requires reporting a change in control of an association. FSLIC regulations set forth the contents of reports that are to be filed by a mutual association when there is a change in control. 12 CFR § 563.18-1 (1984). A "change in control," as to a mutual association, means the power, directly or indirectly, to direct the management or policies of the association. <u>If there is any doubt as to whether a change in control has occurred, the doubt is to be resolved in favor of reporting to FSLIC.</u>

In the case of a stock association, a report is required to FSLIC whenever any person, partnership, corporation, trust, or group of associated persons acquires, receives, or becomes the holder of 10% or more of the outstanding shares of any class of voting stock or voting rights. FSLIC regulations set forth the required contents of reports in the case of change of control of a stock association. 12 CFR § 563.18-1(b)(2) (1984). <u>See</u> 12 CFR §§ 563.18-1 to 563.18-3 (1984), where there are civil penalties for failure to abide by the reporting requirements with regard to change in control.

When there is a change of control and if within a certain time period before or after that change, there is a replacement of the chief executive officer or any director, a report of the change must be filed with FSLIC. FSLIC may also require the association to provide such other reports as are necessary or appropriate for the protection of investors or FSLIC.

Under MSSIC Rules and Regulations § 3-218, an association must notify MSSIC of the resignation and/or election of any director within 15 days after the effective date of the resignation and/or election.

Advertising Restrictions

MSSIC's bylaws provide that a member association may advertise itself as a member of MSSIC and may use the approved emblem in its advertising, as long as it is a member.[132] An association is not to use advertising or make any representation which is inaccurate, or in any way misrepresents its services, contracts, investments, or financial condition.[133] Similarly, under FSLIC, an insured association cannot use its advertising to make any representation which is inaccurate or which in any way misrepresents its services, contracts, investment, or financial condition.[134] Furthermore, under FSLIC an association cannot advertise or hold itself out to the public as a "commercial bank."[135]

FSLIC reserves the right to prescribe the form in which the insurance of accounts may be advertised.[136] An insured association may advertise itself as "a member of the FSLIC." The representation to the public under MSSIC is similar to FSLIC, but MSSIC regulations add that any member of MSSIC may advertise its membership in MSSIC in the following language: "Each savings

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132 MSSIC Bylaws § 2-801.

133 MSSIC Rules and Regulations § 3-207.

134 12 CFR § 563.27 (1984).

135 It is questionable whether Merritt Commercial Savings and Loan Association could have used the term "commercial" under FSLIC regulations.

136 12 CFR § 563.30 (1984).

account of this association is insured up to $________ dollars by the Maryland Savings-Share Insurance Corporation, a corporation created by the laws of the State of Maryland."[137]

Cease and Desist Orders

If seventy-five percent of the board of directors of MSSIC agree, a cease and desist order may be issued if a member engages in or is about to engage in an unsafe or unsound practice, or is violating, has violated, or is about to violate a law, rule, or regulation of the State of Maryland or MSSIC, or certain conditions imposed in writing by the MSSIC board.[138] A cease and desist order may require the association and its directors, officers, employees, and agents to take affirmative action to correct the conditions resulting from the violation.

If seventy-five percent of the MSSIC Board determines that the violation or threatened violation is likely to cause insolvency of the association or substantial dissipation of the assets or retained earnings of the association, or is likely to seriously prejudice the interests of MSSIC, the Board may issue a temporary cease and desist order which is effective upon service as enforceable pending the administrative proceedings. The Board also may suspend officers and directors from participating in the affairs of an association for the association's protection. If a member association violates the provisions of a temporary or

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137 MSSIC Rules and Regulations § 3-207.

138 Id. § 3-222.

permanent cease and desist order, the association is subject to a fine as well as the removal of directors, officers and other persons as determined by MSSIC.

Expulsion and Withdrawal of Association from MSSIC

MSSIC may expel a member association if (1) it is violating any provisions of Maryland law; (2) it is conducting an unsafe or unsound business practice; (3) it is in violation of any of the bylaws, rules, or regulations of MSSIC, or (4) it has had any insurance terminated by FSLIC.[139] If MSSIC is contemplating expulsion of a member association, it will furnish the association a statement outlining the violations. The member association has thirty days to resolve the problem. If a satisfactory correction has not been made, the MSSIC Board of Directors may grant the association an additional thirty days to correct the problem. A hearing will be held and the member may be expelled upon the affirmative vote of seven members of the Board of Directors. The association, upon termination, is required to notify its depositors, and if it fails to do so, MSSIC will do so at the member's expense.[140]

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139 MSSIC Rules and Regulations § 3-601.

140 Id. §§ 3-602, 3-603, and 3-604. PSAIC generally follows MSSIC's expulsion procedure. PSAIC Rules and Regulation VI §§ 1-4. The board of trustees of FIAC may, by the affirmative vote of two-thirds of the entire board, terminate the member's membership in FIAC. The member must notify its depositors of the termination. FIAC Standards and Procedures Article VI § 2. See Exhibit II5.

E. MARYLAND'S RESPONSE TO FEDERAL DEREGULATION AND CHANGING ECONOMIC ENVIRONMENT

Maryland reacted to the federal deregulation of investments and the changing economic environment with deregulation of its own. A variety of bills was introduced in the General Assembly sessions from 1979 to 1985 which sought to confront the economic problems facing savings and loan associations and concomitant problems facing regulators. By and large, the industry found the regulators cooperative and the legislators responsive. Often, bills which would have tightened regulation were rejected and those which increased savings and loan powers passed. The following is a summary of some of the pertinent legislation introduced in that period, along with its fate. As a result of this legislation, Maryland state-chartered associations had the ability to exercise broad investment powers, including the ability to make direct equity investments. These broad investment powers in conjunction with access to brokered funds proved to be an exceptionally volatile combination.

1979
<u>House Bill 1579 - Federal Insurance</u>

Delegate Idamae Garrott introduced House Bill 1579 in the House of Delegates on February 16, 1979. House Bill 1579 required all banks, savings and loan associations as well as credit unions to be federally insured under the applicable federal agency. It was Delegate Garrott's opinion that public confidence would be greatly enhanced and depositor's would have greater guaranty of security of their funds if all accounts were required to have federal insurance. She was of the opinion that some depositors when they made their deposits in MSSIC insured savings and loan associations were not aware of the fact that they were opting for "private insurance" in spite of posted notices. It was also her opinion that with MSSIC the risk was not as widely spread as it was with FSLIC insurance. Delegate Garrott noted that while FSLIC did not have, at the time, the full faith and credit of the United States Government behind it, it did have statutory authority to borrow up to $750,000,000 from the U.S. Treasury. She also noted that MSSIC did not have the full faith and credit of the state behind it. Opponents of the bill included Charles H. Brown, Jr., Charles H. Kresslein, Jr., Robert L. Stocksdale and Harry B. Wolf, Jr.

The Maryland Department of Licensing and Regulation also opposed Delegate Garrott's bill. In a memorandum dated March 6, 1979 to the House Economic Matters Committee[141] it was noted that the savings and loan associations accept deposits from their customers and reinvest those deposits "almost exclusively" in first mortgages secured by residential property, noting that losses in this type of lending are very rare. The memorandum further provided that "no one who has deposited money in a MSSIC-insured association has lost a dime, and this insurance corporation is very capably managed." The memorandum noted that the Division works closely with MSSIC in monitoring the affairs of

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[141] See Department of Licensing and Regulation memorandum, March 6, 1979, Exhibit II6.

the state-chartered savings and loan associations. It also noted that MSSIC-insured institutions were not subject to federal rate control (Regulation Q) and therefore may pay depositors whatever their earnings permit. The memorandum indicated that a change to FSLIC insurance would for all intents and purposes eliminate the rate differential offered by MSSIC-insured associations.

In a letter to Delegate Rummage, Harry B. Wolf, Jr., then Executive Vice President of MSSIC, stated "If H. B. No. 1579 is passed by the legislature and becomes law, it will have catastrophic effect on the state chartered industry." Mr. Wolf stated he was concerned with the monopoly that would be created for the Federal Home Loan Bank Board and FSLIC if the bill were enacted into law. He noted that there is an interchange of information between the Division and MSSIC so that reports and information vital to the operation of the industry were shared by the two organizations. Mr. Wolf also noted that MSSIC institutions were not subject to rate control and therefore were able to pay a greater rate differential than FSLIC insured associations. Furthermore, according to Mr. Wolf, a number of associations operating in Maryland would be forced to close since they would not be able to comply with FSLIC regulations i.e., be in operation five days a week and operate from a ground floor independent office.

On March 8, 1979 the Economic Matters Committee voted unanimously, twenty-six to zero, against House Bill 1579, with two absentees. The unified opposition of the Division and MSSIC to Delegate Garrott's bill was critical to its failure. In opposing the bill, the Division was clearly operating as a representative of the savings and loan industry itself rather than a regulator. A a true regulator of savings and loan associations in 1979 had no interest whatsoever which would have been adversely affected by the federal insurance requirement.

1980
House Bill 1242 - Reserves

House Bill 1242 was introduced by the Chairman of the Economics Matters Committee of the House on February 8, 1980. The purpose of the bill was to permit the Board of Commissioners to waive the requirement of allocating five percent of profits to the reserves of a savings and loan association when doing so was with good reason and the public interest was "adequately protected." Charles H. Kresslein, Jr., on behalf of the Maryland Savings and Loan League, testified in favor of the bill. The bill was also supported in a memorandum dated March 4, 1980, by John J. Corbley, Secretary of the Department of Licensing and Regulation. Under the current law at that time, the Board could grant a waiver if the association met the six percent reserve fund requirement. The proposed amendment provided the Board with authority to waive the reserve allocation irrespective of the fact that the association had not met the six percent reserve requirement. The House Economics Matters Committee voted against the bill and it was not passed.

1981

House Bill 481 - Termination of Membership in MSSIC

House Bill 481 was introduced on January 16, 1981, by the Chairman of the banking subcommittee. The bill authorized the MSSIC Board of Directors to order a member to correct a situation or terminate the association's membership under certain circumstances and generally related to the termination of membership in MSSIC. The thrust of the bill was to require MSSIC to secure the approval of the Division Director before it could revoke the membership of any association. The bill was apparently prompted by a comment in a sunset evaluation report of the Division which indicated that the Division and MSSIC did not always agree on different issues.

On February 18, 1981, Charles C. Hogg, II, Executive Vice President and Chief Operating Officer of MSSIC, stated his opposition to the bill. Hogg noted that the law provided for a free exchange of information between MSSIC and the Division and that the rules and regulations of MSSIC already provided for notice, hearings and procedures regarding termination of insurance. Furthermore, Hogg noted the changes that were taking place in the regulatory and economic operating environment, stating that there was a need for MSSIC to be "prepared to act responsibly and decisively if necessary to protect the public interest."

Harry B. Wolf, Jr., also appearing on behalf of MSSIC, testified that the bill was not needed since the bylaws and rules and regulations provided for "ample protection" of membership in

MSSIC and termination of insurance may not be "arbitrary and discriminatory." Mr. Wolf pointed out that the MSSIC bylaws, rules and regulations could not be revised without the approval of the Division Director pursuant to Subsection 10-111(b)(1) of the Code. Mr. Wolf believed that if the bill were enacted the Division Director would then have direct control of MSSIC, since the power to terminate insurance is an important weapon that MSSIC has to assure compliance with its bylaws and rules and regulations.

Charles H. Kresslein, Jr. also opposed the bill. The Department of Licensing and Regulation took no position on the bill.

On March 3, 1981, House Economic Matters Committee voted sixteen against, three in favor, with three absentees.

House Bill 1645 - Exemption from DIDMCA

House Bill 1645 was introduced by Delegate Ficker on February 13, 1981. The purpose of this bill was to exempt certain loans made in Maryland from certain provisions of the Federal Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). Under this bill, Maryland would override the federal preemption of Maryland's limitation on the rate of interest that may be charged effective July 1, 1981. DIDMCA, affecting state-chartered, federally insured savings and loan associations, established maximum rates of interest that such associations could charge and preempted any state provision that prescribed a rate ceiling below those set forth in those sections. However, the Act in part provided that any state could override these provisions by adopting the law that explicitly stated that the state did not wish the federal interest ceilings to apply. The Economic Matters Committee of the House voted nineteen against, two in favor of, with one absentee.[142] The bill was referred to the "summer study" by the House Economic Matters Committee on March 10, 1981.

Senate Bill 1047
Board of Commissioners Composition

Senate Bill 1047 was introduced by Senator Steinberg, by request, on February 23, 1981. The purpose of the bill was to alter the composition of the members of the Board of Commissioners. The bill increased from three to four the number of industry members on the Board who must have a minimum of five years experience as officers, directors, or attorneys for Maryland savings and loan associations insured by MSSIC. The bill also reduced from two to maximum of one the number of industry members serving on the Board with similar experience with Maryland savings and loan associations insured by FSLIC. W. Thomas Gisriel, Chairman of the Board of Commissioners opposed the bill. The Economic Affairs Committee of the Senate voted unanimously against the bill.

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142 See also Senate Bill 1005, a similar bill introduced by Senators McGuirk, Malkus, Bonvegna, Cushwa, Dorman and Kramer which also received an unfavorable report.

1982
Senate Bill 325 - Savings and
Loan Associations - Investments (Enacted)

Senate Bill 325 was introduced by Senator McGuirk on January 14, 1982. This bill provided that Maryland savings and loan associations could invest in deposit obligations of insured financial institutions in Maryland or other states, provided that total deposits in all branches of the investing association exceeds an amount equal to $100,000 times the number of state-chartered savings and loan associations in Maryland.

W. Thomas Gisriel testified against the bill on behalf of the Board of Commissioners. Michael G. Bosley, representing Fairfax Savings Association, testified in favor of the bill. Eugene Hettleman, representing Merritt Savings and Loan Association, and W. Robert Wolf, representing Friendship Savings and Loan Association, were also proponents of the bill.

In testimony at the hearing before the House Economic Matters Committee on Senate Bill 325, Charles H. Brown, Jr., Division Director, indicated that the Department of Licensing and Regulation was taking a "no position" on the bill. He stated his testimony was merely to give the House Economic Matters Committee some background information on the bill. Brown testified that in order for associations to keep themselves in a liquid position, they have found that they could invest funds in associations out-of-state at a higher rate of return than can be received in the State of Maryland. Brown recommended that the committee in considering the bill decide as to whether or not it desired associations to invest funds out-of-state as opposed to keeping funds in state. Brown noted that deposits can be made in banks in or out-of-state if the banks are insured by FDIC.

The Economic Affairs Committee on February 10, 1982, voted on the bill, with amendments, seven in favor, with two absentees. Final Senate passage of the bill was forty in favor, three nonvoting, and four against.

On March 29, 1982 the House Economic Matters Committee voted seventeen in favor of the bill with five absentees.

Final House passage of the bill was eleven in favor, and thirty nonvoting.

The Attorney General, in a letter to Governor Hughes on May 3, 1982, approved Senate Bill 325 for its constitutionality and legal sufficiency and it was signed into law.[143]

Senate Bill 353 - Savings and Loan Associations - Alternative Mortgage Instruments

Senate Bill 353 was introduced by Senators Stone, Connell, Miller, Smelser, Stroble on January 18, 1982.[144] This bill provided that the Board of Commissioners was required to establish maximum and minimum interest rate adjustments, indexes to be used to determine interest rate adjustments, frequency of interest rate adjustments, the manner of amortization, and disclosure requirements with regard to a mortgage not offered by

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143 See Md. Fin. Inst. Code Ann. § 9-419(a)(11) (1983 Supp.), where this law was later modified effective July 1, 1983.

144 Numerous other bills, with similar purposes, had been introduced in the past all receiving unfavorable reports.

an association other than a direct monthly reduction of principal plan that has a fixed interest rate, level payments and full amortization.

The Board of Commissioners had attempted to adopt regulations implementing Section 9-421 of the Code, dealing with the regulation of alternative mortgage instruments. It was advised by the antitrust division of the Attorney General's office that the Board's statutory authority to regulate certain aspects of alternative mortgage instruments was unclear and involved substantial antitrust concerns best resolved by clarification of the enabling statute. The Board was advised that any attempt to place regulatory limitations on interest rate fluctuations on alternative mortgage instruments without sufficient statutory authority would involve price fixing.[145] The Attorney General's office assisted the Department of Licensing and Regulation in drafting Senate Bill 353 to alleviate the antitrust problem.

The Department of Licensing and Regulation supported the enactment of Senate Bill 353 believing it was an important part of the Board of Commissioners' ability to regulate the future course of business in state-chartered associations. It was the opinion of the Department of Licensing and Regulation that lenders viewed the alternative mortgage instrument as a way to protect the association from high interest rates and high

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[145] See 65 Op. Att'y. Gen. 13 (1980), where the Board of Commissioners would violate antitrust laws if it were to adopt a uniform schedule of rate ceilings, under § 9-405 of the Code, specifying the maximum dividend or interest rates that state-chartered savings and loan associations would be permitted to pay on savings certificate accounts and other types of fixed term accounts.

inflation. However, an alternative mortgage instrument, in the opinion of the Department, which was not subject to some constraints as to a maximum interest rate adjustments could cause hardships on borrowers. In a fiscal note attached to the bill the Department of Fiscal Services noted that any additional work created could be absorbed by the Department of Licensing and Regulations' existing staff funding. The Economic Affairs Committee voted on February 10, 1982, six in favor (with amendments), with three absentees. The Economic Matters Committee on April 9, 1982, voted seven in favor, seventeen against, with three absentees and, consequently, it was not passed.

Senate Bill No. 807 - Investments (Enacted)

Senate Bill 807 was introduced by Senator McGuirk on February 12, 1982. The purpose of this bill was to permit a savings and loan association to invest its funds in the same type of investments that are permitted to banking institutions in Maryland provided that the same conditions were met. The Department of Fiscal Services in its "fiscal note" on the bill stated the Division indicated that the bill would not affect state finances since it pertained only to decisions on the part of savings and loan associations with respect to investments. The note also indicated that no new administrative or regulatory responsibilities would be created for any state agency. Division Director Charles H. Brown, Jr. and Robert Freedman, an attorney for savings and loan associations, spoke in favor of the bill.

The purpose of this bill was to permit savings and loan associations to have lending and investment authority to maintain their profitability.

The Senate Economics Affair Committee on March 17, 1982, voted eight in favor (with amendments) with one absentee. Final Senate passage of the bill was by a vote of forty-one in favor, three opposed (Senators Cade, Helton and Lapides) and three nonvoting. The House Economics Matters vote on this bill was fifteen in favor, with seven absentees. Final House passage of the bill was ninety-five in favor and forty-six not voting. The bill was signed into law by Governor Hughes and became Section 9-419(a)(19) of the Code.

1983
House Bill 284 -
Savings and Loan Associations - Investments (Enacted)

House Bill 284 was introduced by Delegate Rummage on behalf of the Department of Licensing and Regulation on January 26, 1983. This bill authorized state-chartered savings and loan associations to invest in the deposits of certain insured financial institutions. The bill permitted deposits in any other financial institution as long as the deposits were insured by either FSLIC, MSSIC, and any other insurer that was a member of the National Association of State Savings Insurers, the Maryland Credit Union Insurance Corporation, or the National Credit Union Share Insurance Fund.

The bill was amended to add new subsection 9-419(c) to the Code. Subsection 9-419(c) provided that Section 419 of the Code did not prohibit a state-chartered savings and loan association from making any investment that is permissible for a federal savings and loan association. The House Economic Matters Committee voted on February 25, 1983 unanimously in favor of the bill. The Senate Economic Affairs Committee voted on April 1, 1983, unanimously in favor of the bill with "minor" amendments. The Bill was effective July 1, 1983.

1984
House Bill 1130 - MSSIC - Election of Directors

House Bill 1130 was introduced by Delegate Scannello, by request, on February 3, 1984. The purpose of House Bill 1130 was to require that each elected director of MSSIC be representative of a MSSIC member whose net worth was not less than four percent of the association's savings accounts. If the net worth of the Director's association fell below 3.75%, he would cease to be a MSSIC Director. In addition, the bill provided that elected MSSIC directors must have the qualifications determined by the member association, in addition to being a Maryland resident and registered voter.

George Pierson, a member of the MSSIC Board, William Kuethe, a member of the MSSIC Board, and James Otto, representing Saint Casimirs Savings and Loan Association, were in favor of the bill. James D. Laudeman, member of the MSSIC Board, John

Corbley, Secretary of Licensing and Regulations, Charles H. Brown, Jr., Division Director and Charles C. Hogg, II, from MSSIC, opposed the bill.

On February 24, 1984 the House Economic Matters Committee voted seventeen against, one in favor, with five absentees.

Senate Bill 576 - Savings and Loan
Associations - Removal of Director or Officer

Senator Connell, on behalf of the Department of Licensing and Regulation, introduced Senate Bill 576 on February 3, 1984. This bill would have empowered the Division Director to warn and remove a director or officer of a savings and loan association for engaging in an unsafe or unsound practice. Under the bill, after giving the officer or director an opportunity to be heard, if the unsafe or unsound practice continued the Division Director, with the approval of the Secretary of Licensing and Regulation, could remove the officer or director.

The individual affected by the removal order could appeal to the Board of Commissioners. The bill if enacted would have been effective July 1, 1984. On August 15, 1983, John C. Cooper, Assistant Attorney General, gave his opinion that the bill, if enacted, would be valid under federal and state constitutional provisions and court decisions. The Division Director at the time this bill was introduced had no power to remove directors or officers of associations who engaged in unsafe or unsound practices.

The proposal paralleled powers given to the Bank Commissioner under Section 5-801 of the Code. The Federal Home Loan Bank Board also had authority to remove officers and directors of federal associations.

Charles H. Brown, Jr., on behalf of the Division and Charles C. Hogg, II, on behalf of MSSIC, supported the bill. Senator Dennis, supported the bill with amendments which were not directed at changing its substance regarding removal. Specifically, amendments were offered by Senator Dennis to current Section 9-306 dealing with financial statements and to Section 9-426 which would have restricted the size of a deposit that one MSSIC insured institution could place in another MSSIC insured institution. Charles H. Brown, Jr., in a letter dated February 28, 1984, to Senator Connell, referred to the suggested amendments submitted by Senator Dennis with respect to Senate Bill 576. Brown believed that some of the amendments proposed by Senator Dennis could be controversial and could result in Senate Bill 576 failing to pass. He did, however, note that some of the issues raised by Senator Dennis had merit and should be addressed by means of a special joint task of the legislature.

On February 20, 1984, in a fiscal note, the Department of Fiscal Services advised that passage of Senate Bill 576 would not materially affect the work load of the Division and would have no effect on State institutions.

On March 2, 1984, the Senate Economic Affairs Committee voted to "hold" the bill. On March 15, 1984, the Senate Economic Affairs Committee voted six to three against Senator Dennis' amendments. By a unanimous vote of the Senate Economic Affairs Committee referred Senator Dennis' amendments to the Joint Committee on the Savings and Loan Industry for an interim summer study. The Senate Economic Affairs Committee then unanimously voted in favor of Senate Bill 576.

On April 4, 1984, the House Economic Matters Committee voted nineteen to one with three absentees, against Senate Bill No. 576. House Economic Matters Committee referred the entire bill to the summer study.

Senate Bill 949 -
Savings and Loan Associations - Investments

Senator Mitchell introduced Senate Bill 949 on February 17, 1984. The purpose of this bill was to repeal Subsection 9-419(c) of the Code, which provided that state-chartered savings and loan associations were not prohibited from making any investment that was permissible for a federal savings and loan association. The passage of Subsection 419(c) arguably greatly expanded the investment powers of state-chartered associations and deprived the Board of Commissioners of the power to regulate investments that were authorized for federal associations. Thomas Gisriel, Chairman of the Board of Commissioners, was in favor of the bill.

March 28, 1984, the Economics Affairs Committee voted seven against, and two in favor of the bill and it consequently failed.

Joint Subcommittee on the Savings and Loan Industry

The Joint Subcommittee on the Savings and Loan Industry was co-chaired by Senator Howard A. Dennis and Delegate Diane Kirchenbauer. On August 15, 1984, the Joint Subcommittee issued a report summarizing the issues considered by the subcommittee and made recommendations which the subcommittee submitted to the Senate Economic Affairs Committee and the House Economic Matters Committee.

The subcommittee recommended that the Economic Affairs and Economic Matters Committees approve Senate Bill 576 that was introduced in the 1984 session of the General Assembly and that the bill be introduced again during the 1985 session. It noted that the limited enforcement power in the law at that time was useless because a savings and loan association may be sound and well managed, except for the misconduct of one officer or director. In addition, the appointment of a conservator was too drastic a remedy, since it implies that the savings and loan is poorly managed or insolvent. The Subcommittee noted that such an implication could cause a run on the deposits in a generally healthy savings and loan association and ultimately jeopardize its solvency. It was the opinion of the Subcommittee that Senate Bill 576 would allow a Division Director to cure minor problems without destroying public confidence in the institution.

The Subcommittee also recommended that the Division Director be given the power to issue cease and desist orders similar to those vested in the Banking Commissioner.[146] It noted that both Charles H. Brown, Jr. and Charles C. Hogg, II had testified that it was necessary that the Division Director possess effective immediate enforcement powers which would not cause public loss of confidence in the affected association.

The Subcommittee also recommended that Subsection 9-419(c) of the Code be revised to allow a state-chartered savings and loan association to make the same investment as a federally-chartered savings and loan association but that such an investment would be subject to the regulations of the Board of Commissioners.[147] The Subcommittee noted with concern that thirteen of the 115 state-chartered savings and loan associations were accepting brokered savings accounts on a large scale. It was noted by the Subcommittee that the Attorney General had expressed some doubt as to how far the state's regulatory authority could go under current law. The Attorney General had a concern that proposed regulations governing brokered accounts might violate antitrust laws.

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[146] See Md. Fin. Inst. Code Ann. § 5-808 (1985 Supp.).

[147] As a separate subsection, rather than existing under Subsection 9-419(a) of the Code, Subsection 9-419(c) was not subject to any state regulatory jurisdiction. Section 9-419(a) does not prohibit certain types of investments, but rather it authorizes investments subject to the regulatory authority of the Board of Commissioners. See Exhibit II7.

The Subcommittee also advised that the Economic Committee study the issue of examiner salaries at the Division to attempt to arrive at a resolution to retain qualified examiners. It suggested using the franchise tax against savings and loan associations to pay for increased salaries and instituting a per diem change for the examination. The Subcommittee also recommended that an association's statement of financial condition be provided to any <u>person</u>, not just a member, who requested it.

<u>1985</u>

As a result of the recommendations of the Joint Subcommittee, a package of legislation was submitted to the 1985 General Assembly.

House Bill 596 and Senate Bill 109 conferred antitrust immunity on the Board of Commissioners for any restrictive actions which it would take in regulating savings and loan associations. The Senate Bill was enacted and the duplicate House Bill was vetoed.

House Bill 334 and Senate Bill 112 required the Division Director to warn an officer or director of a savings and loan association if he was engaging in an unsafe or unsound practice. The Board of Commissioners was granted the power to remove the director or officer of the association if that person continued to engage in an unsafe or unsound business practice after the written warning. The Senate Bill was enacted and the duplicate House Bill was vetoed.

Senate Bill 111 and House Bill 333 authorized the Division Director to issue cease and desist orders for unsafe or unsound business practices. The House Bill was enacted and the duplicate Senate Bill was vetoed.

Senate Bill 110 and House Bill 335 required savings and loan associations to make publicly available their annual financial statements. The House Bill was enacted and the duplicate Senate Bill was vetoed.

Despite attempts to make the legislation "emergency legislation," in order to have the new laws effective March 1, 1985, the effective date of the legislation was July 1, 1985.

Finally, House Bill 1609 was introduced by Delegate Connelly on February 11, 1985. It would have required MSSIC and its members to disclose in any advertising that MSSIC is not a corporation of the State and that MSSIC is not backed by the faith or credit of Maryland. Because of pressure from the Division and MSSIC, it was withdrawn.

F. THE OPERATION OF THE DIVISION AND MSSIC

In operation, MSSIC and the Division cooperated extensively in the exchange of information and in the joint regulation of savings and loan associations. As a matter of practice, Division examiners who were conducting an examination periodically wrote memoranda concerning problems they discovered which were shared with MSSIC. They also discussed problems with the MSSIC staff on an ongoing informal basis. When the examination field work was completed and "exit interviews" were conducted with the association's management, MSSIC staff members were invited to attend and, consequently, heard the criticisms directed at management and management's response.[148] MSSIC was also provided with a copy of the examiner's comments in their final form and any supervisory letter sent to the association by the Division.

During the course of examinations, MSSIC personnel often joined Division examiners and "spot checked" certain areas. MSSIC also provided the Division with copies of reports that it generated in examining associations. A representative of the Division attended MSSIC board meetings on a regular basis and, for a period of time, the Membership Committee meetings also. MSSIC representatives attended Board of Commissioners' meetings,

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148 Brown transcript of October 30, 1985, pages 147-9.

including the executive sessions. The minutes demonstrate that MSSIC representatives frequently contributed to Board of Commissioners' deliberations.[149]

MSSIC and the Division's cooperation also extended to its attempts to manage problem associations. Charles C. Hogg, II, Paul V. Trice (MSSIC's Chief Operating Officer and Vice President, respectively), and Charles H. Brown, Jr. (Division Director), and William LeCompte (deputy director) consulted on a regular basis regarding steps to take with problem associations. They frequently held joint meetings, with MSSIC's attorneys present, to discuss steps to take in resolving problems with associations. Division personnel, like MSSIC management, relied on the advice of MSSIC's counsel.[150]

The MSSIC board minutes reflect that, on one occasion, MSSIC became extremely concerned about the Division's delay in providing it with a copy of an examination of First Progressive Savings and Loan Association (First Progressive).[151] Trice reported that the examination would not be released. Division employees have denied advising Trice that the report would not be released and Trice does not recall having been so advised or where he received this information. Additionally, Trice admitted that the substance of the report was known to MSSIC staff because of the interim information provided on an informal basis since

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[149] Brown transcript October 29, 1985, page 35, 36.

[150] Brown testimony October 29, 1985, page 37, 87.

[151] MSSIC Membership Committee minutes September 12, 1984, Exhibit II8.

the examination was performed in the field, including memoranda which set forth the major concerns of the examiners. MSSIC employees have acknowledged that virtually every paper at the Division was available to them, if they asked for it. Additionally, the SL200's which were submitted to MSSIC on a monthly basis from each association were also submitted to the Division. MSSIC also supplied the Division with various copies of its computerized reports.

Finally, MSSIC and the Division directly cooperated in counseling with the management of various associations. They repeatedly had joint meetings with associations, such as Old Court Savings and Loan Association, First Progressive, and Merritt Commercial Savings and Loan Association, during which MSSIC and Division regulators took a mutual position in criticizing management for past practices and in attempting to obtain agreements to correct those practices. In short, they operated as if the information of each also belonged to the other. They endeavored to jointly exercise the powers that either entity had in the regulation of associations.

Division and MSSIC Exercise of Powers

In sworn testimony, Brown acknowledged that he had the power, as Director, to issue violation orders to associations which violated state laws or regulations, to order audits of associations at their expense, to order appraisals of assets at an association's expense, to disapprove new branch applications and, through the Board of Commissioners, to institute conservatorship or receivership proceedings. He admitted that he also had the power to disapprove insider loans, but he believed that, if the loan was approved by the directors of an association and supported by an appraisal, he could not arbitrarily disapprove it. In fact, he automatically approved such loans. Finally, Brown acknowledged that he had considerable "jawboning" power by virtue of threatening to use his powers or jointly threatening with MSSIC to use its powers.

Despite acknowledging the existence of these powers, Brown seldom used them. He and other Division representatives have contended that their powers were lacking because they did not have the power to remove officers and directors or issue "cease and desist orders." As a consequence, they contend, their choice was between meaningless "wrist slapping" powers and the drastic power of conservatorship or receivership. They state that conservatorship or receivership often would be inappropriate where an association itself was in acceptable condition but an officer's or director's behavior warranted some form of sanction.

The Office of Special Counsel believes that the powers enumerated in Title VIII of the Financial Institutions Article, although lacking in some respects, were substantial. For instance, pursuant to Section 8-401, the Division Director could issue an order to compel a savings and loan association to comply with its charter, bylaws, any applicable law, or any rule or regulation of the Board of Commissioners. If properly exercised, such orders would be tantamount to cease and desist orders, directing associations to comply with rules and regulations of the Board of Commissioners, thereby ceasing unlawful activity. Such orders were seldom if ever used. Our review of the files of the Division reveals that, from 1978 through April 1985, it issued violation orders to First Progressive (in 1978), Security Savings and Loan Association (in 1980 which was withdrawn), and Fairfax Savings Association (in 1981).[152] No other violation orders were issued.

In testimony, Brown and LeCompte admitted that they were confronted with numerous regulatory violations, many of which are described in Section III of this Report. The regulators were afraid to institute conservatorship or receivership proceedings or issue violation orders because of a fear that a run would start in the savings and loan industry, even as far in the past as 1981. The fear of a run was a general feeling among the regulators. They acknowledged that the Federal Home Loan Bank Board closed savings and loan associations, including Fidelity Federal Savings and Loan Association in Baltimore in 1982, without causing runs on the savings and loan industry. They contend that the closing of federal associations does not cause runs because the public knows the federal government's full faith and credit is behind the FSLIC insurance and because they close associations over the weekend and open them for business on Monday morning, guaranteeing that depositors can withdraw their money. Brown and other Division representatives did not discuss their fears that taking enforcement action would create a run with any economists or anyone at the Federal Home Loan Bank

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[152] See schedule of Division orders, Exhibit II9.

Board. They did not enlist any federal assistance by expert consultation or otherwise when confronted with associations which violated state rules and regulations. The origin for their fears was the closing of an uninsured association in Mississippi in approximately 1978, which caused a run on the state's entire privately insured savings and loan industry.[153] Brown did not advise any higher state officials that he felt that he could not enforce state laws and regulations because to do so would cause a run on the industry.

Brown also acknowledged that, periodically, Division examinations reported facts which created a suspicion of criminal activity. He acknowledged that he had at all times an Assistant Attorney General available to consult with but he seldom reported matters to him. He trusted the Assistant Attorney General and they "worked well together." If an examination showed that a crime had been committed but the response to the examination showed the situation had been rectified, however, the Division would do nothing about it until the next examination when it would be "followed up." Brown stated that they did not have the manpower to follow up on apparent criminal activity and report it to the Attorney General.[154] Division examiners frequently urged Brown and LeCompte to report matters to the Attorney General's office. Some examiners "wanted to turn everything over to the

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[153] Brown transcript October 30, 1985, page 110-115.

[154] Brown transcript October 30, 1985, page 14-16.

Attorney General." Brown testified that, because he and LeCompte were overburdened with work, apparent criminal activity was not reported.[155]

Division examiners reported that they received little, if any, feedback regarding what was done with an association following examinations which revealed substantial violations. No Division staff meetings were held from 1981 through May, 1985. Finally, Division management seldom exercised its practical "jawboning" powers with respect to associations. Although the Division viewed the institution of conservatorship or receivership proceedings as a substantial threat, the threat was seldom used.

Like the Division, MSSIC seldom used its regulatory powers which were acknowledged in testimony by Hogg and Trice. Hogg admitted that MSSIC could issue emergency cease and desist orders that were effective immediately and could issue permanent cease and desist orders. He acknowledged that they had the power to remove officers and directors, to limit or eliminate advertising, to fine associations for late reporting of financial data, to require associations with low net worth to enter into insurance agreements and to expel associations, thus putting them out cf business. He believed that he could not dictate the terms of an insurance agreement to an association which was in violation of the net worth rule but thought the agreement had to be "negotiated," allowing the association input. His counsel agreed with his interpretation. The Office of Special Counsel believes

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155 Brown transcript October 29, 1985, page 126-130.

that MSSIC Regulation Section 3-211(C)(2), which states in part "[i]f the total net worth of a member association declines to 3.00%...the member shall be required...to enter into an Insurance Agreement," together with MSSIC's other substantial powers, clearly gave MSSIC the right and power to dictate all of the terms of an insurance agreement. Finally, Hogg acknowledged that he had substantial "jawboning" power through the threatened use of his other powers.

Hogg's philosophy was to "work with" and cooperate with associations rather than to threaten them. He relied heavily on the advice of his attorneys, VB&H, in regulatory matters. Like Brown, Hogg believed that strong-armed regulatory tactics would cause runs in the savings and loan industry. He never consulted with expert economists or Federal Home Loan Bank Board representatives concerning his fears. His attorneys agreed with his theory. He also discussed his theory with Charles H. Kresslein, Jr., President of the Maryland Savings and Loan League, who agreed with him. The Maryland League is a trade association for all savings and loan associations in Maryland. He also talked with his advertising firm, Gilbert Sandler and Associates, who agreed with his theory.

From time to time, Hogg also talked to his counterparts in Massachusetts, North Carolina, Ohio, and Pennsylvania about the problems of dealing with troubled institutions but they did not tell him that closing an institution would cause a run. He consulted with Donald Beason, the Chief Executive Officer of FIAC, the private insurer in North Carolina regarding his theory of regulating savings and loan associations. Beason "had a tough approach" and "said that the insurer had to take strong action quickly" with its members. The "strong action" included "changing management, kick out the board of the institution." Hogg disagreed with Beason's approach, despite the fact that it did not cause runs in the North Carolina savings and loan industry.[156]

In essence, MSSIC was run as a trade association for state-chartered privately insured savings and loan associations. One of MSSIC's employees, Ralph Holmes, devoted a substantial portion of his time to lobbying on behalf of MSSIC and on behalf of MSSIC associations. MSSIC regularly advertised on behalf of its members and a portion of its budget was devoted to making charitable contributions to enterprises such as the Baltimore Opera and the Aquarium.

MSSIC advertised on radio, television and in print, including publications having such widespread distribution as Time and Newsweek. The advertising copy generally displayed a large reproduction of the MSSIC seal, with such featured headings as "All You Need to Know About Safety of Savings."[157] Television advertisements showed a Baltimore neighborhood street scene in the 1930's with a man walking into a savings and loan and a spokesman saying "at the heart of every neighborhood, you'll find

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156 Hogg transcript October 21, 1985, page 113-120.

157 See Exhibit II10.

a savings and loan," followed by a statement about the protection of deposits and a "zoom in" on the seal.[158] Another television spot featured a lighthouse and the following text:

> It's reassuring.
>
> You know it's always there.
>
> You can depend on it through calm straits and troubled waters.
>
> By day, a landmark of strength.
>
> By night, a comforting beacon to safety.
>
> We're the Maryland Savings Share Insurance Corporation. Look for our symbol of safety at savings and loans throughout Maryland. It means each account is insured up to $100,000.

The common feature in MSSIC advertisements was the prominence of its seal, which closely resembles the reverse, officially used side of the Great Seal of Maryland. The seal was designed by Richard W. Case and has been in use since 1962. The positions of the ploughman and fisherman are reversed on the MSSIC seal as are the positions of the Calvert arms (black and gold) and Crosslan arms (silver and red) in Lord Baltimore's coat of arms. From its inception, the MSSIC seal has created the public impression that MSSIC insurance was provided by or backed by the State of Maryland.

MSSIC officials have stated that its advertisements were designed to maintain depositor confidence and thereby the safety of deposits. They also acknowledged that the affect of the advertisements was to encourage deposits and thereby encourage the growth of MSSIC institutions.

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[158] See Exhibit III1.

MSSIC's role in assisting the growth of its members and, concomitantly, its own potential liability, was not limited to advertising. In 1976, it requested an opinion of counsel concerning its insurance limits. By statute, the insurance provided by MSSIC for each separate account was limited to an amount which "may not exceed by more than the sum of $10,000" the amount of insurance available from FSLIC.[159] The MSSIC Board, chaired by Jerome S. Cardin, majority stockholder of Old Court, had adopted a bylaw stating that its insurance limit for "each separate share account" of any association may not exceed the FSLIC limit by more than $10,000. Their purpose was to provide insurance for each separate account as it appears on an association's records, regardless of the number of accounts a single depositor had. Prior to 1976, MSSIC insurance guidelines for coverage purposes combined separate accounts with common ownership.

MSSIC's counsel, Jacques T. Schlenger of VB&H, who was also counsel to Jerome Cardin, in an opinion letter dated August 17, 1976,[160] pointed out that the statute was intended to achieve some sort of parity between the MSSIC and FSLIC insurance limits. FSLIC, through a complex set of regulations, treated various types of accounts and ownership interests as single accounts for insurance purposes. Counsel nevertheless stated that MSSIC had strong arguments supporting its definition of accounts in a manner which permitted it to insure multiple accounts of a single

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159 Md. Ann. Code, Article 23 § 161 SS(1973 Repl. Vol.).

160 See Exhibit II12.

depositor. The opinion was rendered with the reservation that, if the change in insurance were perceived as a competitive maneuver against FSLIC associations, it might be vulnerable to attack as contrary to the statutory intent of providing parity. Counsel concluded, however, that: "For the time being, however, we suggest that you defend your recent amendment as being consistent with your charter authority."

In the opinion of the Office of Special Counsel, the MSSIC bylaw was contrary to the intention of the legislature in enacting MSSIC's charter. The statute was clearly intended to give MSSIC no more than a $10,000 competitive insurance advantage over FSLIC. The impact of the opinion and MSSIC's bylaw change was that, in effect, MSSIC provided unlimited insurance. Merely by opening separate accounts, a single depositor could exceed the maximum coverage at will. If the General Assembly had intended that MSSIC provide unlimited insurance, it could have so stated in simple, direct language.

The rapid growth of member associations was stimulated by the new coverage provided by MSSIC, especially through brokered deposits. The impact on the liability assumed by the State of Maryland, through the creation of MDIF and its assumption of MSSIC's liabilities, is substantial. At Old Court, for instance, the Office of Special Counsel has estimated that approximately $87,000,000 was deposited in multiple accounts of single depositors. Over fifty percent of the deposits were from out of state. Approximately $76,000,000 of these accounts would have been uninsured under the old MSSIC bylaw. Despite numerous inquiries, the Office of Special Counsel has received no explanation as to why MSSIC, an insurer, took the extraordinary step in 1976 of voluntarily and vastly increasing its own liability. We have concluded that this step was a primary example of MSSIC acting on behalf of the industry as a trade association rather than as an insurer of depositors' accounts. Only aggressive associations which wanted to grow benefitted from MSSIC's decision.

In the view of the Special Counsel's office, the control of both the Board of Commissioners and MSSIC by representatives from the industry made it unlikely that either regulator would operate effectively. Industry control was no where more apparent than in the hiring of both the Director of the Division and the Chief Operating Officer of MSSIC. Brown, in 1975, was president of Traders Savings and Loan Association (Traders). On July 1, 1975, Traders was merged into American National Building and Loan (American National) and Brown became a vice president of American National. He became Director of the Division in February of 1976. At the time, the position was open and "several people in the industry," including Charles Kresslein, approached Brown about becoming Division Director. He expressed an interest and was nominated by the Board of Commissioners. Sources have informed the Office of Special Counsel that, because of the merger of Traders and American National, Brown's position with the surviving association was diminished and he was, in essence, "looking for a job." The industry found him one as their regulator.

Hogg was a commercial loan officer in Maryland for First National Bank of Chicago. One of his accounts was MSSIC. In the fall of 1980, he was approached by the Board of Directors of MSSIC about becoming its chief operating officer, replacing Harry Wolf. Wolf had been the chief operating officer of MSSIC for many years and certain members of the board became dissatisfied with him. He had a reputation for being "tough" with associations. The dissatisfied members believed that Hogg would be a more "flexible" regulator. As a result, they selected him to be Wolf's successor and forced Wolf to resign.

Thus, the savings and loan industry in Maryland embarked on its most challenging economic times - the 1980's - with two hand picked regulators, both subject to the control of boards dominated by the industry. The result, in the words of Lamar Heath, Executive Vice President of the Federal Home Loan Bank Board in Atlanta, based on his analysis in 1985, was that "there was no regulation in Maryland. Each association was as good or as bad as the people who ran it wanted it to be."

III. SAVINGS AND LOAN PRACTICES IN MARYLAND

A. INTRODUCTION

This section of our report discusses in detail the practices of certain savings and loan associations and describes how the Division and MSSIC, as regulators, responded to those practices. We do not comment on all 102 of the MSSIC institutions. For the most part, we have selected associations which illustrate the pattern of violations of statutes, regulations and common law fiduciary duties which comprised one of the major causes of the 1985 crisis.

B. FIRST PROGRESSIVE AND OLD COURT SAVINGS AND LOAN

The First Progressive 1978 MSSIC Cease and Desist Proceedings

First Progressive Savings and Loan Association (First Progressive) was a mutual association chartered in 1914 which had its offices at 416 North Charles Street in Baltimore City. For many years, First Progressive was run by Samuel J. Aaron, Esquire, a Baltimore attorney, out of his law office. Sometime prior to 1978, control of the association passed to Samuel Aaron's son, Albert G. Aaron, also an attorney. In 1978, Albert Aaron was president of the association, Stewart J. Greenebaum was vice president and the secretary was Jeffrey A. Levitt. Levitt was also the association's general counsel and settlement attorney.

In early 1978, MSSIC became concerned about mismanagement at First Progressive and issued, on May 25, 1978, a temporary cease and desist order pursuant to its bylaws, directing corrective action to be taken. A hearing was held before MSSIC's Board of Directors on June 28, 1978, at which a First Progressive representative appeared to answer MSSIC's various criticisms. In considering their choice of remedies, the MSSIC Board consulted their general counsel, VB&H, for advice about further steps to be taken.[1]

Two memoranda were prepared at VB&H analyzing MSSIC's statutory authority and its regulatory options. In the first, dated October 9, 1978, the facts stated were that "MSSIC desires to take action against First Progressive Building and Loan Association as quickly as possible in order to either terminate insurance or to take some other action in order to improve the management of First Progressive." The memorandum continued to describe the cease and desist proceedings brought by MSSIC and to describe the Division examination of February 28, 1978, which recently had been produced. After considerable legal analysis, the memorandum concluded that MSSIC had the power to issue cease and desist orders and to expel members. The writer recommended that "MSSIC should consider action under both sections so as to terminate insurance and act under the cease and desist section to change the management and control of the building and loan association while termination proceedings are pending."

In a follow-up memorandum, dated October 18, 1978, additional research was provided. The writer again recommended that, if MSSIC wished to take definitive action against First

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[1] See memorandum to Mr. McCarthy dated October 9, 1978, Exhibit IIIB1.

Progressive, it should initiate termination proceedings. The writer pointed out that such proceedings would pose a "very direct and great incentive to the management of First Progressive to comply with and correct any poor management practices specified by MSSIC." On the front of the memorandum, in hand writing, the words "Stewart J. Greenebaum VB&H Client" were written.[2]

Counsel for MSSIC advised MSSIC's executive vice president, Harry B. Wolf, Jr., to take no further action against First Progressive. The basis for the advice was that the Division had scheduled a hearing with respect to First Progressive in the near future and, therefore, the public interest would be protected. Additionally, VB&H cautioned that MSSIC's powers were not so clearly defined that they should be tested against First Progressive. Finally, the opinion letter cited representations by MSSIC's field examiners that a number of the unsafe and unsound practices which precipitated the original hearing had been corrected. MSSIC took no further action.[3]

VB&H believes that it disclosed its representation of Greenebaum to Wolf and obtained his consent to the dual representation. Wolf does not recall being so informed and consenting, but states that it is possible. In short, the strong legal analysis and advice with respect to MSSIC's powers set forth in the memoranda was diluted in the letter of advice

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[2] See memorandum to Mr. McCarthy dated October 18, 1978, Exhibit IIIB2.

[3] See letter from VB&H to Harry B. Wolf, Jr. dated October 23, 1978, Exhibit IIIB3.

rendered to MSSIC regarding its options with respect to First Progressive, on whose Board of Directors, the attorneys knew, sat one of their clients. It is VB&H's position that its advice was correct and uninfluenced by its dual representation.

First Progressive 1978 Division Examination

Paul R. Freeman,[4] Glen C. Berger and Charles J. Marshall, three examiners from the Division, conducted an examination of First Progressive as of February 28, 1978.[5] The examination consumed 239-1/2 man days.[6] It revealed such flagrant violations of Maryland laws and regulations that, at its conclusion, the examiners undertook the unusual step of writing a special memorandum to Charles H. Brown, Jr., Division Director, expressing their concerns. The memorandum stated, in part, as follows:

> At the completion of this examination, we had an informal meeting to discuss the findings of our examination. We unanimously concluded that the people who are currently operating First Progressive Savings and Loan Association should not be permitted to operate a savings and loan association. This statement is not made lightly as not one of us, either individually or collectively, have made such a statement before. Together, we represent over 27 years of experience as savings and loan examiners.

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[4] Paul Freeman was later hired by First Progressive and served as its managing officer.

[5] The "as of date" for an examination is the date that the books of the association are closed for examination purposes. Relevant portions of the First Progressive 1978 examination are set forth in the appendix as Exhibit IIIB4.

[6] In 1978, a normal examination for an association with $10,000,000 in assets would have taken approximately 50 man days.

> As evidenced by the previous comments, First Progressive Savings and Loan Association is not being operated in the public interest as required by Maryland law and we recommend that either a supervisory merger be effected or that a conservator be appointed. . . .
>
> Management has demonstrated a total disregard for State statutes and regulations which establish lending limitations and procedures. Due to the pervasive self-dealing which is discussed in the report of examination, First Progressive is a burden on the community which it supposedly serves.
>
> The problems noted in our examination of this association violate not only the provisions of all pertinent statutes and regulations but transcend the bounds of acceptable savings and loan practice. (emphasis supplied).

Under the standard examination section entitled "Loans Subject to Comment" four loans to Levitt were listed, all of which were at least six months delinquent in interest payments. Documents in twenty loan files disclosed that borrowers were charged for title insurance policies (for a total of $1,653.70) by the settlement attorney, Levitt, but there was no title policy in the file. The loans were all granted more than one year before the examination. The association consistently granted "loan modifications" to friends of officers and directors whose mortgages were delinquent (for up to two years) while pursuing an aggressive foreclosure policy against other delinquent borrowers.

Levitt handled foreclosure proceedings for the association. In numerous proceedings, he failed to remit the correct amount of money to the association (always too little), failed to remit on a timely basis (up to eleven months late) or failed to disburse an excess amount from the foreclosure sale to the mortgagor. In numerous real estate settlements, he inordinately delayed in turning proceeds over to the association. On one occasion, as settlement attorney, he withheld settlement funds to pay real estate taxes and certified that the taxes were paid. Sometime after the settlement, the property was sold at tax sale for unpaid taxes. On another occasion, he withheld proceeds for taxes, certified that they were paid and, fourteen months later, they were still unpaid.

The association regularly loaned money to corporations owned by officers and directors, sometimes in excess of required loan to value ratios. Appraisals were insufficient, sometimes consisting of three sentences by an officer or director who was not a qualified appraiser. The books and records of the association were in disarray and included frequent entries by Glass, Friedman and Trivas, C.P.A., which indicated that they made management decisions concerning accounting entries despite the fact that they were the "outside" auditors required to certify the annual financial statement. Directors were paid fees for directors' meetings they did not attend and the association leased its premises from its president on unfavorable terms.

In short, without stating every detail of the report, the examiners' comments in their memorandum were well-substantiated. The comments were sent to each member of the Board of Directors with a management letter from Brown, admonishing them to adhere to their fiduciary duties and giving them time to respond. The association retained counsel and filed a response. Various assurances were made that the comments would be corrected. No further regulatory action was taken and the same management was permitted to continue operating First Progressive.

1979 and 1981 Division Examinations

Through regular examinations, the Division continued to monitor First Progressive. An examination as of December 31, 1979, produced to the Board of First Progressive with Brown's cover letter of May 26, 1980, pointed out that the association was still experiencing difficulties in receiving timely and accurate title certifications and policies from its settlement attorney. The examination comments pointed out further discrepancies, including a settlement sheet which showed $3600 withheld for real estate taxes with no evidence whatsoever in the file that the taxes had been paid. Eleven of nineteen mortgage files reviewed contained mortgage instruments which were filed more than two months after the date indicated on the attorney's certificate of title, jeopardizing the association's lien priority. Several files indicated that title premiums were paid but contained no title policies. A share loan to a Levitt partnership was not paid when it was due. Additionally, the examiners pointed out that the offices leased by First Progressive from Albert G. Aaron included second floor law offices for Levitt[7]. No corrective action was taken by the Division with respect to the examination.

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[7] See examination of First Progressive as of December 31, 1979, Exhibit IIIB5.

The association was again examined by the Division as of March 31, 1981. Brown's cover letter dated November 4, 1981 to the Board of Directors stated that he was "somewhat shocked" at the association's failure to correct past violations. At this time, the officers of the association were as follows:

Albert G. Aaron - President

Harrison E. Greene, Jr. - Executive Vice-President

Paul R. Freeman - Vice President

Jeffrey A. Levitt - Secretary

Benjamin Lehman - Treasurer

Renee Portney - Assistant Treasurer

Comment 7 indicated that of twelve delinquent free share loans, nine were in Levitt's name. One of the "other assets" of the association was an account entitled "due from Jeffrey Levitt" in the amount of $81,034.95. In one transaction, settled on November 14, 1980, the mortgage was not recorded until February 5, 1981. In another, Levitt sold property to the association and acted as the settlement agent but there was no certificate of title. Bonuses were paid to the executive vice president and controller which were not approved by the Board of Directors. The books of Monumental City Service Corporation (Monumental City), a wholly-owned subsidiary of First Progressive, had not been posted beyond March 31, 1980. In April of 1980, Monumental City purchased a $30,000 second mortgage loan made to Jeffrey and Karol Levitt from Becky, Limited, a company of which Jeffrey Levitt was president. The loan had originally been granted by First Progressive on March 17, 1976 for five years and there had been no amortization of the principal. There was no appraisal, title certificate or settlement sheet in the file and the insurance policy did not name Monumental City. There were no Board of Directors minutes recording approval of the transaction. The books of Monumental City contained an entry for $10,000 in legal fees paid to Jeffrey Levitt for the year ending December 31, 1980. There was no breakdown concerning the nature of services and, pursuant to the decision of the Maryland Court of Appeals in Attorney Grievance Commission v. Levitt,[8] Levitt had been suspended from the practice of law for almost the entirety of 1980. The examination comments also pointed out that the association took excessive loan origination fees into income on loans and paid bonuses despite the fact that the association sustained a net loss.[9]

The First Progressive and Old Court 1981 Insurance Agreements

In 1981, First Progressive's net worth fell below three percent, triggering a breach of MSSIC Regulation 3-211(C)(2). This prompted MSSIC to propose an "insurance agreement" with First Progressive, pursuant to which MSSIC intended to closely monitor and control First Progressive's affairs. At the time, it was well known to Division and MSSIC personnel that First Progressive was controlled by Aaron and Levitt.[10]

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[8] 286 Md. 231 (1979).

[9] See Division examination of First Progressive as of March 31, 1981, Exhibit IIIB6.

[10] Testimony of Charles Hogg, Hogg transcript dated October 21, (footnote continued)

At the time, MSSIC's general counsel was still the Baltimore law firm of VB&H. A member of VB&H attended almost every MSSIC board meeting. Officers and employees of MSSIC consulted VB&H concerning every matter of significance to the company, and every major document issued or received by MSSIC was drafted or reviewed by their attorneys. During the time period when Charles Hogg was the Chief Operating Officer of MSSIC (1980 through 1985), VB&H was consulted by him on an "almost daily" basis.[11] VB&H, through one of its partners, Terry F. Hall, drafted the First Progressive/MSSIC Insurance Agreement.[12] At the same time, VB&H was also counsel to Levitt, a fact which was not disclosed to MSSIC.[13]

The First Progressive/MSSIC Insurance Agreement, dated December 31, 1981, required First Progressive to obtain prior approval from MSSIC before any loan to an insider was made.[14] It also required regular reporting of financial conditions at First

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(footnote continued from previous page)
1985 at 56-57. Testimony of Charles Brown, Brown transcript dated October 29, 1985 at 72-73.

11 Hogg transcript dated September 10, 1985 at 18.

12 Hall transcript 11/18/85, p. 86-87.

13 VB&H had previously represented Levitt in an Attorney Grievance Commission proceeding in which he had been accused of requiring a loan applicant to pay him cash for procuring a loan from First Progressive. They also represented Levitt in the proceeding resulting in his suspension and represented, in 1975, a partnership composed of Levitt and Greenebaum. In addition, in 1979, Greenebaum, Levitt, Pearlstein and Gerald M. Katz, a partner at VB&H, entered into a business venture together known as Emmorton Industrial Park, an industrial development in Harford County.

14 See Insurance Agreement, Exhibit IIIB7.

Progressive and that MSSIC be permitted to have a representative on the premises at any time, to monitor the operation. The agreement additionally required prior MSSIC approval of any increase in compensation for an officer or director. Under the "Remedies" section, if First Progressive violated the insurance contract, MSSIC was entitled to enter a cease and desist order without a hearing and to dismiss officers and directors. Both MSSIC and the Division relied on the Insurance Agreement to control First Progressive's activities.[15]

At approximately the same time, the net worth of Old Court fell below the MSSIC standard. A majority of the stock of Old Court was owned or controlled by Jerome Cardin who, for many years, had also been a client of VB&H. VB&H proceeded to represent MSSIC in its negotiation of an Insurance Agreement with Old Court, which was executed in July 1981.[16] Like the First Progressive Insurance Agreement, the Old Court agreement required MSSIC approval for insider loans and increases in officer compensation. It also required regular reporting of Old Court's financial condition. The remedies, however, were materially weaker in that MSSIC was not enabled to dismiss officers and directors for violations of the Insurance Agreement.

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[15] Hogg transcript dated October 21, 1985 at 63-65.

[16] The Old Court Insurance Agreement, Exhibit IIIB8.

The First Progressive Insurance Agreement was discussed at the executive session of the Board of Commissioners on January 18, 1982.[17] Hogg of MSSIC advised the Board that the agreement had been entered into and pointed out that it authorized MSSIC to effect a merger of the association. He also discussed the Old Court Insurance Agreement but stated that MSSIC did not view Old Court as a "desperate situation." William LeCompte, deputy director of the Division, mentioned that these problem associations were being presented to the Board for not being in compliance with rules and pointed out that the Board could take supervisory action. He stated, however, that the problems were being addressed and advised that he felt further Board action was not warranted. Robert Stocksdale, a Board member, asked to what extent MSSIC was directly involved in the management of these institutions. Hogg stated that MSSIC was involved to the extent of weekly or even daily monitoring, and controlled management by means of the insurance agreements but, did not directly manage the associations.

Change of Control of First Progressive

Pursuant to the Insurance Agreement, First Progressive was required to submit a management plan demonstrating that the association would be operated in a safe and sound manner. That plan was submitted by Levitt and stated that he personally would

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17 See Board of Commissioner minutes, January 18, 1982, Exhibit IIIB9.

control the operation of the association.[18] It was well known among Division and MSSIC personnel that control of First Progressive passed to Levitt and Allan Pearlstein at approximately this time. No inquiry whatsoever was made as to how control was transferred.[19] Although the Office of Special Counsel has questioned Division and MSSIC management regarding their knowledge as to how the change of control took place, no one knew the answer. Several witnesses responded that they assumed Levitt and Pearlstein "bought Aaron out," but when reminded that First Progressive was a mutual association, agreed that such a purchase would be illegal.

At the time when Levitt and Pearlstein took over control of First Progressive, Levitt was well known as the person responsible for a major portion of First Progressive's problems for a number of years in his role as an officer and counsel for the association. He had also received a one year suspension from the practice of law by the Court of Appeals.[20] The reported opinion revealed that Levitt lied in a hearing to Baltimore City

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[18] See First Progressive management plan, Exhibit IIIB10.

[19] Control in a mutual association may be obtained by depositing more than 50% of the association's savings, giving the depositor a majority of the votes. At the time, First Progressive had approximately $9,000,000 in deposits and it was well known that Pearlstein and Levitt had not deposited half that amount. Another manner of changing control in a mutual association is to sell a controlling number of proxies, which is a violation of Division Regulation 43. Although asked questions under oath concerning the change of control of First Progressive, Albert G. Aaron refused to testify, invoking his Fifth Amendment privileges against self-incrimination. See transcript of Albert G. Aaron.

[20] See Attorney Grievance Commission v. Levitt, 286 Md. 231 (1979).

Superior Court Judge Joseph H. H. Kaplan in an attempt to reverse a District Court judgment against a Levitt corporation which owned property in Baltimore City. Levitt claimed before Kaplan that he had no knowledge of the existence of the lawsuit, of the hearing date or of interrogatories filed against his corporation. He stated that he had no knowledge of the proceedings until he received the District Court card indicating that judgment had been entered against his corporation. A default judgment had been entered in District Court because of his failure to answer interrogatories.

Levitt's claim was contradicted by two return receipts of service of process signed by his secretary with his name, a letter on his stationery requesting a postponement of the hearing date, various letters to District Court by opposing counsel with carbon copies to him and a motion for sanctions, a copy of which was sent to him. Later, under oath before the Attorney Grievance Inquiry Panel, Levitt admitted that he had known about the existence of the case but stated that he was attempting to get an insurance company involved. Still later, under oath again, he denied before Judge Pines that he knew of the lawsuit before he received the judgment card.

The only dispute on the Court of Appeals was whether he should be suspended or disbarred. The majority held that he should be suspended for a year. Judge Orth, writing a dissent joined in by Judge Murphy, wrote:

> [I]t appears that Levitt was willfully dishonest, seeking personal gain by means of fraud, deceit or misrepresentation. . . . Levitt has amply demonstrated by his conduct that his word is not

to be trusted, that he is not fit to be an officer of the Court, and that he is unworthy of continued membership in the Maryland Bar.[21]

Shortly before submission of Levitt's management proposal for First Progressive, he was subjected to another Attorney Grievance Commission proceeding, this time instituted by personnel at the Division. A borrower from First Progressive complained to the Division that, upon application for a loan, he was told by Levitt that he would have to pay Levitt, personally, $5000 cash for putting the loan through. At settlement, the complainant stated, Levitt did not turn over the entire proceeds of the loan. Division personnel gathered a file and advised their assistant Attorney General who proceeded to file a complaint with the Attorney Grievance Commission. Some Division personnel appeared before the Commission but no disciplinary action was instituted.[22] At the Attorney Grievance Commission proceedings, Levitt was represented by the law firm of VB&H.

Levitt's disciplinary troubles did not end, however, with this second Attorney Grievance Commission proceeding. In March of 1981, the Court of Appeals of Maryland affirmed the granting of his motion for acquittal of criminal charges against him in State v. Levitt.[23] There, Levitt was charged with violating Article 2B Section 198 of the Maryland Code, which

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21 Id. at 244.

22 Because Attorney Grievance Commission files are confidential by statute, the Special Counsel's Office has been unable to review files concerning this complaint. Information concerning this proceeding was obtained from interviews of former Division employees.

23 48 Md. App. 1 (1981).

prohibits making false statements in any report or oath required by the State Alcoholic Beverage Law. The evidence showed that Levitt's mother owned a liquor license which was about to expire. An application for renewal was filed containing an affidavit that Mrs. Levitt had appeared before a notary and sworn that information contained in the renewal application was true. Levitt signed as notary and the evidence showed that he also forged his mother's name to the affidavit. At trial, Judge Raine of the Circuit Court for Baltimore County acquitted Levitt, apparently because Levitt was not required under the Alcoholic Beverage Law to submit any application and, therefore, there was no violation of the statute. Judge Raine went on to suggest, however, that Levitt was guilty of "forgery, guilty of conspiracy to violate the liquor laws, guilty of subornation of perjury and guilty of false pretenses. . . . Why the State did not put in four or five counts to cover the waterfront is beyond me." Thus, although the Judge believed Levitt had committed crimes, he had not committed the crime with which he was charged and the charges were dismissed.[24]

In addition to Levitt's criminal and Attorney Grievance Commission proceedings, he was generally known as a former slum landlord, who notoriously violated the Housing Codes and as an officer and the settlement attorney at First Progressive who was the subject of numerous comments in Division examinations in the past. One examiner who joined the Division in 1980 immediately

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[24] In State v. Levitt, one of Levitt's counsel was Gary Huddles, Esquire, who will be discussed, infra.

began hearing Levitt stories. He heard that Levitt played the "refinance game," having First Progressive refinance mortgages which were in default, generating fees to himself and then foreclosing on the next failure to pay, generating more fees. There was also a rumor that Levitt "pocketed" money from escrow accounts.[25]

Despite this history, MSSIC approved Levitt's management plan and approved his and Pearlstein's takeover of the management of First Progressive.[26] MSSIC's Chief Operating Officer, Charles Hogg, had no knowledge of the criminal case or two disciplinary proceedings despite the fact that MSSIC's general counsel, VB&H, had represented Levitt in the disciplinary matters[27] and despite consulting with his attorneys concerning the management plan. Thus, the man Judge Orth described as "not to be trusted" was approved as First Progressive's new chief executive officer by MSSIC with the full knowledge of the Division. The rationale expressed by Brown and Hogg was that they believed Levitt "had turned himself around."[28]

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[25] <u>See</u> interview of Art Friedman, July 19, 1985.

[26] The Division had clear knowledge of Levitt's legal problems. Their files on First Progressive contain a Baltimore <u>Morning Sun</u> article dated January 29, 1980 entitled "suspended lawyer indicted in liquor probe" summarizing the suspension from the practice of law and criminal indictment.

[27] Although it would have been a breach of their attorney-client relationship with Levitt to reveal to MSSIC any information concerning Levitt gathered from that confidential relationship, it would have been proper to advise MSSIC of the reported opinions described here.

[28] <u>See</u> Brown transcript dated October 29, 1985 at 89-92.

The change in control of First Progressive was discussed at two executive sessions of the Board of Commissioners. On February 11, 1982, Brown advised the Board that a plan of reorganization had been submitted involving new management and that Levitt was one of the principals. He further stated that he was not sure that the plan would be acceptable to either MSSIC or the Division. At the March 11, 1982 meeting, Ralph Holmes, Vice President of MSSIC, reported on the reorganization of the First Progressive Board. He stated that there was to be a $100,000 hypothecation to MSSIC and a considerable reduction in salaries at First Progressive. He further stated that the First Progressive Charles Street office would be closed by the end of 1982. William LeCompte, deputy director, stated that First Progressive's relocation from Charles Street to Westminster would result in a significant expense reduction to the association.

Levitt and Pearlstein Acquisition of Old Court

Levitt and Pearlstein wasted little time in putting the assets of their newly-controlled mutual association to use for their own purposes. By letters of September 22, 1982,[29] Levitt sought the approval of the Division and MSSIC for a $500,000 loan from Monumental City to Franklin Associates.[30] Levitt

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[29] *See* letters dated September 22, 1982, Exhibits IIIB11 and IIIB12.

[30] Franklin Associates was 50% owned by Levitt and 50% owned by Pearlstein. Approval for such insider loans by the Division was required by § 9-307 of the Code. Approval was required by MSSIC (footnote continued)

represented that the loan was to be secured by 250 acres of land in Prince George's County owned by Franklin Associates which was appraised for $5,500,000. The purpose of the loan was to enable Levitt and Pearlstein to purchase eighty-two percent of the stock of Old Court. Hogg and Brown approved the transaction.

On October 4, 1982, Levitt wrote two more letters to Brown and Hogg seeking approval of a $1,700,000 loan from First Progressive to Franklin Associates.[31] The security was the same 250 acres of land in Prince George's County. The purpose of the second loan was to provide $1,000,000 in funds to deposit in Old Court and hypothecate with MSSIC and the Division, $500,000 to repay the September 22 loan and $200,000 for "settlement purposes and balance due on outstanding stock being acquired."[32] The Division and MSSIC approved this second loan. Thus, by "borrowing" money from a mutual association of which they gained control by undetermined means, Levitt and Pearlstein were able to buy a majority of the stock of Old Court--all with Division and

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(footnote continued from previous page)
pursuant to the insurance contract with First Progressive. Franklin Associates was incorporated by VB&H.

31 See October 4, 1982 letters, Exhibits IIIB13 and IIIB14.

32 The purpose of such a hypothecation, according to Brown and Hogg, was to require the principals of an association which is in violation of the net worth requirement to have their own money pledged to MSSIC in the event that a liquidation takes place. The MSSIC and Division theory was that, if management had their own money at risk, they would be motivated to manage the association properly. Here, however, that principle was violated by permitting Levitt and Pearlstein to take $1,000,000 from one association which they controlled and put it in another, without exposing any of their own personal assets.

MSSIC approval, despite their wretched track record, and apparently without spending or putting at risk any of their own money.

At its meeting on October 11, 1982, the Board of Commissioners was advised that the stock of Old Court had been purchased by Levitt and Pearlstein by paying four dollars per share for 161,719 shares of Jerome Cardin's stock.[33] The Board was also advised that the purchasers were hypothecating $1,000,000 with MSSIC, which would increase the association's regulatory net worth and that Paul Trice, a MSSIC employee, had been hired as president of Old Court. Brown advised the Board that Old Court had requested the Board's approval to form four new subsidiaries under their wholly-owned service corporation, Old Court Investment Corporation (OCIC). New management felt that "additional efficiency and control would be gained by segregating the various different types of business currently being conducted" by OCIC. Brown also advised the Board that Old Court had requested four new certificate programs to keep the association competitive. The Board had a lengthy discussion in which several members expressed their concern over Old Court's poor financial condition and the high rates paid on deposits. The Board also discussed the "pros" and "cons" of a hypothecation and the extent to which it protected the interest of MSSIC and the Division.

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[33] See Board of Commissioners minutes dated October 11, 1982, Exhibit IIIB15.

Neither Brown nor Hogg knew that the 250 acres used as collateral for the total of $2,700,000 in loans in September and October of 1982 were not owned by Franklin Associates at the time. Franklin Associates did not buy the property until December 6, 1982. Despite the prior appraisal for $5,500,000, the purchase price was $607,000, suggesting that the loans grossly exceeded the value of the collateral. Despite the representations made in the October 4, 1982 letter concerning the distribution of the proceeds of the $1,700,000 loan, $500,000 was not used to repay the first loan. Additionally, $1,000,000 was not immediately placed into Old Court to be hypothecated to the Division and MSSIC. Instead, Levitt purchased ten $100,000 certificates of deposit with the money and held them on deposit at First Progressive, disbursing interest in monthly checks to Franklin Associates until November 17, 1983 when the money was deposited in Old Court for a subordinated debenture in favor of Levitt and Pearlstein. No portion of the $1,700,000 loan has been repaid and, through June 30, 1985, the entire principal amount plus $581,733.82 accrued interest was due. Additionally, through June 30, 1985, no portion of the $500,000 loan has been repaid. On March 12, 1984, Franklin Associates stock was sold to Leon Rudd and Gerald Gottlieb for $3,750,000, to be paid by assuming the $2,200,000 in loans from First Progressive and accrued interest with the difference paid in cash. On the same date, Old Court granted Gottlieb and Rudd a $2,000,000 loan to finance the transaction, secured, once again, by the 250 acres in Prince George's County. On February 1, 1985, Franklin Associates borrowed $541,220 from Old Court which was loaned to Karol's Landing Limited Partnership, a Levitt-controlled entity, which had $4,700,000 in previous Old Court loans. The February 1, 1985 loan was also secured by the 250 acres in Prince George's County. In March 1985, Franklin Associates was merged into FA, Inc. and, pursuant to articles of transfer between FA, Inc. and Rudd, Rudd surrendered his shares of stock and FA, Inc. transferred to Rudd the Prince George's County land. Levitt, on behalf of Old Court, consented to the transfer and waived any personal liability that Rudd might have.

In summary, Old Court and First Progressive loaned a total of $4,751,220 to Franklin Associates secured by the Prince George's County property which Franklin Associates bought for $607,000 in December of 1982. None of the principal of any of these loans has been repaid and the property used as collateral has been transferred from Franklin Associates to Rudd. Levitt and Pearlstein were able to use the money to buy Old Court stock and to buy the land and sell it at a profit. Old Court and First Progressive have no clear means by which they can obtain repayment of the money because the loans were accomplished without establishing personal recourse against Levitt, Pearlstein, Gottlieb or Rudd.

VB&H Representation of Old Court

In December of 1982, Levitt asked Gerald M. Katz, a partner at VB&H, to represent him in a transaction involving the purchase of Water Street Mews from Old Court. The purchasers of the property were to be Levitt, Cardin and Pearlstein. As a result of a meeting with Levitt concerning the transaction, Yaakov Neuberger, a second year associate at VB&H was concerned that the planned transaction was not "at arm's length." VB&H proceeded to analyze its representation of Levitt, Old Court and MSSIC from an ethical viewpoint. It issued a memorandum of its internal ethics committee concluding that the representation was permissible provided that it did not represent Levitt or Old Court regarding matters which were included in the Old Court/ MSSIC Insurance Agreement.[34] Because the Water Street Mews project did not conform to the ethics memorandum, VB&H referred the matter to the law firm of Cardin and Cardin.

Terry F. Hall, MSSIC's counsel, testified that on January 11, 1983, in a five minute phone conversation, he disclosed VB&H's opinion with regard to the simultaneous representation to Charles Hogg. He testified that Hogg agreed to the terms of the representation. Hogg has no recollection of the conversation.

Hall also testified that he brought the simultaneous representation to the attention of the MSSIC Board at a subsequent meeting where a critical discussion of Old Court and Levitt was taking place. Hall recalled that, at that time, he told the Board that VB&H represented Old Court and Levitt and that he was "uncomfortable and uneasy with this kind of personal attack." Board members of MSSIC do not recall any such

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[34] See VB&H Ethics Committee memorandum, January 11, 1983, Exhibit IIIB16.

discussion, nor do the minutes reflect it. In interviews with the Office of Special Counsel, all Board members expressed surprise that VB&H provided any representation to Old Court or Levitt. Chairman of the Board Pierson stated that, if he had known of the simultaneous representation, he would not have permitted it.

Hogg's only recollection of any knowledge concerning the simultaneous representation is that, sometime after May of 1984, in his office, Hall disclosed to him in a private conversation that VB&H provided some limited representation to Levitt. He says Hall told him that the representation only involved personal tax matters. Hall did not suggest that MSSIC had any right to object and suggested no alternatives. Hogg has no recollection whatsoever of any other disclosure.

Subsequent to the January 11, 1983 VB&H ethics committee memorandum, VB&H proceeded to represent Old Court, Levitt, Pearlstein, Cardin and related entities in numerous transactions, some of which violated their own ethics memorandum.[35]

Levitt's Employment at Old Court

Pursuant to the Insurance Agreement between MSSIC and Old Court, prior MSSIC consent was required before any Old Court officer could receive any bonus or increase in salary. Levitt

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[35] VB&H's billings for Old Court, Levitt, Pearlstein and related entities from 1982 through May 1985 totalled approximately $295,000. For the same period, their MSSIC billings were approximately $321,000.

entered into an executive employment agreement with Old Court dated November 17, 1983, which provided that he would be paid $75,000 per year to act as president.[36] Levitt also entered into consultant agreements with Old Court's subsidiaries which were guaranteed by Old Court.[37]

These agreements were drafted on behalf of Levitt by VB&H. Despite misgivings by the attorneys concerning the amount of compensation to be paid to Levitt, the agreements were submitted by Levitt to MSSIC for approval and approval was given. The total compensation paid to Levitt under the agreements was $192,000 per year.

On December 21, 1983, Levitt wrote to Ralph Holmes, purportedly setting forth his total compensation from Old Court and its subsidiaries and requesting MSSIC approval. Holmes signed the letter approving the compensation.[38]

Old Court and First Progressive Management

During 1983, Old Court and First Progressive embarked on an aggressive advertising campaign, offered high interest rates to depositors and grew rapidly in total deposits. Although audited financial statements were not produced on a regular basis, the associations reported this rapid growth on its SL200

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[36] See executive employment agreement dated November 17, 1983, Exhibit IIIB17.

[37] See consultant agreements, Exhibits IIIB18.

[38] See letter of December 21, 1983, Exhibit IIIB19.

monthly reporting forms that were submitted to the Division and MSSIC. The reports represented that Old Court was becoming a profitable association.

The minutes of the MSSIC Board and Membership Committee reflect periodic concern during 1983 about First Progressive and Old Court. On February 9, 1983, it was reported that Old Court and First Progressive were improving in profitability and liquidity based on their SL200's.[39] The Membership Committee was informed on March 9, 1983 that First Progressive had now established sufficient accounting records for the accounting firm to do the 1982 audit.[40] On June 8, 1983 at the Membership Committee meeting, Mr. Dietz asked how Old Court and First Progressive could provide sufficient capital to achieve three percent net worth based on their savings growth. Mr. Elsnic expressed concern about their high cost of funds. They were told that the MSSIC staff would provide projections.[41] At the Membership Committee meeting on July 13, 1983, hope was expressed that First Progressive's accountants had started the 1982 audit so that MSSIC could get a picture of their "uncertain financial position."[42] At the Board meeting on July 27, 1983, it was reported that Division examiners had found various "accounting record deficiencies" in their current examination and that there

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[39] MSSIC minutes, February 9, 1983, Exhibit IIIB20.

[40] MSSIC minutes, March 9, 1983, Exhibit IIIB21.

[41] MSSIC minutes, June 8, 1983, Exhibit IIIB22.

[42] MSSIC minutes, July 13, 1983, Exhibit IIIB23.

had been no audit for the year ending December 31, 1981.[43] At the Membership Committee meeting on August 10, 1983, Dietz asked about First Progressive's status and was advised by staff that auditors were continuing to work to establish the financial position of the association and that Division examiners were still performing their examination.[44] The Board on August 24, 1983 was advised that First Progressive's audit for 1981 was likely to be a "compilation and that 1982 would be an audit that was to be expected in the future."[45] Delinquent loans at First Progressive were discussed by the Membership Committee on September 14, 1983. Dietz inquired about Old Court's violation of the construction loan regulation, lending regulation and borrowing policy statement. Ralph Holmes, replied that "staff tries to work with the associations in these matters, and at times, assumes a flexible posture concerning some of the rules and regulations if the association is operating responsibly and in a profitable manner."[46] At the Membership Committee meeting on October 12, 1983, Holmes presented an organizational chart on Old Court's management and subsidiaries and a chart regarding progress management had made in improving the association's net worth. Trice reported on eleven projects he visited in Ocean

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[43] MSSIC minutes, July 27, 1983, Exhibit IIIB24.

[44] MSSIC minutes August 10, 1983, Exhibit IIIB25.

[45] MSSIC minutes, August 24, 1983, Exhibit IIIB26.

[46] MSSIC minutes, September 14, 1983, Exhibit IIIB27.

city which were "well collateralized and near completion."[47] At the Board meeting on October 26, 1983, Franklin Associates' request for permission to convert the $1,000,000 hypothecation to a subordinated debenture at Old Court was approved.[48] The Membership Committee on November 9, 1983 was advised by MSSIC staff member Mahon that mortgage loan concentrations and investments of Old Court violated MSSIC rules and that they were in flagrant violation of the liquidity rule.[49] At the Membership Committee meeting on December 14, 1983, Wallace and others inquired about First Progressive's large amount of borrowings and general condition. Mahon reported that the 1982 audit was completed but that MSSIC had not seen it and that the net worth was 2.3%. Holmes reported on Old Court's two hydroelectric plant loans in New York in amounts of $4,100,000 and $12,000,000. He stated that file documents were satisfactory and the loans were not "an extraordinary insurance risk." He also pointed out that Old Court had equity participations in the loans. When Brooks questioned the amounts of the loans, stating that the $12,000,000 loan exceeded Old Court's net worth and was therefore a regulatory violation, Holmes responded that "Levitt would sell a participation if we asked him to" but the matter was left unresolved.[50] At the Board meeting on December 28, 1983, concern was expressed about the large amount of borrowing at First

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[47] MSSIC minutes, October 12, 1983, Exhibit IIIB28.

[48] MSSIC minutes, October 26, 1983, Exhibit IIIB29.

[49] MSSIC minutes, November 9, 1983, Exhibit IIIB30.

[50] MSSIC minutes, December 14, 1983, Exhibit IIIB31.

Progressive and Old Court's violation of loan limits.[51] At each of the MSSIC Board of Directors meetings, their counsel, Terry F. Hall, was present, giving legal advice.

Considerably less discussion took place at the meetings of the Board of Commissioners during 1983 concerning Old Court and First Progressive. The Executive Session minutes of the Board reflect that Old Court was first discussed on November 3, 1983, when they requested permission to issue a $1,000,000 subordinated debenture to replace the $1,000,000 hypothecation. LeCompte pointed out that Old Court's reported net worth was 3.7% and that the funds "will probably be eligible for release" from the insurance contract in the near future. Brown stated that Old Court met the requirements and that there was no reason to deny their request.[52]

On December 8, 1983, Board member Rittenhouse noted that First Progressive's delinquent mortgage loans "seemed quite high." Brown stated that First Progressive recently had been examined and there were "several areas of concern." He also stated that there had been discussions concerning a merger with Old Court and that staff would monitor the situation closely.[53]

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[51] MSSIC minutes, December 28, 1983, Exhibit IIIB32.

[52] Executive Committee Session minutes, November 3, 1983, Exhibit IIIB33.

[53] Executive Session minutes, December 8, 1983, Exhibit IIIB34.

1983 Examination of First Progressive

At the same time these meetings were taking place, examinations of First Progressive and Old Court were being conducted by Division examiners. Jeffrey Fine was the examiner in charge at First Progressive and, during the summer of 1983, reported to his superiors more than "several areas of concern."

Fine's examination team began their field work on April 13, 1983. Fine quickly realized that "things were so bad" that he should make special reports to his superiors, Brown and LeCompte. He also discovered that Monumental City, First Progressive's service corporation, had "virtually no records" and therefore asked examiner Charles F. Endres to come to First Progressive and assist him by examining the service corporation.[54]

On July 20, 1983, Fine sent a handwritten memorandum to Brown enclosing a list of problems with loans at First Progressive which was intended to be a sample of the problems encountered.[55] Mortgage loan files had numerous documents missing because the settlement attorney for the association, Levitt, had not remitted them. Files lacked recorded mortgage instruments, settlement sheets, certificates of title or title insurance policies. Some mortgages were recorded long after settlement, up to one year later. Levitt also continued to be

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[54] See interview of Jeffrey Fine dated July 23, 1985.

[55] See Jeffrey Fine memorandum to Charles Brown, July 20, 1983, Exhibit IIIB35.

slow remitting money from settlements due to the association.[56] Examiners discovered settlement sheets signed in blank and, in one instance, a mortgage signed in blank. There was a general ledger account entitled "due from Jeffrey Levitt" totalling $350,139.59 as of March 31, 1983. The account included funds due in the amount of $79,741.24 from a foreclosure in 1979. The association had not received a court auditor's report regarding the foreclosure or any funds. The bulk of the rest of the account was for buying treasury bills and securities for Levitt's personal account and money for remodeling, repairs, gas and electric for Levitt's offices.

Fine sent an additional memorandum to Brown and LeCompte on August 4, 1983 concerning Glass and Associates' attempt to audit First Progressive.[57] Fine had obtained information from Glass that the 1981 audit would be a "compilation audit" which would not be certified. Glass had also advised him that the 1982 audit would be given a disclaimer because the opening 1982 figures were not audited. He also stated that Glass "pulled out" on two occasions to let the association perform paper work which they could audit. Fine pointed out that the last certified audit for First Progressive was "as of" December 31, 1980.

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[56] See Samuel Aaron letters of January 5, 1983 and February 18, 1983 to Paul R. Freeman, Exhibits IIIB36 and IIIB37.

[57] See Jeffrey Fine memorandum to Brown and LeCompte dated August 4, 1983, Exhibit IIIB38.

Charles Endres also submitted an interim report on four loans at Monumental City.[58] The service corporation's general ledger contained an entry for a loan to Rita Weinapple in the amount of $10,000. Under the account "mortgage loans receivable" a ledger sheet for the loan contained the following entry:

One Year Commercial Loan	15% Percent	Check to Rita Weinapple Per Jeffrey Levitt BALANCE $10,000	November 18, 1982

The association had a cancelled check in the amount of $10,000 to Rita Weinapple dated November 18, 1982, signed by Robert H. Hudson, Vice President of the service corporation "per Jeffrey Levitt." The entire loan file consisted of one letter dated February 4, 1983 requesting payments. The examiner questioned Hudson who said that Levitt authorized the loan but that when Weinapple received the letter requesting payments, she contacted Hudson and said that no loan was made to her. She stated that Levitt owed her $10,000 and the check was payment of the debt.

Endres also discovered that no payments had been made on the Franklin Associates loan which had enabled Levitt and Pearlstein to buy Old Court stock. The loan was originally issued in September of 1982.

Endres discovered a $60,000 loan to Gary and Linda Huddles on the books of Monumental City. The security for the loan was a second mortgage on the borrowers' residence and the mortgage stated that the full amount was due to be paid by January 1, 1983. The records for the loan were in Monumental

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58 See First Progressive examination as of March 31, 1983 "a review of work papers," Exhibit IIIB39.

City's "loan receivables closed" file but the ledger sheet showed the full amount due. The examiner asked Hudson about the loan who stated that Levitt said the "loan is paid in full." The clerk who kept the records for Monumental City, however, stated that no money had ever been received by Monumental City. Records also show that the loan proceeds were disbursed in the amount of $60,000 on March 29, 1982 and deposited in Levitt's escrow account. The settlement sheet showed points charged in the amount of $1500, interest collected nine months in advance for $7497 and a thirty dollar charge for a credit report. Two checks were drawn on Levitt's escrow account for $7497 and $1550 but were never deposited with Monumental City and apparently, as of the examination, the money was still in Levitt's escrow account.

Endres also commented on a $95,000 loan to Gilbert Sapperstein, who was the subject of comments in previous First Progressive examinations. The loan was granted in two disbursements of $10,000 and $85,000 but the service corporation was charging interest on the $10,000 portion of the loan only. Hudson stated that the $85,000 was disbursed on Levitt's instructions. Both checks had been deposited in Levitt's escrow account.

Endres reported these various transactions to the Chief Examiner, Joseph Barbera, and to Brown and LeCompte. After making their interim reports in the summer of 1983, Endres and Fine "made nuisances of themselves" with Brown and LeCompte. They went through the review examiner, Barbera, and talked to Brown and LeCompte two or three times about the specific transactions and the overall picture of how bad the records were. They suggested having the Attorney General's office look at the matter. Brown would listen and LeCompte "played devil's advocate" concerning their allegations. Endres and Fine got no feedback concerning any action taken.

In September of 1983, the rough examination comments were submitted to Art Friedman to review and edit. Friedman was a review examiner with the Division. He started his review and quickly realized that the nature of the examination required special attention. He spoke to Barbera, and said that they had a real problem on their hands with the examination and that it should not be subject to the normal review process. Barbera instructed him to do a "worst case memo" which he could take up with Brown and LeCompte.

Friedman, Fine and Endres did a memorandum on the four Monumental City loans (Weinapple, Huddles, Franklin Associations and Sapperstein) and submitted it. The purpose was to "get things rolling quickly," get the Attorney General involved for a criminal investigation and conservatorship if necessary. Barbera took up the memorandum with Brown and LeCompte.

After submitting the memorandum, Friedman stopped editing the First Progressive comments and turned to other matters, expecting Brown and LeCompte to make some decision concerning First Progressive. He heard nothing. At the end of October or early November, he asked Barbera about the status of the examination, who responded that he "did not know." In the meantime, Friedman had reviewed "item 16" on the balance sheet for First Progressive, which is entitled "exchange account" and which examiners considered to be a "red flag." Levitt used the exchange account to deposit personal checks with First Progressive and have First Progressive checks issued. His personal checks would then be returned for insufficient funds. A Carroll County bank would no longer accept Levitt's personal checks. Friedman and Fine believed that Levitt was taking money out of First Progressive through this account and there was very little documentation concerning it. There was also a miscellaneous "receivables" account in the amount of $561,432.16, part of which was due from Levitt, according to the work papers. Friedman highlighted this and some other matters, particularly securities transactions, for Barbera in another memorandum. This memorandum was also forwarded to Barbera, Brown and LeCompte. No response was received.[59]

Barbera submitted Friedman's memoranda to Brown and LeCompte but heard nothing back from them. At one point, he was told to "hold off" on finishing the editing of First Progressive's examination because the association was going to be merged. Around Thanksgiving of 1983, Barbera was hospitalized with an eye problem and was out of work for a month or two.[60]

While Barbera was in the hospital, Friedman started editing the First Progressive examination again despite the fact that he still had not heard from Brown or LeCompte. Shortly before Christmas, he went to LeCompte and asked what they were

[59] Interview of Art Friedman on July 29, 1985.

[60] Interview with Joseph Barbera August 12, 1985.

going to do. He stated that he believed that Levitt had committed fraud or embezzlement and that the examination was very serious. LeCompte agreed that it was serious but also stated that Levitt had told them that it was being "cleaned up." LeCompte stated that the Division "could not just go on Levitt's reputation." He directed Friedman to give him the First Progressive report. Friedman delivered the First Progressive file to LeCompte.

<u>The December 31, 1982 Examination of Old Court</u>

Division examiners also conducted an examination of the books and records of Old Court in 1983. The examination of Old Court's books as of December 31, 1982, was completed on May 6, 1983.

The Officers and Directors of Old Court were the following:

Jeffrey A. Levitt - President, Director

Dennis Guidice - Executive Vice President, Director

Allen Feinberg - Vice President Secretary, Director

Robert Pearlstein - Treasurer, Director

David Uhlfelder - Director

Samuel Shoubin - Director

The preliminary findings of the examiners disturbed the lead examiner, Gregory Watkins, who reported his findings to LeCompte. Among other matters, Watkins reported that the general ledger was inaccurate, SL200's were inaccurate and the books would not balance, which aroused Watkins' suspicions. LeCompte responded that Watkins was "not an accountant" and did nothing.

The examiners' comments were not sent to the Old Court Board of Directors until April 3, 1984, accompanied by a letter of the same date from Brown.[61] In his letter, Brown stated that the comments and criticisms contained in the examination were "too numerous to mention" and that management had "lost control of the operations of the association."

The examination showed that the total assets on December 31, 1982 were $146,800,000. Numerous loans had been made in excess of Old Court's net worth, a violation of Division and MSSIC regulations. In several instances, both the association and its subsidiaries took loan origination or processing fees, resulting in the booking of excessive points, violating regulations and artificially inflating income. Subsidiaries also "double booked" loan origination fees.

The examination also revealed that, after Levitt and Pearlstein purchased a majority of the stock, the association embarked on a program of making high risk loans to joint ventures which were participated in by Old Court subsidiaries and which were essentially acquisition, development and construction projects. From October, 1982 through February, 1983, Old Court granted four loans to "Crab Cove Limited Partnership"[62] totaling

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[61] Our investigation has revealed that the examiners' comments were edited in the Division's office and, for a substantial period of time, the report simply sat on a desk, waiting to be sent to the Board of Directors of Old Court. The letter of Charles H. Brown explained the delay as having been caused by his illness and a "backlog of work".

[62] Crab Cove Limited Partnership was 50% owned by Old Court Joint Venture, one of Old Court's service corporations.

approximately $1,300,000. On the loans, Old Court took excessive fees into income and insurance was obtained which was inadequate to cover the security. A title letter from Levitt indicated that the property was "free and clear," which was incorrect. No approval from the Division was obtained for these loans. In addition, Old Court clearly controlled Crab Cove, which was developing the land. Therefore, for accounting purposes, the "loan" should have been treated as an investment and no income should have been generated to Old Court as a result of it.

Old Court also loaned approximately $2,300,000 to Amber Waves Limited Partnership, without regulatory approval.[63] The purpose of the loan was to acquire nine lots in Ocean City and build condominium units on them. A title policy was paid for but not received. At settlement, $851,456 was disbursed despite the fact that the land, which was the only collateral for the loan, was appraised for $725,000, violating Division regulations.

Jerome Cardin, owner of eighteen percent of the stock of the association, had outstanding unsecured note loans in excess of $14,000.

The report also commented that Levitt businesses wrote "exchange checks" to Old Court, on which Old Court would simultaneously issue checks on behalf of the businesses. The Levitt checks would subsequently be returned for insufficient funds. In the handling of loan-in-process funds for Amber Waves, a bookkeeping error resulted in Levitt being paid $69,000 which

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[63] Amber Waves was a partnership owned by Walter Otstott, Old Court Joint Venture and Levitt's children.

was due to the association, which had not been refunded by Levitt. In certain files, where checks were written to "Old Court, J. Levitt" for disbursement to the borrower, there was no evidence that the money had been disbursed.

The examiners also reviewed the books and records of two Old Court subsidiaries, Old Court Joint Venture and Old Court Investment Corporation. They found that Old Court Joint Venture did not have any accounting records other than a check register. Their lack of bookkeeping was caused by their "continued involvement in establishing many other partnerships." The examiners commented that "lacking records, management cannot possibly know what the return on their investment is or if the partnership is in financial danger." The examiners also pointed out that there were no financial statements for any of the partnerships formed by Old Court Joint Venture and that there were no corporate minute books or bylaws available for review.

The examiners reviewed documents relating to Summit Ridge Partnership (Summit Ridge), one of Old Court Joint Venture's subsidiaries. Their analysis showed that Summit Ridge consisted of Summit Ridge Development Corporation and Phillip Altfeld as fifty percent owners. Although each partner originally contributed $50,000 as capital to the partnership, they subsequently obtained loans of $800,000 from Old Court and $860,000 from United Virginia Bank. They also received a land development loan of $1,911,000 from Old Court. In December of 1982, Summit Ridge Development Corporation and Altfeld pulled out their capital contribution, reducing their personal investments to zero. The examiners pointed out that Summit Ridge and Altfeld had no risk and that, because the only contribution of funds to Summit Ridge was from the loans, interest payments could be made only from the loan proceeds.

The examiners also reviewed documents relating to Gettysburg Limited Partnership. They commented that "the limited partnership agreement provided us during our review of the Gettysburg loan does not note that Old Court Joint Venture has any financial interest in it." An examination of the records of Old Court Investment Corporation revealed that "association directors Levitt and Pearlstein are involved in the limited partnership. The loan was not approved by the Division Director as required by Title 9-307(b)(2) and the appraiser was not approved by Division Director as required ...".[64] Gettysburg Square was a joint venture formed for Levitt and others by VB&H, the attorneys for MSSIC.

While the Old Court examination proceeded during 1983, the examiners reported their findings back to the Division on an interim basis, although no formal memoranda were written. Thus, during the year 1983, the Division was accumulating a vast quantity of information concerning violations of their regulations and state law by the management of First Progressive and Old Court. This accumulation of information was not shared with the Board of Commissioners with the exception of Director Brown's brief comments about "several areas of concern" at First

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[64] See Division examination of Old Court as of 12/31/82, Exhibit IIIB38.

Progressive on December 8, 1983. The examiners shared their information with the MSSIC staff, which provided some ongoing information to the Board of MSSIC. Despite the discoveries of the examiners at the Division, however, no action whatsoever was taken by the Division or MSSIC.

The December 31, 1982 examination of Old Court was delivered to Old Court's Board of Directors with the management letter of April 3, 1984. Although Brown stated in the letter that "management had lost control," no remedial action was proposed or taken with respect to Old Court. At the time, Old Court was reporting substantial profits, advertising aggressively and growing rapidly. It was also regularly in violation of MSSIC regulations governing lending limits, especially Regulation 3-217(A)(1), which limited the outstanding principal balance of all construction loans to twenty-five percent of the total savings. Brown testified that no regulatory action was taken because he generally believed that Old Court was "making money."[65] Additionally, he believed that any drastic regulatory action, such as cease and desist proceedings or conservatorship, would start a run in the industry.

The Old Court examination was delivered to MSSIC, as were all Division examinations. The MSSIC staff, including Charles Hogg and Paul Trice, reviewed the examination. Hogg also testified that he would have consulted his counsel, Terry F. Hall, concerning the examination. Hall testified that he did not remember reviewing the examination but was generally aware of the

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[65] Brown transcript dated October 30, 1985 at 12-21.

bad results. MSSIC took no regulatory action as a result of the examination, nor did Hall, their counsel, advise them to take any regulatory action. Additionally, Hall did not disclose to them that Old Court was a client of his firm.

In April of 1984, Old Court sought Division approval to open new branch offices. By law,[66] the Director is required to approve an application for a new branch if he finds that the public interest will be promoted and the office will be operated efficiently and in accordance with the statute. Division Regulation .40 further requires that an applicant for a new branch have a total net worth of at least four percent or, in the alternative, have adequate net worth to support the new branch office, sound management, sound practices, assets of above average quality and satisfactory operating results. The Division examination which had been produced in April of 1984 showed Old Court's net worth to be considerably below four percent. No audited financial statement had been produced for the year ended July 31, 1983. Although the association was reporting considerable profits and an increased net worth, there was no independent verification of that reporting. Trice, on behalf of the MSSIC Membership Committee, objected to Old Court's applications for three branch offices.[67] Despite the MSSIC

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[66] Md. Fin. Inst. Code Ann. § 9-309 (1980).

[67] See letter of Paul V. Trice to Charles H. Brown, Jr. dated April 16, 1984, Exhibit IIIB41.

objections, the statute, the Division rule, and Brown's letter of April 3 stating that management had lost control of Old Court, one of the branch applications was approved.[68]

Termination of Old Court Insurance Agreement

In 1984, the minutes of the MSSIC Board of Directors and Membership Committee show an increased regulatory concern for Old Court and First Progressive. In February of 1984, it was discovered that First Progressive had made an unauthorized investment in a lost or stolen credit card reporting company known as Action Line. First Progressive officers had made a substantial investment in Action Line but various claims, including fraud claims, were being made against them. One First Progressive employee received a kickback from Action Line for obtaining the investment. Levitt specifically authorized the investment, after other management personnel objected to it. MSSIC staff and their counsel, Hall, met with First Progressive management, including Levitt, to discuss the Action Line matter. Levitt agreed to hypothecate $500,000 in savings in order to cover the potential losses.

At the MSSIC Membership Committee meeting on March 14, 1984, a discussion of the John Hanson/Milton Savings and Loan proposed merger took place. Hall rendered an opinion that a merger can be disapproved if the association fails to meet the standards of MSSIC. Later in the meeting, three members of the

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[68] See Order of Division approving branch application, Exhibit IIIB42.

committee discussed the question of whether they should meet with James D. Laudeman, counsel for Chevy Chase, and a member of the MSSIC Board, concerning Chevy Chase's insurance agreement. The members asked Hall for an opinion as to whether Laudeman's position would constitute a conflict of interest pursuant to Section 2-803 of the MSSIC bylaws. Section 2-803 provides:

> (a) No member of the Board of Directors who represents as counsel, director, or other officer a member of the corporation which has a matter before the Board of Directors that may require action by the Board shall present to the Board the case of the member which he represents, and no such member of the Board of Directors shall participate in any deliberations of the Board of Directors or the action of the Board with respect to such matter.
>
> (b) No member of any committee of the corporation shall participate in the deliberations of or actions pertaining to any matter concerning an association with which he is connected as counsel, director or officer.

Hall and Hogg rendered the opinion that a conflict existed but recommended meeting with Laudeman anyway, in the interest of resolving any misunderstanding of facts concerning proposed amendments to an insurance agreement between Chevy Chase and MSSIC. Laudeman stated that he would not be negotiating on behalf of Chevy Chase; he would simply be providing factual information.[69]

Later in the meeting, Hogg reported on a meeting at MSSIC with the staff, Division representatives and representatives of Old Court and First Progressive. The purpose of the meeting had been to make Levitt and Pearlstein aware that

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[69] _See_ MSSIC minutes of March 14, 1984, Exhibit IIIB43.

certain conditions were not acceptable and to discuss corrective measures to be taken. The Action Line investment was discussed and it was agreed that an officer would be dismissed from First Progressive, the certified audit for First Progressive of December 31, 1982 would be completed and submitted to MSSIC by March 28, 1984, Action Line would be sold and a hypothecation of $500,000 in savings would be made to cover the losses. Hogg also stated that he instructed Levitt to reduce Old Court and First Progressive's aggressive savings solicitation programs, especially for brokered deposits. He finally reported that Old Court's management goal was to merge First Progressive into Old Court. During this discussion, despite the prior concern with Laudeman's potential conflict, Hall made no disclosure whatsoever that his firm represented Old Court, Levitt, Pearlstein and Cardin.

At the Board meeting on March 28, 1984, Ralph Holmes reported concerning the First Progressive investment in Action Line without MSSIC knowledge or approval. He estimated that losses due to improper management would total $950,000 and that MSSIC, which currently held a hypothecation in the amount of $109,000 from management, would be getting another hypothecation in the amount of $500,000 from Levitt and Pearlstein. The possibility of a merger with Old Court was also discussed, providing MSSIC approved the merger.[70]

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[70] See MSSIC minutes March 28, 1984, Exhibit IIIB44.

At the Membership Committee meeting on April 4, 1984, Mahon reported that First Progressive's borrowings using "reverse repos" exceeded 100% of savings, grossly in violation of MSSIC's borrowing policy statement. He stated that the increase in borrowed funds was in direct contradiction to MSSIC staff's instructions to decrease borrowed funds. There was also a discussion concerning the lack of an audit for First Progressive or Old Court. The Committee resolved to require that an audit be submitted for First Progressive by April 23, 1984 and for Old Court by June 30, 1984 and that, if they were not, independent auditors would be employed by the corporation at the associations' expense. The Committee also discussed the preliminary comments from the Division examinations of Old Court and First Progressive. It was noted that the preliminary examination comments contained "numerous and substantive comments indicative of weak operational standards." The committee also voted to express MSSIC's concerns to the Division Director regarding Old Court's branch office applications. At the outset of the meeting, Mr. Brooks expressed his concern about MSSIC's lack of progress in resolving problem institutions in a timely manner. He inquired about specific actions that are available to MSSIC to resolve violations by member institutions. Hogg responded that MSSIC has the ability to issue cease and desist orders but that it has been his policy to attempt to work with associations in resolving their problems rather than to automatically grant financial assistance. Mr. Mahon also discussed the staff's procedures regarding violations that are discovered. He stated that the management of associations point to differences between State and MSSIC regulations as reasons for noncompliance and that association responses often elicit a debate on the appropriateness of a rule or regulation rather than a course of corrective action. It was the consensus of the committee that it was "essential that member associations comply with existing MSSIC rules and regulations until such time as they are revised." According to the minutes, counsel for MSSIC, who was present, made no comments regarding MSSIC's cease and desist powers, removal of officer and director powers, temporary cease and desist powers or expulsion powers.[71]

At the Board of Directors meeting on April 25, 1984, there was a review of the Membership Committee comments regarding Old Court and First Progressive and a review of Trice's letter objecting to the establishment of new Old Court branches. Mr. Donahue, a public member of the Board, expressed his concerns as to the prolonged and seemingly unresolved problems at First Progressive. He stated that he was disturbed about the way the association operated. Hogg, in reviewing the net worth of various associations, stated that they may be approaching a cease and desist order with First Progressive.[72]

The rule violation reports which were generated by MSSIC's staff and distributed to directors and their counsel, showed that Old Court was in violation of a substantial number of MSSIC's rules every month from January through April of 1984.

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71 See MSSIC minutes, April 4, 1984, Exhibit IIIB45.

72 See MSSIC minutes, April 25, 1984, Exhibit IIIB46.

Pursuant to MSSIC Regulation Section 3-217(A), commercial loans were not to exceed forty percent of total savings. Each month, Old Court's commercial loans exceeded sixty percent. MSSIC's borrowing policy statement limited borrowing to fifteen percent of its savings accounts; Old Court consistently exceeded twenty percent. MSSIC Regulation Section 3-210 required each association to maintain a liquidity fund equal to six percent of its savings accounts; Old Court was consistently less than six percent. Pursuant to MSSIC Regulation Section 3-217(A)(1), construction loans were limited to twenty-five percent of savings; Old Court's ranged from thirty-four to thirty-six percent.

In April of 1984, Old Court sought to prepay its subordinated debenture to MSSIC and thereby terminate its Insurance Agreement and Voting Trust Agreement. Despite the recent examination showing that Old Court's management "had lost control," MSSIC's opposition to the establishment of new branches, the concerns expressed at MSSIC committee and Board meetings and the persistent rule violations, MSSIC management, with the advice of counsel, terminated the Insurance Agreement and Voting Trust Agreement. The Termination Agreement, dated April 23, 1984, among Jerome Cardin, Jeffrey Levitt, Allan Pearlstein, and MSSIC, was drafted by MSSIC's counsel.[73] Although no disclosure of the fact was made to MSSIC at the time, Hall's firm had an attorney-client relationship with every party to the termination agreement. Termination of the Insurance

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[73] _See_ Termination Agreement, Exhibit IIIB47.

Agreement released Old Court from numerous covenants with MSSIC which permitted MSSIC to monitor Old Court's operation. Pursuant to the agreement, prior MSSIC consent was required for any expenditure not contained in a budget approved by MSSIC every six months, any capital expenditure in excess of $1000, any fee or payment to Board members, any increase in salary or other compensation to officers, stock dividends, and loans to any organization controlled by any person owning five percent or more of Old Court's stock. In addition, the agreement permitted access by MSSIC's staff at all times and monthly, weekly, and daily reporting. Despite the fact that the recent Division examination showed that loans had been made to insiders without MSSIC's written consent, and that Old Court was in breach of the Insurance Agreement, MSSIC permitted the owners of Old Court to prepay the subordinated debenture and release themselves from MSSIC's additional regulatory control. Hall testified that he believed, and advised his client MSSIC, that they had no authority to refuse to terminate the Insurance Agreement because the subordinated debenture had been repaid.

Old Court/First Progressive Merger

In May of 1984, the staffs of the Division and MSSIC were so concerned about the management of First Progressive that they scheduled a special meeting on May 3, 1984 with First Progressive's management. They quickly learned that $69,000,000 of First Progressive's investment portfolio of $83,000,000 had been secured as collateral for borrowing. Thus, only $17,000,000 or nineteen percent of the entire portfolio was actually owned by First Progressive. Based on current estimates of market value of the portfolio, they would incur an estimated $6,400,000 loss if liquidated. The MSSIC and Division staffs also talked to Edward Jacobson of Glass and Associates, who was working on the First Progressive 1983 audit. He "seemed almost relieved" to talk with members of MSSIC and the Division. He stated that the books and records for 1982 could not be audited and that it was his firm's decision to reconstruct a set of records which could be audited. He commented that "this is the worst he has ever seen in his experience; simple transactions were difficult to trace in their entirety; intercompany transactions as well as the famous 'exchange account' caused them considerable problems."

The expected loss from the Action Line credit card operation was increased to $1,400,000. The examiners discovered that the investment was made by Michael Bosley, Vice President of First Progressive, who purchased fifty percent of the stock ownership in Action Line while he was on vacation in Nevada. Paul Freeman, President of First Progressive, was upset with the investment and initiated a stop payment order on the check. This order was revoked by Levitt and Monumental City became the fifty percent owner of Action Line. Roger Rosen, the association's controller, and Bosley each received checks in the amount of $6250 as fees for purchasing the stock of Action Line.

The staff members pointed out the various problems they discovered at First Progressive in a memorandum to Brown and LeCompte dated May 4, 1984.[74] The memorandum was also given to MSSIC.

Despite the problems uncovered at First Progressive, no mention was made of First Progressive or Old Court at the executive sessions of the Board of Commissioners in January and February of 1984. On March 8, 1984, the Board discussed deceptive advertising practices by Custom Savings Association. Mr. Gisriel, Chairman of the Board, suggested "that we should get all the facts and send it to the Attorney General for possible prosecution." LeCompte responded that the Attorney General's office was already involved. At the March meeting, LeCompte also reported that First Progressive, Old Court and Fairfax Savings Association will show considerable amounts of borrowed money. He stated that "these institutions have large investments in government obligations and securities which they have used in securing reverse-repurchase agreements at a cost of about 9-3/4 to ten percent. This money they are investing at a positive spread." A general discussion regarding the "extreme growth of the savings and loan industry in Maryland" also took place.[75]

At the April 12, 1984 meeting of the Board, nine days after the Old Court examination was released with Brown's cover letter stating that "management has lost control," no discussion

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[74] See memorandum of May 4, 1984, Exhibit IIIB48.

[75] See Board minutes, March 8, 1984, Exhibit IIIB49.

whatsoever regarding Old Court or First Progressive took place.[76] On May 10, 1984, for the first time, Brown reported to the Board regarding First Progressive's Action Line investment. He stated that Action Line was not an authorized investment and that, when it was discovered, the Division and MSSIC met with First Progressive and required them to divest themselves of Action Line. He stated that people who have purchased the service for a fee of ninety-five dollars for five years have a right to a refund and that First Progressive would have to honor their requests. The estimated loss appeared to be $500,000. Brown reported that a meeting was held with Levitt, Pearlstein and Cardin who agreed to hypothecate $500,000 to MSSIC and the Division. At the time, First Progressive had approximately $800,000 in net worth. Brown also reported that the association had a sizeable paper loss on the purchase of large amounts of GNMA bonds and borrowing against them through repurchase agreements. Finally, he reported that the Division and MSSIC would be meeting shortly with Cardin and Levitt to discuss merging First Progressive into Old Court.[77]

At the June 14, 1984 meeting, Brown reported again on First Progressive. He stated that, because of the Action Line loss and some sizeable paper losses on bonds, First Progressive had a liquidity problem. He reported that the Division and MSSIC had reviewed the situation carefully and believed "the only way to resolve this problem is to merge First Progressive into Old

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[76] See Board minutes, April 12, 1984, Exhibit IIIB50.

[77] See Board minutes, May 10, 1984, Exhibit IIIB51.

Court. Old Court is the natural candidate as the management of two institutions are already affiliated. The merger will be a regular statutory merger rather than a supervisory merger." Throughout these meetings, Brown and LeCompte made no mention of the fact that First Progressive and Old Court were both ultimately controlled by Levitt and Pearlstein and that the most recent Division examination of Old Court revealed substantial mismanagement. No information was given to the Board from which they could conclude that the proposed merger was, in fact, a merger of two completely mismanaged associations.[78]

At the MSSIC Membership Committee meeting on May 9, 1984, the proposed First Progressive/Old Court merger was discussed. Hogg reviewed the progression of events involving Levitt and Pearlstein at First Progressive. He stated that due to the significant cost of either liquidating the association or merging First Progressive with financial assistance, it was the staff's position that a merger with Old Court might be the best alternative available. Hogg indicated that under such a merger, Old Court would have to "agree to numerous stringent requirements due to the management of Old Court Savings and Loan being responsible at least in part, with[sic] the deterioration of First Progressive Savings and Loan." He then proceeded to list ten proposed requirements for the merger. The consensus of the Committee was for Hogg to pursue a plan of merger between Old Court and First Progressive under the stringent requirements that

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78 See Board minutes, June 14, 1984, Exhibit IIIB52.

he outlined.[79] At the Board of Directors' meeting on May 22, 1984, the Board unanimously directed MSSIC staff to pursue a merger.[80]

Although not set forth in the MSSIC minutes, Hogg memorialized his thoughts regarding the merger in a memorandum dated May 9, 1984.[81] He viewed the options available as the following:

1. do nothing - continue to monitor;
2. liquidate - cost, publicity;
3. assume management - consultant, staff, etc.;
4. merge with Old Court; and
5. merge with other - cost.

He concluded that the best solution was to merge with Old Court. He also set forth his ideas regarding management requirements, including an accounting update by another accounting firm, a requirement that they change accountants, management and staff; that they reduce borrowings, restrain growth, correct all discrepancies, reduce advertising and divest all noncomplying investments. Hogg discussed his alternatives regarding the First Progressive/Old Court situation with his counsel. Hall concurred that the merger was the best solution.

Throughout the summer of 1984, Division representatives, MSSIC representatives, Hall, and management and counsel for First Progressive and Old Court met regarding the terms of

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79 See MSSIC minutes, May 9, 1984, Exhibit IIIB53.

80 See MSSIC minutes, May 22, 1984, Exhibit IIIB54.

81 See Hogg memorandum of May 9, 1984, Exhibit IIIB55.

the merger. Despite the mandate set forth in the MSSIC minutes, timely audited financial statements were not produced for either First Progressive or Old Court. Contrary to the MSSIC resolution, independent auditors were not hired by MSSIC at Old Court's and First Progressive's expense. Old Court continued to breach the lending limitation rules and liquidity rule of MSSIC. On August 13, 1984, Paul V. Trice, sent to Levitt, as President of Old Court, a "cease and desist" letter, because of these violations.[82] In the letter, Trice directed Old Court to "immediately cease and desist from any further commitment to grant loans in these [construction, commercial or land loan] categories until compliance has been effected and demonstrated to the corporation." At the time, construction, commercial and land loans exceeded seventy percent of Old Court's savings despite the fact that MSSIC regulations prohibited exceeding forty percent. Construction loans were thirty-six percent of savings, despite the regulation limiting them to twenty-five percent. Old Court was also in violation of the borrowings policy statement. Trice also again opposed, on behalf of MSSIC, an application by Old Court for a new branch in Ocean City.

At the Board of Directors' meeting on August 22, 1984, Trice asked for the Board's ratification of his issuance of the staff cease and desist letter to Old Court. Dolivka moved that the Board ratify and his motion was seconded. Hall stated that he viewed the letters as the "first step in a process." He further stated that "staff should be absolutely certain that the

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[82] See Trice letter August 13, 1984, Exhibit IIIB56.

Board will support their action and that he hopes that the associations involved will react properly and make every effort to effect compliance." In testimony, Hall stated that his remarks were intended to advise Trice that the staff cease and desist letters were not authorized and probably not effective. Once again, Hall made no disclosure that Old Court was a client of his firm.[83]

A substantial portion of the time spent by MSSIC in Membership Committee and Board of Directors meetings through the summer of 1984 until the end of October 1984 was spent discussing the First Progressive and Old Court situation and the resolution to merge the two institutions. At the meeting on September 12, 1984, Faulkner requested staff to notify the Division that it was MSSIC's position that possible criminal activities conducted by former employees of First Progressive (regarding the Action Line investment kickbacks) should be referred to the Attorney General's office for review. Although counsel for MSSIC was present, he made no recommendation regarding referral of any other criminal activity.

Also at the September 12 meeting, Patrick McCracken of the MSSIC staff presented the committee with a report regarding his review of Old Court's investment in a project in Pennsylvania known as Meadowick. The Division had commenced an examination of Old Court in April of 1984 which was still ongoing. Periodic reports which were given to Division management and MSSIC evidenced extreme concern regarding Old Court's management and

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[83] See MSSIC minutes, August 22, 1984, Exhibit IIIB57.

investment practices. McCracken reviewed Meadowick simply to confirm that there was actually construction taking place. McCracken stated, at the meeting, that Meadowick was in excellent condition and location. Meadowick was an acquisition and construction development project to build apartments in which Old Court subsidiaries participated as general and limited partners. Old Court was substantially in control of the project. VB&H gave advice to Levitt about the partnership. It was further reported at the meeting that First Progressive had violated the staff cease and desist order concerning trading futures and options. No further corrective action was recommended.[84]

At a subsequent meeting of the Membership Committee on October 10, 1984, which Hall attended, McCracken made another presentation of Old Court's loans and projects which he had reviewed to determine whether Old Court was in compliance with MSSIC rules and regulations. McCracken's notes of the presentation identify the projects he discussed.[85] He included the following projects in his discussion: Amber Waves, Marple Woods, Meadowick, Chadford Estates, The Falls (formerly Summit Ridge), Montgomery Air Park-Kolb Center, World Building Silver Spring and Leesburg. McCracken noted only that Marple Woods and Montgomery Air Park were Old Court joint ventures. In fact, Amber Waves, Meadowick, Chadford, World Building and Leesburg were all Old Court joint ventures.

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[84] See MSSIC minutes, September 12, 1984, Exhibit IIIB58.

[85] See McCracken notes, Exhibit IIIB59.

Additionally, McCracken reported on Emmorton Industrial Park, a $2,500,000 and $1,800,000 loan in Harford County. He assumed that it was a third-party, arm's length transaction. In fact, Emmorton Industrial Park Limited Partnership consisted of Levitt, Pearlstein, Gerald Katz -- a partner at VB&H, and Stewart Greenebaum, another client of VB&H. They purchased the property in Harford County in 1979. In December of 1983, they sold their partnership interest to Steven Hankin, a developer, who financed his purchase with a loan from Old Court, giving Old Court Joint Venture and Old Court Investment Corporation a one percent general partnership interest and forty-nine percent limited partnership interest, respectively. Levitt, Pearlstein and Katz each realized a taxable gain of $184,000 on the transaction. By the transaction, Levitt and Pearlstein were able to directly profit from doing business with the association they controlled. Hall, in attendance at the meeting, made no mention of his partner's, Levitt's or Pearlstein's involvement in the Emmorton deal. He also made no mention of the fact that his firm provided some representation in the Marple Woods, Meadowick, The Falls, Montgomery Air Park and Leesburg projects.

First Progressive Division Examination as of March 31, 1983

The staff of the Division did not know what was done with First Progressive's examination report which was taken by LeCompte in December of 1983. In the summer of 1984, Art Friedman saw a notice in the Maryland Register about the proposed merger between First Progressive and Old Court. He talked about it with other examiners, concerned that Levitt's debt to First Progressive would be lost in the merger and concerned about Levitt "running Old Court into the ground also." In October of 1984, Barbera told Friedman that they were going to need the First Progressive report. They went over the comments together, with Barbera taking out comments he viewed to be "too accusatory."

Comment 23 in the examiner's draft comments stated that First Progressive gave Ryland Homes a $1,000,000 commitment to make loans to purchasers of homes. The commitment letter was addressed to Mr. Sonny Katz of Ryland Homes. Monumental City issued two checks on July 9, 1982 and July 12, 1982 in the amounts of $3000 and $2000, respectively, to Nathaniel "Sonny" Katz. Freeman, President of First Progressive, described the payments as a "placement fee" for the Ryland commitment. The examiners viewed it as an illegal kickback. The entirety of Comment 23 was deleted, apparently by Barbera.

Portions of draft Comment 24 were also deleted. The comment described a method by which Levitt Builders and other Levitt associated companies obtained financing at rates five to eight points more favorable than financing given to other borrowers. Again, the comment was deleted by Barbera.

In the Monumental City comments, the Huddles loan previously referred to was "written up." The comments regarding Levitt stating that the loan was "paid in full" were deleted, however, again by Barbera. Barbera had no explanation as to why the comments were deleted other than the fact that they "had plenty" on Levitt in the examination and did not need these additional comments. The examiners who performed the examination viewed these comments as evidence of potential criminal activity and expressed to Division management their opinion that the Attorney General should be consulted. He never was.

The comments were finalized and delivered to First Progressive's Board of Directors with a management letter from Brown dated October 18, 1984[86] at a meeting jointly held among the Division, MSSIC and management of Old Court and First Progressive. The meeting was attended by Charles Brown, William LeCompte, Charles Endres, Charles Hogg, Paul Trice, Terry Hall, Jeffrey Levitt, Allan Pearlstein and Jerome Cardin. The point of the meeting was to "call management on the carpet."[87]

The First Progressive examination was accompanied by an October 18, 1984 letter from Brown which stated that the comments and criticisms:

> in the examination as well as in the audit report and management letter are of a very serious nature and reflect quite unfavorably on the management of the association and on its Board of Directors. Based on the numerous violations of the Financial Institutions Article of the Annotated Code of Maryland as well as the rules and regulations of the Board of Commissioners, it is apparent that the management as well as the Board of Directors has lost control of the operations of the association.

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86 See Division examination of First Progressive as of March 31, 1983 and October 18, 1984 letter from Brown, Exhibit IIIB60.

87 See testimony of Terry Hall, dated November 20, 1985 at 120-126; testimony of Charles Hogg dated October 22, 1985, at 65-91.

The comments enumerated numerous examples of the same problems encountered at First Progressive in examinations over the preceding six years.

Comment 1D stated that "settlement attorney Jeffrey Levitt is slow to remit funds withheld from settlement for escrow." Comment 1E stated "attorney Jeffrey Levitt is still holding funds from the settlement of loan 4205 and has not paid off the prior loan 4073 also held by the association. Over one year has elapsed since settlement." Comment 1G revealed that first and second mortgage loans had been made on Levitt's residence in excess of the market value of the property. Settlement sheets in thirty-four different loan files revealed that the borrowers were charged for title insurance policies but there were no policies in the files. Other files showed overcharges by the settlement attorney, Levitt, both at mortgage settlements and foreclosures. Subsidiaries' share loan records reflected four loans for which interest was unpaid for over ninety days. The loans totaled $37,000 and all were attributable to Levitt or Security Storage, a Levitt company.

The comments for Monumental City included the Rita Weinapple, Gilbert Sapperstein, Franklin Associates and Huddles loans previously discussed.[88] Comment 2 indicated that Levitt was paid a $30,000 "management bonus" on December 1, 1982, despite the fact that, in the analysis of the Division, "management had lost control" and that the net worth of the association was grossly in violation of regulatory requirements.

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[88] See page 177, 178, supra.

Comment 20 indicated that on two occasions Levitt provided a check to First Progressive for $6,889, directing that the check be deposited and an exchange check issued payable to Carroll County Bank. The check to Carroll County Bank was used to pay the mortgage of Westminster Properties (a Levitt company) on 229 East Main Street, Westminster, Maryland. Levitt's check to First Progressive was returned twice for insufficient funds and, as of the date of the examination had not been repaid. Additionally, Comment 20 referred to the September 19, 1979 foreclosure of loan 4076. The account showed $79,741.24 due from Levitt for the foreclosure sale.

Comment 15C stated that Levitt, at settlement on August 25, 1976, withheld $2000 from the proceeds of loan 3910 for "exterior repairs." The association subsequently wrote off a loss in excess of $28,000 on the loan (not including the interest due). The examiner asked Levitt whether he was still holding the $2000 but received no response. Comment 4(5) referred to a $30,000 loan to Levitt and Becky Limited which was located in the closed files. The loan showed a balance of nothing due but there was no evidence that interest due from April 1, 1980 through December 10, 1982 in the amount of $15,800 was paid. A letter dated January 11, 1983 regarding the overdue interest stated "disregard letter for collection of interest January 17, 1983".

Loan "B" to Steve Hankin in the amount of $15,000 was indicated to be paid off on the subsidiary records. However, there were no documents showing that Monumental City ever received any funds to pay off the loan. The settlement sheet on the loan indicated that it was a third mortgage. Steve Hankin was the purchaser of the partnership interest of Emmorton Limited Partnership, a joint venture involving Levitt, Gerald Katz, Greenebaum and Pearlstein. Old Court financed the purchase.

Without setting forth all of the details of the examination, the facts stated in it clearly supported Brown's management letter. Brown was strongly suspicious that Levitt was dishonest and stealing money from the institution at this point. He did not consult the Assistant Attorney General assigned to the Division regarding potential crimes or regarding what to do about First Progressive or Old Court. He felt that the best thing to do was to merge First Progressive and Old Court quietly so that Old Court could absorb First Progressive's losses and so that there would be no publicity.

Hogg also strongly believed that Levitt was dishonest and stealing from First Progressive. He, too, thought that the best solution was to merge First Progressive and Old Court, thus putting all of their regulatory problems "under one roof." The pervasive feeling at MSSIC was that "no one deserved First Progressive more than Jeffrey Levitt." Hogg consulted with his counsel regarding action to take against First Progressive, Old Court and their principals. Hall agreed with Hogg's conclusion to proceed with the merger and not take any other action.

At the meeting on October 18, 1984, attended by MSSIC, Division, Old Court and First Progressive representatives and by counsel to MSSIC, various matters in the First Progressive examination were reviewed. Hall took notes concerning the meeting which reflect that, among other matters, the account on the books of First Progressive "due from Jeffrey Levitt" was discussed.[89] Hogg stated that he wanted it paid off immediately. Hall wrote Levitt's response as "Jeffrey says will be paid off tomorrow; other obligations will also be paid off immediately. Jeffrey will clean this all up in a couple of days when Glass gives him a figure." At the meeting, the $3,400,000 in delinquent loans was also discussed. Levitt "guaranteed that there would be no loss" on those loans. With respect to Franklin Associates, Levitt stated that he no longer had an interest in it and that it was sold to Leon Rudd. He also represented that he would give a written explanation of the Rita Wineapple loan. Despite his track record, the Division, MSSIC and attorney Hall apparently accepted Levitt's promises as if they came from a reliable source. Hogg, Brown and Hall admitted in testimony that they had strong doubts about Levitt's integrity at this point. Hall took no step to report Levitt to the Attorney Grievance Commission or any law enforcement authority or to consult with criminal law experts in his own firm.

As a result of the meeting and delivery of the examination comments, no corrective action was taken. Old Court and First Progressive proceeded to effect the merger on November 1, 1984, which merger was approved by both the Division and MSSIC.

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89 See Hall notes of October 18, 1984 meeting with Old Court, Exhibit IIIB61.

Old Court Examination as of April 30, 1984

In the summer of 1984, Division examiners commenced another examination of the books and records of Old Court. Charles F. Endres and Thomas Berger reported back to the office on an almost daily basis and discussed what they were finding with Joseph Barbera. Based on their comments, it was generally known at the Division that the "disease had spread from First Progressive to Old Court and that Jeffrey Levitt was going wild."[90] In October of 1984, the field work was complete and the reviewers at the Division started editing the examination. On November 26, 1984, the examination was forwarded to the Board of Directors of Old Court, with a carbon copy to MSSIC.[91]

Comment 1 of the examination regarded overdrafts of NOW accounts. The following accounts were overdrawn on April 30, 1984 and June 20 or June 30, 1984 in the amounts set forth:

Name	4/30/84 Balance	*6/20/84 or 6/30/84 Balance
The Glass Smith, Inc.	$ 71,379.70	$ 71,379.70
Levitt Family Partnership	155,205.77	193,126.93
Levitt, Pearlstein Management Co.	11,539.71	36,000.05
Ruxton Post Limited Partnership	300,352.70	478,368.94
Light Street Partnership	28,762.40	*216.40
Calvert and Redwood Limited Partnership	140,692.67	184,624.60
Chadford Associates	45,030.34	47,934.26
Pearlstein Levitt Investments	19,106.94	Credit Bal.
Pearlstein Levitt Investments	12,114.11	24,343.58
Western Cross Limited Partnership	88,499.86	246,362.87
	$872,684.20	$1,282,357.33

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90 Interview with Art Friedman July 31, 1985.

91 See Division examination of Old Court as of April 30, 1984, Exhibit IIIB62.

No overdraft penalties were assessed with respect to the accounts. Levitt was a principal in the Levitt Family Partnership, Levitt Pearlstein Management Company, Light Street Partnership, Calvert and Redwood Limited Partnership, and Pearlstein Levitt Investments. Pearlstein was a principal in Levitt Pearlstein Management Company and Pearlstein Levitt Investments. Ruxton Post Limited Partnership and Chadford Associates were also related entities through the association's service corporations. In short, entities controlled by Levitt and Pearlstein were permitted to overdraw their NOW accounts at Old Court at will.

Comment 2 in the examination set forth the unsecured note loans from the association to entities in which Levitt was a principal, as follows:

Borrower's Name	Loan Amount
Calvert and Redwood Ltd. Partnership	$ 100,000
Levitt and Pearlstein Investments	285,000
Charles St. Title and Jeffrey Levitt	2,960,000
Levitt and Pearlstein Investments	385,000
Levitt and Pearlstein Investments	25,000
Levitt and Pearlstein Investments	200,000
Logan Village, Ltd. and Levitt and Pearlstein Realty	225,000
Levitt and Pearlstein Investments	125,000

The total of the unsecured note loans to Levitt and Levitt and Pearlstein businesses was $4,305,000.

The examination also commented on eleven loans by Old Court, ten of which exceeded $1,000,000, where it appeared to be common practice for the association to lend money for projects which it controlled in amounts which violated regulatory loan to value ratios, taking fees into income for loans which were to itself and limiting the borrowers' liability to the property used as collateral. Some of the comments are summarized below.

Comment 3 analyzed a $3,401,000 loan to Whitpain Associates (also known as Meadowick, the same project commented on by Patrick McCracken before the MSSIC Membership Committee). The loan was originally made on July 26, 1983, secured by an unrecorded second mortgage on 273 townhouse apartments. By agreement, the mortgage was not to be recorded. The note limited the lender's recourse to the property itself. Old Court Investment Corporation was one percent general partner and Old Court Joint Venture was a 45.6% limited partner. Despite their participation and apparent control of the project, a 2.86 point loan fee was taken into income by Old Court. All costs were paid from settlement, including paying off of a $100,000 note loan for a down payment for the property. There was no cash contribution by any of the partners. $1,500,000 of the loan was deferred and placed into a twelve percent certificate of deposit at Old Court. The interest on the certificate was used to pay the interest on the loan. Thus, Old Court provided 100% financing for the project, including financing fees paid to itself and taken into income and including financing the interest to be paid. The borrowers incurred no risk whatsoever.

Comment 4 addressed three loans in the amount of $3,207,000 to MSDL Partnership, which was comprised of David, Steven and Mark Hurwitz (sons of Zell Hurwitz, President of Sharon Security Savings and Loan) and Edwin Lax. The loans were at a submarket eleven percent fixed rate with a three percent service fee and were secured by stores leased to a convenience store chain around Buffalo, New York. There were two sets of appraisals, one day apart, performed by Robert H. Hudson, Executive Vice President of Bankers Appraisal Services Inc., a subsidiary of Old Court. Hudson was formerly a Vice President of First Progressive. On each loan, the new appraisal increased the appraised value, decreasing the loan to appraisal ratio. Despite the reappraisals, however, only one of the ratios was within the eighty percent limitation established by Division regulation. The examiners noted that the loan was at a submarket rate.[92]

Comment 5 addressed various loans to Chadford Associates Limited Partnership, which consisted of eighty-five percent ownership by Old Court Investment Corporation, 7.5% ownership by Zell Hurwitz, President of Sharon, and 7.5% ownership by MSD Associates, a partnership of Hurwitz's sons. The partners made no capital contribution to the partnership. On October 29, 1982, Old Court made a $330,000 second mortgage loan to the partnership secured by 909 West University Parkway, an apartment building. Loan proceeds of $140,000 were placed into escrow. The seller of the apartment building had taken back a $345,000 first mortgage. By July 7, 1983, the escrow account was overdrawn by $4,586.76 but no interest had been paid and, in

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[92] The apparent explanation for the submarket rate is that the principals of Sharon and Old Court used cross lending to avoid the requirement that Division Director approval be obtained for insider loans. During the same period that the MSDL loans were made by Old Court, Sharon and Security were making similar loans to Old Court insiders. See Section IIIH.

fact, it was not paid until November of 1983. In November, the first mortgagee sought to foreclose for nonpayment of interest but Old Court bought the first mortgage for $380,810.42. On December 20, 1983, Old Court issued a $1,200,000 mortgage loan, paying off the first and second mortgages and taking a three percent loan fee. The appraisal in the file established a renovated market value of $782,000, making the loan to appraised value 153%, in violation of Division regulations, limiting loan to value ratios to eighty percent. Interest payments on the new loan were paid from Chadford Associates NOW account with Old Court. The NOW account was overdrawn for most of the period from January 9 to June 30, 1984, and the overdrawn balance as of June 30 was $47,934.26. There was no insurance policy in the file, nor was there a title policy, despite the fact that a fee had been charged for one. On January 19, 1984, $45,000 was disbursed to Levitt Pearlstein Management Company for work performed on the property.

The examiners addressed eight land acquisition and development loans totaling $15,000,000 to Karol Springs in Comment 6. The borrowers were eight corporations in which Levitt was the only listed director. The land securing the loans was located in Coral Gables, Florida. A three point loan commitment fee was charged on each loan. In Karol Springs Limited Partnership 1, Levitt was a general and limited partner, listed to receive ninety-eight percent of the profits. The appraisals were performed over a month after the loans were settled, revealing loan to value ratios ranging from 94.5% to 121%. The examiner commented that there was no Division Director approval of the insider loans, in violation of Section 9-307(b)(2)(iii) of the Code, that Regulation .23B required appraisals to be made before the loan, and the loan to appraisal ratios exceeded the seventy-five percent limitation set forth in Regulation 30C(8).

Comment 7 focused on Karols Landing Limited Partnership, to which the association granted a $4,500,000 land loan, charging a three percent commitment fee. The loan was secured by 109 acres of land on Back River Neck Road. A total of $2,700,000 was distributed for land acquisition, to the buyers, Old Court Investment Corporation and L&P Realty Corporation, despite the fact that the sales agreement showed a sales price of $2,200,000. Directors Levitt and Pearlstein were principals in L&P Realty Corporation. There was no appraisal in the file and the loan was for 214% of the sales price of the property, in violation of Division regulations.

An informational comment near the end of the examination stated the following: "For nine months ending April 30, 1984, the association recorded $6,660,000 in loan fees. A substantial portion of these fees was taken out of loan proceeds. The association also has a practice of paying interest on mortgages through interest reserves."

The total net worth of the association as of April 30, 1984, as determined by the examiners, was $997,859. Subsequent events have shown that there was a negative net worth. Thus, from the examiners comments, despite the fact that Old Court was reporting substantial income and profits, and despite the fact that Brown, LeCompte and Hogg reviewed Old Court as a "profitable" association, it was clear that the profits Old Court represented that it was making were completely false. They were based on fees paid to the association out of loans made by the association for projects which the association controlled and for which it bore all of the risk of loss through its subsidiaries' investments. In fact, as the examiners picked up in their examination, Old Court was operating with a negative net worth.

Board of Commissioners and the Old Court/ First Progressive Examinations

The Board of Commissioners received an entirely different picture of the Old Court operation from that conveyed by the examiners. At the Executive Session meeting on October 11, 1984, Charles Hogg and Martin Becker of MSSIC appeared to discuss the Old Court/First Progressive merger. Hogg stated that MSSIC would enter into an agreement with Old Court after the merger which would outline certain changes in the operations of the surviving company having to do with security portfolios, compliance with lending regulations, record keeping and audit procedures. He stated that MSSIC was looking forward to the merger as a resolution of one problem and that it "would not put us into a position of having a larger problem." Gisriel, Chairman of the Board, expressed his concern over the large investments by some associations, such as Old Court, in real estate. He questioned whether there was any self-dealing in the projects and whether the income realized from these projects was real. Hogg responded that "no self dealing was evident in the real estate joint ventures at Old Court." Becker responded that, with respect to income recognition from investments in real estate acquisition, development and construction, some accounting rulings and changes will be forthcoming. Hogg stated that the rulings would deal with the timing of income recognition.

Mr. Stocksdale, a member of the Board, expressed concern over the percentage of larger loans at Old Court involving construction, acquisition and land development. He added that fees were being recognized but whether there was any real profit in the project would not be determined until completion of the development. Hogg stated that MSSIC had done some site inspections of various Old Court projects and had been "very pleased with the product and its apparent viability." Hogg and Becker then discussed generally some real estate projects of Old Court which would be generating "various significant real profits which would help to defray the losses which would be brought into Old Court via the merger with First Progressive."

Brown and LeCompte attended the Board of Commissioners meeting. At that very moment, the Old Court 1984 examination was being edited in their offices. They had received reports from the examiners concerning the severity of the report. They made no disclosure whatsoever concerning the various unsafe practices which the report revealed, permitting the assurances of the MSSIC representatives to the Board to go unchallenged.[93]

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[93] See Board minutes, October 11, 1984, Exhibit IIIB63.

On December 13, 1984, the Board of Commissioners held its first Executive Session meeting after the Old Court 1984 examination was released to MSSIC and the Old Court Board. Stocksdale stated that Old Court was in violation of the commercial real estate lending limitation and expressed concern about an article in the newspapers concerning their involvement in a development project in Florida. He also questioned the fluctuation in their profitability. Brown responded that Old Court had until the end of December to reply to the Division's examination report and that the Division would "evaluate their operation at that time." He also stated that a newspaper article regarding Old Court's involvement in the Poinciana Project was very misleading and that Old Court had "about $4-1/2 million in a very secured real estate acquisition loan." The Board stated that they would like to have the principals of Old Court address the Board at a future executive session meeting. The Old Court examination was not presented to the Board of Commissioners.[94]

Brown believed that the examination revealed probable criminal activity on behalf of Levitt. He believed, however, that he should not do anything until the association had an opportunity to respond to the comments set forth in the examination. LeCompte concurred that nothing could be done until the association responded. Neither consulted the Assistant Attorney General assigned to the Division.

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[94] See Board minutes, December 13, 1984, Exhibit IIIB64.

MSSIC Reaction to the Old Court Examination

MSSIC received its copy of the Old Court examination in late November or early December. The staff immediately reviewed it, including Paul Trice and Charles Hogg. They also consulted with their attorney concerning the examination. They decided to send their own examiners into Old Court.

At the MSSIC Membership Committee meeting on December 12, 1984, the Old Court examination was discussed. Otto moved that Old Court be required to submit daily reports, which motion was seconded by Dietz but a vote was not taken. Otto also recommended that the Board consider requiring a MSSIC staff member to attend all Old Court Board and committee meetings. Dietz again seconded and the motion carried. Brooks moved that in view of the violations of the lending rules and violations of the staff cease and desist letter, the Membership Committee recommend that the Board issue a cease and desist order. Dolivka seconded the motion and it passed unanimously.[95]

At the Board of Directors meeting on December 19, 1984, Pierson, the Chairman, expressed his concern over the leak of confidential information to the press. Counsel for MSSIC discussed the potential liabilities of MSSIC if leaks of information lead to bad publicity for a specific association or for all associations. He expressed the opinion that MSSIC could have substantial liability to associations under such circumstances.

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[95] MSSIC minutes, December 12, 1984, Exhibit IIIB65.

The Board also discussed the Membership Committee's recommendations regarding Old Court. Although the Membership Committee had voted not to allow Old Court to convert First Progressive's hypothecation into a subordinated debenture, Trice noted that under the terms of the hypothecation agreement, MSSIC had no basis to delay disbursement of the hypothecated funds after the merger, if Old Court complied with the net worth requirement. The Board then voted to allow the conversion. There was no discussion about the false picture of Old Court's net worth given by their reporting on SL200's, which was exposed by the Division examination.

After the report of the Membership Committee's recommendation that a MSSIC staff member attend all Old Court Board and committee meetings, there was a discussion as to the legalities of the recommendation. Laudeman noted that a cease and desist order may be necessary before such action could be taken. After discussion, the Board rejected the recommendation. The Board also discussed the Membership Committee recommendation that a cease and desist order be issued subject to a confirmation of a violation of the staff cease and desist letter issued in August of 1984. In discussion, it was noted that the Poinciana Project had been reviewed by the staff and may not have violated the cease and desist letter. Action was deferred on the Membership Committee recommendation. During the entirety of the Board of Directors meeting, at which all of the Membership

Committee recommendations regarding action to take against Old Court were rejected, counsel for MSSIC was present, rendering legal advice.[96]

In December of 1984, Hall believed that his firm was entering a potential conflict position in its simultaneous representation of Levitt, Old Court and MSSIC. He advised his firm's managing partner, Jacques T. Schlenger, of his concerns. Schlenger told him to discuss it with Gerald Katz, the attorney responsible in the firm for Old Court, Levitt and Pearlstein. Hall went to see Katz, who was not in his office. He did not return to see Katz or raise his concerns with anyone else.

A more persistent inquiry would have revealed his firm's representation of Old Court subsidiaries in the Tega Cay transaction, which had just been completed in November of 1984. The transaction involved the purchase of the stock of four companies in South Carolina comprising a major residential development. The assets of two of the companies, TC126 and TC22, consisted of development lots and improvements. The other two companies, Tega Cay Recreation and Tega Cay Utilities, consisted of an eighteen hole golf club and a utility company serving the development. VB&H handled the transaction pursuant to which Tega Cay Development, Inc. was formed (sixty percent to OCIC, an Old Court subsidiary and forty percent to Edward R. Oppel) to purchase the stock of all four Tega Cay companies. Financing for the purchase was provided by a $7,000,000 mortgage loan from Old Court, despite the fact that the purchase price for the stock was

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96 MSSIC minutes, December 19, 1984, Exhibit IIIB66.

$5,000,000. Cardin and Cardin, rather than VB&H, handled the loan from Old Court, preparing the loan documents almost two months after settlement. The stock of Tega Cay Recreation and Tega Cay Utilities was assigned to Levitt, Pearlstein, Cardin and Oppel for the purported consideration that they agreed to contribute $100,000 in capital to each corporation <u>that they were given</u>. Thus, although Old Court paid for the recreation and utility companies, they were <u>given</u> to Old Court's stockholders with Old Court receiving nothing in return.[97]

Katz and James D. Wright of VB&H have testified that Old Court, through its investment in Tega Cay Development, Inc., benefited from the act of giving away the recreation and utility companies to Levitt, Pearlstein, Cardin and Oppel. In their opinion, the recreation and utility companies had no real value, were in existence solely to benefit the two development companies and the promise of the stockholders to contribute capital to the recreation and utility companies would thereby enhance the value of the development companies and, hence, Old Court's investment.[98] The Office of Special Counsel strongly disagrees that the recreation company, with its eighteen hole golf course and lengthy schedule of personal property and the utility companies, which was undergoing a rate hearing at the time of the transaction, were worthless. That claim is belied by the fact

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[97] James D. Wright transcript; September 25, 1984 letter Wright to Levitt, Exhibit IIIB67; October 4, 1984 memorandum, Exhibit IIIB68; and November 6, 1984 letter Katz to Levitt, Exhibit IIIB69.

[98] Wright transcript dated December 3, 1985, at pages 74-79. Katz transcript dated December 9, 1985, at pages 112-115.

that Katz advised Levitt that the gift of the recreation and utility companies to the Old Court stockholders and Oppel created a "very substantial tax exposure" for them.[99]

Update Examinations by MSSIC and Division

Following the completion of the 1984 Old Court examination, both the Division and MSSIC sent examiners into the association to update the comments. Both of the regulators' examiners found confirmation of the past practices and newer, more questionable practices and regularly reported their findings to MSSIC and the Division.

Patrick McCracken, a MSSIC examiner, led the examination on behalf of MSSIC. On January 31, 1985, he produced a memorandum concerning the current status of overdrawn NOW accounts at Old Court.[100] McCracken's detailed analysis showed that 403 of Old Court's 7,125 NOW accounts were overdrawn for a total of $9,926,570. Forty-seven of the overdrawn accounts accounted for 99.5% of the total overdrafts. Thirty of the forty-seven were easily identified as held directly or indirectly by related parties, accounting for a total of $5,724,421 of overdrafts.

McCracken also reviewed the unsecured note loans from the association to related parties. He found that there were at least twenty such loans for a total of $5,787,979. He additionally performed a brief analysis of loans with poor

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99 Exhibit IIIB69.

100 McCracken memorandum, January 31, 1985, Exhibit IIIB70.

underwriting and documentation. One of the loans he analyzed was a $1,001,921 loan to Jeff and Walts Air Service. There was limited documentation in the file and the loan was to a related party, reflecting a conflict of interest which had not been approved pursuant to Section 9-307 of the Code. Jeff and Walts Air Service was a company formed by Levitt and Walter Otstot to purchase an airplane. VB&H performed legal work in forming the company.

McCracken reported the information he gathered to MSSIC management and counsel in January and February of 1985. He also discovered that, in 1984, Levitt had been paid $2,100,000 in the form of various fees from Old Court, its subsidiaries and related entities. He presented representative documents of Levitt's ongoing claims for fees, such as the invoices from the law offices of Jeffrey A. Levitt dated February 6, 1985.[101] The invoices from Levitt's law firm are both for "arranging" loans and are in the amount of $250,000 each. There are no details of any services performed nor any specification as to whether the services were law-related or other types of services.

McCracken also discovered minutes of Board of Director meetings of Meridian Mortgage Investments, Inc., an Old Court subsidiary. For example, the minutes of the meeting dated June 12, 1984 attended by Allan Feinberg, Jeffrey Levitt, Dennis Guidice, and Roxanne Helm granted a fee of $100,000 to Levitt "as a consulting fee." Karol Levitt and Robert Pearlstein, son of

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101 See invoices of February 6, 1985 from Ann Marie Buscemi to Old Court Joint Ventures Inc., Exhibit IIIB71.

Allan Pearlstein, each received $1500 in consulting fees. Allan Feinberg received $20,000 in consulting fees for the month and an agreement was made between Levitt and Walter Otstot requiring Meridian Mortgage to pay Otstot a fee of $40,000 per month for a period of twelve months for "good will." Otstot was a partner of Levitt's in real estate ventures at Ocean City.[102]

On July 10, 1984 the Meridian Board voted a $150,000 end of year bonus to be paid to Levitt. Again, Karol Levitt and Robert Pearlstein were given $1500 in consulting fees, Otstot was given $40,000, Feinberg $2000 and Susan Grant, who was just reinstated as Executive Vice President of Meridian on July 9, 1984, was given a company car - an Avanti, at the cost of $39,572.25.[103]

MSSIC's Membership Committee asked their counsel whether the overdrafts of NOW accounts by officers and directors constituted a violation of Maryland law, MSSIC rules or Division rules. On February 14, 1985, Hall had a conference with Trice concerning the overdrafts.[104] Trice advised Hall that the "problem regarding the overdrafts was Levitt," his firm's client.

Hall produced an opinion on February 22, 1985.[105] It concluded, in response to the question of whether "any law of the

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102 See Meridian Mortgage Investments, Inc. Board of Directors meeting minutes for June 12, 1984, Exhibit IIIB72.

103 See Meridian Mortgage Investments, Inc. Board of Directors meeting minutes for July 10, 1984, Exhibit IIIB73.

104 See Hall handwritten note of February 14, 1985, Exhibit IIIB74.

105 See opinion of VB&H to Membership Committee of MSSIC dated February 22, 1985, Exhibit IIIB75.

state of Maryland has been violated," that the conflict of interest provisions of Sections 9-307 and 9-323 of the Code were violated because the NOW account overdrafts constituted an unsecured loan from the institution to an insider. The opinion did not mention Levitt by name. Although Hall testified that he made an analysis of whether other provisions of Maryland law, including criminal provisions, were violated, he included no discussion of other statutes in his opinion. He acknowledged that there were other attorneys in his firm who were experts in criminal law but he did not consult them.[106] When the overdraft problem was described to Attorney General Sachs several months later, he immediately requested authority to conduct a criminal investigation on the grounds that such overdrafts constituted violations of numerous provisions of the Maryland criminal law.[107] In the opinion of the Office of Special Counsel, the NOW account overdrafts by insiders at Old Court constituted clear violations of criminal statutes.[108]

On February 22, 1985, while McCracken was reviewing documents at Old Court, he was advised by an Old Court employee that they were going to work all weekend, in order to create documents to complete files. He immediately requested Martin Becker, who was examining Merritt, and various staff members at MSSIC to come to Old Court to help him copy documents in order to

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106 Hall transcript dated November 20, 1985 at pages 174-177.

107 See letter from Attorney General Stephen Sachs to Governor Harry R. Hughes dated May 3, 1985, Exhibit IIIB76.

108 See opinion of the Office of Special Counsel regarding NOW account overdrafts by officers and directors, Exhibit IIIB77.

assure that they were not altered over the weekend. Dennis Guidice, an Old Court officer, called Charles Hogg to complain. Hogg called Martin Becker and ordered him to "finish up what he was copying" and leave. In testimony, Hogg stated that he was concerned that female MSSIC employees were working late on a Friday night in downtown Baltimore and would be unsafe returning to their cars. Becker and McCracken stated that they were not finished copying documents, that they viewed it important to continue copying until they were through and that they viewed Hogg's direction as interfering with their efforts to assess the situation at Old Court.

The Board of Directors of MSSIC considered the Old Court situation on February 27, 1985. After a discussion of the examinations, the Board resolved that Old Court be subjected to a Cease and Desist order under Section 3-222A of MSSIC's Regulations. The Board resolution specified that the order should state that within thirty days following receipt by Old Court of notice of the Board's determination to issue a cease and desist order, Old Court would be required to enter into a operating agreement with MSSIC. If such an agreement was not entered into, Old Court would be required to attend a hearing at MSSIC regarding their violations. Apparently, although counsel was present, there was no discussion regarding issuing an emergency cease and desist order pursuant to MSSIC regulations, nor was there discussion regarding removal of officers or directors.[109]

Subsequent to the Board meeting, a meeting was held with MSSIC management, Division management, Hall, Pearlstein, Levitt and Cardin.[110] At the meeting, the Old Court representatives were told of the Board action. Levitt, Pearlstein and Cardin advised MSSIC that John Faulkner, formerly Chairman of the Board at MSSIC, had been hired by Old Court as a "consultant." Chairman Pierson stated that MSSIC had "bent over backwards for you guys" and that "you guys are capable guys, we want to cooperate but something must be done." Hogg also spoke at length about the specifics of the corrective action he wanted taken. The Old Court management expressed their agreement with the MSSIC decision, stating that they were also anxious to "straighten things out" and representing that most of the problems were administrative. Jerome Cardin, on behalf of the association stated that "there are some positives - profitability was as good or better than ever."[111]

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109 MSSIC minutes, February 27, 1985, Exhibit IIIB78.

110 _See_ McCracken memorandum February 28, 1985, Exhibit IIIB79.

111 In fact, at this point MSSIC and the Division had received the certified financial statement for Old Court as of July 31, 1984. _See_ Exhibit IIIB80. Footnotes to the audit pointed out that only the recognition of fees permitted under regulatory accounting practice permitted Old Court to have a positive net worth. As of July 31, 1984, if Old Court had taken fees into income in accordance with generally accepted accounting principles, it would have had a negative net worth, a point noted by the Division examiners in their examination as of April 30, 1984.

During this period of time, Division examiners Thomas Berger and Charles Endres were performing an updated examination of Old Court. They reported their findings on a regular basis to Brown and LeCompte and set forth their findings in a memorandum to Brown dated April 1, 1985.[112] The report reiterated the same concerns regarding unsecured note loans and NOW account overdrafts of insiders. It also pointed out various violations of regulations regarding loans and loan documentation.

MSSIC and Division Corrective Action

In January of 1985, Charles Hogg attempted to correct the mismanagement situation at Old Court by introducing Jeffrey Levitt to Huell E. Connor, M.D., a psychiatrist. Hogg had known Dr. Connor for several years. Dr. Connor was a former treating psychiatrist who, around 1980, entered into the full time business of providing consulting to small, growing businesses and entrepreneurs. Hogg considered him an expert in dealing with "people with newly acquired wealth." He arranged a lunch meeting with Levitt and Connor, after which Levitt hired Dr. Connor. His fees were paid by Old Court. Dr. Connor proceeded, over the next several months, to provide management analysis and consulting services to Levitt and Old Court.

After the MSSIC Board of Directors' resolution on February 27, 1985, MSSIC staff and their counsel met to draft the cease and desist order. The order was not issued until March 22,

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[112] See memorandum to Charles H. Brown, Jr., Director, April 1, 1985, Re: Review of Old Court Examination April 30, 1984 and December 31, 1984, Exhibit IIIB81.

1985.[113] The letter was drafted by counsel for MSSIC. It specified numerous violations by Old Court of statutes and regulations and set forth the Board's requirement that Old Court enter into an operating agreement with MSSIC or submit to a cease and desist proceeding.

After the cease and desist letter was delivered to Old Court, negotiations for an operating agreement commenced. Hall, counsel for MSSIC, drafted the initial Operating Agreement and then entered into negotiations with Old Court's counsel, Cardin and Cardin, regarding its terms. Hall testified that he felt that MSSIC did not have the authority to simply require terms by threatening cease and desist proceedings or expulsion. Therefore, he permitted the various terms insisted upon by counsel for Old Court to be placed into the Agreement. For instance, Paragraph 1A of the Agreement prohibits Old Court from making construction loans or commitments for them without MSSIC's prior written consent. Cardin and Cardin insisted that a provision stating that MSSIC's consent "shall not be unreasonably withheld" be inserted into the Agreement. The same provision prohibiting MSSIC from "unreasonably withholding consent" was placed into the Agreement wherever MSSIC's consent was required. MSSIC's remedies for breach of the Agreement were the right to issue a temporary cease and desist order under MSSIC's rules "requiring Old Court to cease and desist from such default," the ability to require execution of a voting trust agreement and the

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[113] See letter from Charles Hogg to Jeffrey Levitt dated March 22, 1985, Exhibit IIIB82.

right to exercise any other rights MSSIC had under its rules, bylaws or other laws. Old Court acknowledged in the Agreement that "any uncured default by Old Court in the performance of any of its covenants" in the Agreement constituted grounds for issuance of a cease and desist order, in which they acquiesced.[114] The Agreement also called for a "legal audit" of Old Court's documents by their counsel, Cardin and Cardin, to be reviewed by MSSIC's counsel, VB&H, and required that loans could not be made by Old Court unless Cardin and Cardin had reviewed and approved all documents prior to settlement. Finally, the Agreement left Old Court's management in place, including Levitt as President and a Director. There was no provision for removal of officers or directors, even as a sanction for violating the Agreement. The Operating Agreement was executed on April 23, 1985, almost two months after the cease and desist resolution passed by the Board of Directors of MSSIC. Considering the relevant facts, the Office of Special Counsel considers the Agreement to be woefully inadequate.

The Board of Commissioners was not kept apprised of the developments concerning Old Court. At the Executive Session meeting on February 14, 1985, Brown stated that Old Court was scheduled to have its management attend a meeting and address the Board concerning their operation. Brown asked that the meeting be postponed until the Division had time to review Old Court's responses to the examination. He also stated that the Division

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114 See agreement dated April 23, 1985, Exhibit IIIB83.

had commenced another examination of the association.[115] At the meeting on March 14, 1985, Brown advised the Board that, although they had anticipated a meeting with the Old Court Board on that day, Jerome Cardin, counsel for the association was out of the country and was not able to attend and that, therefore, the meeting would be postponed. Brown also advised that the examiners had just completed a review of Old Court's response to the 1984 examination, stating that the report and response were quite lengthy and that it would take quite some time for a review to take place. Hogg reported to the Board of Commissioners that members of his staff had found further violations of the MSSIC and Division rules and that they were preparing a letter including a list of charges and an operation agreement for corrective action. He stated that failure to sign the agreement would result in the issuance of a cease and desist order. The Board agreed to have a special meeting on April 4, 1985 to review the examination and the associations response.[116]

At the special meeting on April 4, 1985, the Board of Commissioners was given copies of the 1984 Division examination of Old Court. Thomas Berger and Charles Endres summarized some of the problems which they had found, including the NOW account overdrafts. Hogg described the corrective action taken by MSSIC, including the threatened cease and desist proceeding and management agreement. He also enumerated the charges set forth in MSSIC's March 22, 1985 letter to Old Court and described the

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[115] Board minutes, February 14, 1985, Exhibit IIIB84.

[116] Board minutes, March 14, 1985, Exhibit IIIB85.

terms of the proposed operating agreement. He further suggested that the Board of Commissioners direct Levitt and Pearlstein to appear before the Board of Commissioners, express their concerns and state that the Board directed Levitt and Pearlstein to enter into the operating agreement or the Board would take action. Gisriel stated that the Board should advise Old Court of the Board of Commissioner's concerns and state that if Levitt and Pearlstein were not present for a meeting with the Board of Commissioners "we will seriously consider putting them into conservatorship or receivership." LeCompte stated that failure to show up for a meeting was not a basis for conservatorship or receivership and that they would have to prove the association to be impaired. A lengthy discussion followed regarding the various options open to the Board of Commissioners. At the conclusion of the meeting, MSSIC's letter of March 22, 1985 was distributed to the Board members.[117]

A special meeting of the Board of Commissioners was held on April 11, 1985, attended by the Board members, the directors of Old Court, Hogg and members of the MSSIC staff. Gisriel expressed the grave concerns of the Board over Old Court's operation. Cardin, on behalf of Old Court, stated that their lending practices were not significantly different from those of their competitors. Fitzgerald asked whether Levitt would be removed from Old Court and Cardin responded that his removal was not being considered, stating that he is "very knowledgeable with respect to real estate and its development"

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117 Board minutes, April 4, 1985, Exhibit IIIB86.

but "not a good documentation person." (Incredibly, this rather complimentary view of Levitt seems to have persisted with Brown, LeCompte, Hogg and Hall to the present time.) Cardin further represented that the real estate deals put together by Levitt are "extremely sound, viable and profitable." At the conclusion of the meeting, Gisriel informed the Old Court directors that they should take action to correct all violations and that they should sign the operating agreement with MSSIC. If this were not done, he stated that the Commissioners would reconvene and take whatever action was deemed necessary "regardless of the impact it may have."[118]

In April and early May of 1985, meetings commenced with various government officials concerning the operation of Old Court. At a meeting on May 2, 1985, for the first time, the MSSIC cease and desist letter of March 22, 1985, was revealed to state and federal officials. (This statement excludes Division employees.) Subsequent meetings culminated in the conservatorship for Old Court instituted on May 13, 1985, described, infra.

Attorneys for Levitt, Pearlstein and Cardin have indicated that, if subpoenaed to appear and testify concerning matters in this report, their clients would choose to assert their Fifth Amendment privileges against self-incrimination.

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118 Board minutes, April 11, 1985, Exhibit IIIB87.

C. MERRITT COMMERCIAL SAVINGS AND LOAN ASSOCIATION

Introduction

In 1982, Gerald S. Klein and Robert V. Gibbs each owned fifty percent of Middle States Financial Corporation (Middle States). Middle States purchased one hundred percent of the stock of Merritt Savings and Loan, Inc. (Merritt) in May of 1982 from Dr. Gilbert Cullen, Eugene Hettleman and Milton Sommers.[1] Merritt subsequently changed its name to Merritt Commercial Savings and Loan Association.[2]

When purchased, the association had $80,000,000 in assets. In the next three years it grew to $350,000,000 in assets, a growth rate far in excess of a rate considered acceptable by the Federal Home Loan Bank Board (FHLBB).

Management

Shortly after its purchase by Middle States, Merritt's officers and directors were:

1. Gerald S. Klein, Chairman of the Board and Executive Vice President
2. Milton Sommers, President
3. F. Ripley Bowman, Vice President
4. William M. Dubit, Controller
5. William L. Lebling, Jr., Vice President
6. Carol Reely, Vice President

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[1] Supplementary Stock Sale Agreement, May 25, 1982, Exhibit IIIC1.

[2] <u>See</u> Section II of this Report, Footnote 135.

7. Suellen M. Taylor, Vice President

8. Regina Lee, Secretary, Treasurer

9. Mary Ellen McDowell, Auditor

10. George Klein, Vice President

11. Charles Vanes, Vice President[3]

Several of these individuals retained their positions until Klein and Gibbs had a dispute in July 1984, when the following "interim board" was elected:

Alan I. Baron

J. Jay Boland

Lowell R. Bowen

Eugene Hettleman

Zelig Robinson

Milton Sommers[4]

Earlier Klein had removed himself as a director and an officer in an attempt to avoid insider loan prohibitions.[5] After the interim board was elected Klein and Gibbs maintained their equal ownership interests, until November 1984 when Klein bought out Gibbs.[6]

Merritt's rapid growth was primarily fueled by practices in violation of Maryland law, and Division and MSSIC rules and regulations. The association became the primary risk taker in a

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[3] Division examination of Merritt as of December 31, 1982, Exhibit IIIC2.

[4] Merritt Board of Directors minutes, July 27, 1984, Exhibit IIIC3.

[5] Trice testimony at 224-228; Charles Hogg's handwritten notes, Exhibit IIIC4.

[6] See infra at 255.

series of joint ventures, real estate investment equity partnerships and service corporations where the association, or its controlling parties engaged in self-dealing and insider transactions. These activities are detailed at length in the Division examinations, as of December 31, 1982 and as of January 31, 1984.[7]

Division Examinations

The Merritt Examination as of December 31, 1982

Merritt's examination as of December 31, 1982 was conducted from January 12, 1983 to March 8, 1983. Four Division examiners spent a total of 134 examiner days at the association. The examiner in charge was Charles F. Endres. The examination comments along with a supervisory letter from Division Director Charles Brown were mailed to the association on July 26, 1983 and the association's reply was received two months later.[8] In general, the examination revealed: loan files without any appraisals in deals totaling over $500,000; twenty-six delinquent mortgage accounts with a combined outstanding balance of over $3,000,000; over $500,000 in delinquent and unpaid interest on other "loans subject to comment"; over $1,000,000 invested in "unsecured federal funds"; the Alexander Grant Company (Alexander Grant) audit for the fiscal year ending September 30, 1982 had not been received at the conclusion of the examination (March 8, 1983); a $160,000 variance was noted between the "equity in

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[7] Footnote 2, supra; Exhibit IIIC2; and Exhibit IIIC5.

[8] Division Examination as of December 31, 1982 and Supervisory letter of July 26, 1983, Exhibit IIIC2; Merritt's reply to the as of December 31, 1982 Division Examination, Exhibit IIIC6.

Institutional Service Corp" (a wholly-owned subsidiary, hereinafter "Institutional") on Merritt's books and the retained earnings on Institutional's books; Merritt had $11,500,000 in certificates of deposit in the name of its related entities, affiliates and subsidiaries, as opposed to in Merritt's name as required by Section 9-422 of the Code; consultant fees of $36,000 were paid to Gibbs and to Gerald S. Klein, Chartered, without Board of Directors approval; and Klein had only attended three of fourteen board meetings.[9]

Comment 10, specifically referred to in the Division Director's supervisory letter accompanying the examination comments, noted:

> The examiners were informed on February 9, 1983 that Delmarva Venture Corporation is not a subsidiary of Merritt Capital Corporation, but rather a wholly-owned subsidiary of Middle States Financial Corp. Middle States is the sole stockholder of Merritt Savings and Loan. Mr. Gerald S. Klein, Director and Chairman of the Board of Merritt Savings and Loan, and Mr. Robert Gibbs are equal owners of Middle States Financial Corporation.
>
> On January 26, 1983 Merritt Capital Corp. had $900,000.00 in notes receivable from Delmarva Venture Corp.; however, as of February 9, 1983 <u>this amount was removed from Merritt Capital Corp.'s books. Instead, it was placed on Merritt Savings and Loan Association's books as an unsecured note loan to Delmarva Venture</u>.
>
> In reference to Mr. Gerald S. Klein, this loan did not meet the requirements of Financial Institutions Article 9-307(b)(2) (ii and iii). In reference to Mr. Robert Gibbs, the requirements of Financial Institutions Article 9-323(d)(1)(1) and 9-323(e)(2) and (3) were not met.[10] (emphasis

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[9] Exhibit IIIC2, Comments 1-9.

[10] *Id.*, Comment 10. Merritt Capital Corporation was a wholly-owned subsidiary of Merritt.

supplied).

The cited statutory provisions prohibit insider loans except under specified situations and with specific Division approval.[11]

A separate section of the comments dealt with Institutional, a wholly-owned subsidiary of Merritt.[12] These comments detailed the following:

1) Institutional's books contained a $3,000,000 asset representing the contribution "by Merritt S/L of 2 shares of the capital stock of Ocean Development Corp. to the capital of ISC - at fair market value." The $3,000,000 valuation, according to the examiner, was supplied by management in reliance on an Alexander Grant evaluation. The examiner noted, however, regarding the Alexander Grant evaluation, that "no work papers were available to the examiners to verify the amounts recorded by the association." It also was noted that an additional million-plus in note loans to Ocean Development were recorded without any described purpose.

2) Another Institutional asset valued at $1,450,000 represented "1 share (100%) of the capital stock of Wellington Development Corp. in consideration for arranging mortgage

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[11] Md. Fin. Inst. Code Ann. §§ 9-307, 9-323 (1980), see also Md. Admin. Code Tit. § 09.05.01.43 (1985), see infra at 240-244.

[12] Analysis of Merritt affiliates received from D. Dickie, Division Examiner, and Martin Becker, MSSIC Analyst, Exhibits IIIC7 and 8.

financing from Merritt Savings and Loan, Inc." Again, management claimed the valuation was established by Alexander Grant, and again no confirmatory work papers were available.[13]

A final section of the comments related to Merritt Capital Corporation (Merritt Capital), another wholly-owned subsidiary of Merritt. The examiners noted that since its incorporation in September 1982, no capital contribution to Merritt Capital had been recorded and no officers or directors of Merritt Capital existed.[14]

Merritt's response to these comments was in the form of a September 14, 1983 letter from Klein to Brown.[15] In essence, Klein, on behalf of Merritt, agreed to review questioned practices and "act accordingly." The Alexander Grant work papers were said to have been supplied by Alexander Grant, and Klein defended the $900,000 insider loan referred to in Comment 10 by citing an opinion of Eugene Hettleman, Esquire. The "Hettleman Opinion," contained in an undated letter from Hettleman to Brown, contended that as long as a loan to a controlling person was made indirectly, through an intermediary, as opposed to directly from the association, no violation of Maryland law occurred.[16] Hettleman wrote:

> Merritt has made a loan to Delmarva Venture Corporation, which corporation is wholly-owned by Middle States Financial Corp., whose stock is held by Gerald S. Klein (director, officer, and

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[13] Institutional Comments 1 and 3, Exhibit IIIC2.

[14] _Id_., Merritt Capital Comments 1 and 2; Exhibit IIIC7.

[15] Exhibit IIIC6.

[16] Exhibit IIIC9.

'controlling person' of Merritt), and by Robert Gibbs (not an officer or director, but a 'controlling person' of Merritt).

> Prohibitory statutes are to be construed strictly. Section 9-307 prohibits a loan to a corporation in which an interest of 10% or more is owned by an officer or director. None of the stock of Delmarva Venture is owned by Klein or Gibbs. The examiners apparently read into the statute the language "10% or more is owned <u>directly or indirectly</u> by an officer or director...."
>
> That the framers of this section were aware of the use of these words "directly or indirectly" is shown in the preceeding portion of the same statute which refers to a loan being made "directly or indirectly." Therefore as the loan is not one which is prohibited by the plain reading of the statute, it is not an improper loan as far as 9-307 is concerned. (emphasis in original).

Hettleman continued:

> Section 9-323 which deals with controlling persons, must also be read strictly, and its contrast with 9-307, on the same general subject is evident. 9-307 specifically includes a loan to a corporation in which the disqualified person is a 10% or more owner. The fact that this language is omitted from 9-323 is striking, and certainly not an oversight by the careful and distinguished committee, including yourself, which prepared the present statute.[17]

Therefore, according to Hettleman:

> [Section] 9-323 deals only with a transaction had directly with a controlling person, and does not include a corporation to which the controlling person may have an interest.
>
> A loan can, of course, be made directly to a controlling person, by following the statutory procedure, and this language also makes it clear

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[17] This "careful and distinguished" committee was comprised of Charles H. Kresslein, Jr., Lowell R. Bowen, Charles H. Brown, Jr., Jerome S. Cardin, R. Terry Connelly, Thomas Costantini, Nathaniel Exum, W. Thomas Gisriel, Franklin Goldstein, James D. Laudeman, Dennis C. McCoy, Donald F. Munson, William G. Rogers, Jr., Ellen R. Sauerbrey, Robert Stocksdale, David H. Wells, Jr. and Harry B. Wolf, Jr. <u>See</u> Section II of this Report.

> that it is applicable to the laon[sic] being made directly to the controlling person, as the language in 9-307 does not appear.
>
> It is requested therefore that you review Comment 10 and possibly reconsider the same. If not please advise of the possible remedial actions which you believe the statutes provide to bring the loan in compliance.[18]

Sections 9-307 and 9-323, while not perfect, clearly covered and prohibited (without Division approval) loans such as described in Comment 10. Nothing in Section 9-323 separates a "controlling person" from other entities in which he has an interest.

In fact, the opposite is the essence of the statute. A "controlling person" is defined in subsection (a) of Section 9-323, as an:

> individual or legal entity, acting <u>directly or indirectly, individually or in concert with one or more other individuals or legal entities</u>, or through one or more subsidiaries, who owns, controls, or holds with power to vote, or holds proxies to vote more than 20 percent of the voting shares of the capital stock association, or controls in any manner the election of a majority of the directors of the capital stock association. (emphasis supplied).

Therefore, the requirement of Division approval of a loan to a "controlling person" within subsection (e) of Section 9-323, by definition, includes loans made to the controlling person's related entities or subsidiaries as enumerated in subsection (a).

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[18] Exhibit IIIC9.

Hettleman's contention concerning Section 9-307 was equally specious. The plain and unambiguous language of the statute prohibits loans:

> directly or indirectly to:
>
> (i) Any officer or director of the association; or
>
> (ii) Any corporation or business in which an interest of 10 percent or more is owned by an officer or director of the association.... (emphasis supplied).

To argue that it is necessary to include, again, the phrase "directly or indirectly" in subsection (ii) before the word "owned," after that prohibition is contained in the introductory language to the subsection, is unsupportable. When Hettleman discussed this "distinction" he neglected to mention that the "preceeding portion" of the statute the "direct or indirectly" was mentioned in, modified the "portion," namely subsection (ii), he relied on.[19] Additionally, the unambiguous meaning of the word "owned" includes an indirect interest, or a degree of proprietorship - complete dominion is not required.

Hettleman's opinion was absurd. Sections 9-307 and 9-323 were designed to regulate and restrict "insider loans" which have been a major cause of the failure of numerous financial institutions. Acceptance of Hettleman's opinion would have allowed a savings and loan to loan money at will to insiders, without Division knowledge or approval, as long as an intermediary corporate entity was used as a conduit for the money.

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[19] Exhibit IIIC9.

The Division took no further action in response to the Hettleman letter and the examiner who drafted Comment 10 was never informed about its resolution.[20] Charles Brown testified that he disagreed with Hettleman's opinion but did not respond to it. He simply disregarded it.[21]

The Merritt Examination as of January 31, 1984

Merritt's examination as of January 31, 1984, was conducted from March 15, 1984 to June 29, 1984. A total of two hundred and eighteen examiner days were spent by six different examiners. The examiner in charge was Gregory L. Watkins. A supervisory letter with comments was mailed to the association on February 19, 1985.[22] Division records do not reflect that a formal reply was ever received from the association.

The comments detailed the following violations of Maryland law and Division rules and regulations.

1) Loans totaling $4,500,000 were made to Delmarva Venture Corporation (DVC), a wholly-owned subsidiary of Middle States, which was the parent company of Merritt. No mention was made of this relationship in the comments. The examiner, Donna Dickie, suspected that DVC was owned by Middle States but was told by LeCompte to "drop it." Dickie was told that she could only review entities owned vertically downstream from Merritt, not entities owned laterally by Merritt's holding companies, Middle

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20 Interview with Division Examiner, Charles F. Endres.

21 Brown transcript at 96,97.

22 Exhibit IIIC5.

States and Middle States Holding Company (MSHC).[23] The purpose of the loans to DVC was to form a construction company to "handl[e] all the construction business of Merritt's subsidiaries and related entities in the Ocean City area - Ocean Development Corporation, Beach Development Corporation, Fenwick Development Corporation and Bridge Development." No current appraisals on the property and equipment purchased by DVC were obtained prior to the loans, in violation of Division Regulation .23B. One appraisal, when finally received, was neither dated nor signed by the appraiser. Based on the appraisals, when received, the total security for the $4,500,000 loan was $1,700,000, rendering the loan far in excess of loan to value limits required by Division Regulation.[24]

2) On March 21, 1983, Merritt granted a $2,500,000 third mortgage loan to Seagate Development Corp. A current appraisal for the property serving as security was not obtained prior to the loan, and the Division's request for a list of the officers and directors of Seagate Development was not furnished. Seagate Development was owned by Devinco of Florida, Inc. (DFI),

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[23] Interview with Division Examiner, Donna Dickie (Dickie Interview). Merritt's management questionnaire, part of Exhibit IIIC5, did disclose the DVC relationship. It was also uncovered in the as of December 31, 1982 examination. Exhibit IIIC2, Comment 10.

[24] Exhibit IIIC5, Comment 2A.

which was owned by International Capital and Development Company (ICDC) an entity Robert Gibbs controlled. After an inquiry from the examiner, this control was disclosed.[25]

3) On May 23, 1983, Merritt granted a second mortgage loan to S.P.H. Associates for $7,400,000 purportedly to construct 280 condominium units in Florida. The association also had granted the first mortgage for $2,500,000. Total loans on the property equalled 107.75% of the associations's net worth, in violation of Division Regulation .30B(1). Additionally, subsequent investigation by the Office of Special Counsel has disclosed that the St. Paul Corporation, a wholly-owned subsidiary of Merritt Capital, owned sixty percent of S.P.H. Associates.[26]

4) The association made a $1,250,000 loan to Pleasanton Park, Inc. for acquisition and development of a trailer park. The loan violated Division Regulation .30C(8)(a) because the appraised value of the property was only $975,000, making the loan in excess of 128% of the appraised value. The regulation required that land acquisition and development loans not exceed seventy-five percent of the market value of the security. Additionally, no financial statements were in the loan file.[27] Finally, although not

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[25] Exhibit IIIC5, Comment 2B; Analysis of Gibbs' affiliates, received from M. Becker, Exhibit IIIC10, <u>see also</u> Exhibit IIIC13.

[26] Exhibits IIIC7 and 8; Exhibit IIIC5, Comment 2C.

[27] Exhibit IIIC5, Comment 2E.

revealed in the examination comment, Institutional, Merritt's subsidiary, owned 100% of Beach Development Corporation, which in turn owned 100% of Pleasanton Park, Inc.[28]

Several other loans were noted to share these and other problems:

1) $4,320,000 to Ketay Southern Corp. (new appraisal necessary);

2) $550,000 to Metro Industrial Park, Inc. (loan to appraisal ratio in violation of Regulation .30C(6)(a), no title certificate and no evidence of hazard insurance);

3) $1,200,000 to Fruitland Park Corporation (loan to appraisal value in excess of eighty-five percent of market and no appraisal until six months after loan was made, no financial statements or title certificates); and

4) a $7,500,000 second mortgage loan to Ketay Enterprises, Inc. dated September 30, 1983, with an appraisal dated January 4, 1984.[29]

More serious, according to the examination comments, was a $4,800,000 second mortgage loan to the St. Paul Corporation on November 21, 1983. The loan was at ten percent for a three year term to finance St. Paul Corporation's purchase of a shopping center in Florida from Devinco of Florida, Inc. (DFI), which was controlled by Robert Gibbs.[30] Further investigation by the Office of Special Counsel revealed that St. Paul Corporation was 100%

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[28] Exhibits IIIC7 and 8.

[29] Exhibit IIIC5, Comments 2(D), (F), (G) and (H).

[30] Id., Comment 2i.

owned by Merritt Capital, which was a wholly-owned Merritt subsidiary.[31] There is no evidence in the Division comment that this interlocking ownership and control was ever disclosed to the Division, nor is there any evidence of Division approval of this transaction where all involved parties were controlled by the financing institution or its owners.

Other problems with this loan noted by the examiner were:

1) the appraisal on the secured property was over a year old at the time of the loan application, in violation of Division Regulation .23B;

2) the loan to value ratio was in excess of ninety-nine percent of the market value of the security in violation of Regulation .30C(4)(b);

3) the combination of a first mortgage on the property earlier purchased by Merritt for $5,600,000 and the $4,800,000 second mortgage was in excess of 100% of the association's net worth in violation of Regulation .30B(1); and

4) the second mortgage loan at ten percent was a submarket rate.[32]

Numerous other problems were written up by the examiners.

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[31] Dean Digiondomenico memorandum to Paul Trice, March 1, 1985, Exhibit IIIC11.

[32] Exhibit IIIC5, Comment 2i.

1) On December 15, 1983, Merritt loaned $5,000,000 to Riverpoint, Inc., secured by "what appeared" to be a fourth lien on property in Florida. Over $3,500,000 of the loan proceeds were disbursed at settlement for attorney's fees, to purchase a judgment against the borrower, and to pay off delinquencies on three other mortgages on the property. The remaining proceeds were placed in a trustee account to pay interest on the four mortgages. Numerous serious violations of Division regulations existed in the Riverpoint file with the most serious being the discovery that Robert V. Gibbs owned a controlling interest in Riverpoint. This ownership interest violated Section 9-323(e) of the Code and Division Regulation .43A(1), (2), (3) and (4). Additionally, the loan file did not contain any financial statements. It also lacked a current appraisal and an insurance policy. Finally, the examiner questioned the association's recognition of a $200,000 gain on the project because the loan was "of such poor quality." It was therefore recommended, but not mandated, that the "gain be deferred until the loan is paid in full."

2) On January 13, 1984, Merritt made a $1,350,000 "farm loan" to Delmarva Grain Corporation. Although not disclosed in the Division comment, the borrower was owned by Delmarva Venture Corporation (DVC), which was wholly-owned by Middle States, which in turn, owned Merritt.[33] The appraisal in the loan file was dated over ninety days after the loan date. The appraisal was also for 547.1 acres more than the acreage set forth in the

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[33] Exhibits IIIC7 and 10.

mortgage instrument as security. No title certificates or financial statements were in the loan file, and the loan to value ratio was in excess of 100%.

3) On March 7, 1984, Merritt made a second and apparently a third mortgage to Plaza West Associates totaling $18,000,000 for "site development" in Annapolis. The association had already loaned $3,600,000 on the same property in 1983. These loans exceeded 100% of the association's net worth and the files did not contain signed loan applications or mortgage notes, in respective violation of Division Regulation .29A(2)(a) and .29A(2)(f). Furthermore, Office of Special Counsel investigation has revealed that Plaza West Associates was owned in part by Institutional Service Corporation, a wholly-owned subsidiary of Merritt.[34]

4) Merritt made a June 28, 1983, $9,000,000 loan to Beautywood Homes, Inc., secured by a recorded second mortgage subject to a first mortgage of $3,000,000 in favor of another savings and loan. When made, this loan exceeded the association's net worth and the loan file did not contain an application.

5) In Comment 3 the examiner noted that many loans made by Merritt had "commitment letters" with exculpatory clauses which released the officers or shareholders of the borrowing entity from personal recourse on the loans. The comment recommended, but did not require, that these clauses "be deleted from all loan documents."

[34] Exhibit IIIC7.

6) Comment 8(c) referred to several NOW account overdrafts with year-to-date totals over $1,400,000. The examiner pointed out that these overdrafts represented unapproved, unsecured loans in violation of Division Regulations. The chief benefactors of these overdrafts were, "Ocean Group, Delmarva, [and] Matson Homes...."[35] Thirty-six percent of Matson Homes was owned by Merritt and Middle States, Merritt's parent, had various levels of ownership in the different "Delmarva" entities.[36]

Although not specifically mentioning these ownership interests, the examiner alluded to them in Comment 8(C):

> [T]he association is advised that F.I. 9-307(b)(2)(iii) prohibits the granting of <u>any</u> unsecured loan to any officer, director, member of the immediate family of an officer or director, or any corporation or business in which an interest of 10 percent or more is owned by an officer or director of the association or any member of the immediate family of an officer or director. (emphasis in original).

The examiner also discussed the "Merritt Tower." Review of the construction project, however, was shortcircuited by the lack of any "written feasibility study." When the association's controller, Bruce Penczek, supplied the examiner with some cost projections, there was no back-up information to support the figures.[37]

Comment 1 of the examination also referred to the Tower:

> the examiners were informed... of management's intention to utilize an accounting procedure whereby a portion of the association's dividend/interest expense on savings would be capitalized to

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35 Exhibit IIIC5, Comments 2J, 2K, 2L, 2M, 3, and 8C.

36 Exhibits IIIC7 and 8.

37 Exhibit IIIC5, Comment 10.

> the Merritt Towers project. It is the position of the Division that such a procedure would understate dividend/interest expense, thereby overstating net income and net worth.[38]

The association was then "requested" to furnish a written opinion from an outside auditor if it intended to continue this practice. When first written, this comment was lengthier and more critical. Specifically, the unedited comment pointed out that the compound effect of Merritt's accounting method would "artificially increase reserves to a level that would allow major stockholders to receive cash dividends on the associations capital stock."[39] Investigation to date has not revealed the identity of the editor.

On another matter, the examiner complained that Merritt failed to comply with a request for all information concerning entities in which Klein or Gibbs had a direct or indirect financial interest.[40] Instead, in response to this request Klein wrote to Brown claiming it would be very difficult "to list the myriad of entities which are subsidiary in whole or in part to Merritt, and all of the transactions between Merritt and them would require many pages." In referring to entities such as Ocean Development, Beach Development Corporation and S.P.H. Associates, which he admitted were wholly-owned by Merritt or its service corporations or subsidiaries, Klein wrote "[i]t is not my understanding that entities of this description constitute entities with respect to which the stockholders of Merritt's

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[38] Id., Comment 1.

[39] Draft Comment 1 for the Merritt as of January 31, 1984 examination, Exhibit IIIC12.

[40] Exhibit IIIC5, Comment 11.

holding company have a direct or indirect interest."[41] This assertion by Klein, according to Division records, apparently went unchallenged.

Finally, as to Merritt, the examination noted that only twenty-seven percent of the association's total assets were residential/owner-occupied loans in violation of Division Regulation .30D(1) which required that these loans "shall constitute in excess of 50 percent of the association's total assets".[42]

Institutional was also examined during this period. Besides noting that no minutes were recorded for Institutional from May 27, 1982 through February 14, 1984 in its minute book, the examiner also stated in Comment 3:

> As of January 10, 1985, the Division has not received the supporting work papers pertaining to the $3,000,000 Ocean Development Corporation capital contribution. These work papers were requested in the prior report of examination (Institutional Service Corporation - Comment #1); these work papers were also requested in the letter dated June 21, 1983 from the Division Director, Charles H. Brown, Jr., addressed to Association President Milton Sommers.[43]

In the face of over an eighteen month delay as of the 1984 examination, the examiner concluded "[a]ccordingly, the association is directed to furnish these work papers to the Division along with the response to these comments."[44]

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41 Klein letter to Brown, July 9, 1984, Exhibit IIIC13.

42 Exhibit IIIC5, Comment 12.

43 Id., Institutional Comment 3.

44 Exhibit IIIC5, Institutional Comment 3.

Although not discussed in the Division examination, investigation by the Office of Special Counsel has revealed that Gerald S. Klein received over $336,000 in management fees from Ocean Development Corporation.[45]

As in the prior Division examination of Merritt, Merritt Capital was included, and its major comment was unchanged after more than a year and a half - "[n]o meetings have been held by the Board of Directors of Merritt Capital Corporation since its incorporation; in effect, no officers or directors have been formally elected or appointed."[46]

Office of Special Counsel examination of the records of all three reviewed entities (Merritt, Institutional and Merritt Capital) did not reveal written approval of any transaction between Merritt and its related entities other than the $4,000,000 loan to Fenwick Development Corporation, discussed <u>infra</u> at 265. This supports the Division Director's recollection that he did not approve the insider loans discussed above.[47]

Klein's Purchase of Merritt from Gibbs

1. Introduction - The Interim Board

The interim Merritt Board of Directors was elected in July 1984, as a result of a dispute between Gibbs and Klein. Zelig Robinson, Eugene Hettleman, and Milton Sommers, were placed on the board to represent Klein's interests; Lowell Bowen, Allan

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[45] Ocean Development payments to Klein, Exhibit IIIC14; letter November 14, 1985, Frank Wise to Office of Special Counsel, Exhibit IIIC15.

[46] Exhibit IIIC5, Merritt Capital Comment 2.

[47] Brown's transcript at 100-102.

I. Baron, and J. Jay Boland were on the board for Gibbs. Gibbs and Klein entered into negotiations to end their business relationship and these negotiations were consummated in late November and early December of 1984, when Klein purchased Gibbs' interest in Merritt and several related entities for $7,000,000.[48]

2. <u>The Purchase</u>

Klein had ongoing discussions with Brown to seek approval of his purchase of Gibbs' interest in Merritt. By letter dated November 23, 1984, Brown authorized Klein's buyout of Gibbs with certain conditions.[49]

In pertinent part the letter provided:

> This is in reference to Mr. Hettleman's recent request that Merritt...be authorized to make a loan to Fenwick Development Corporation, which is 100% owned (or will be) by Gerald S. Klein, presently a major stockholder of Merritt....
>
> In the interest of settling the dispute between the stockholders of Merritt Commercial, you are advised the Division will take no supervisory objection to the association making a loan in the amount of $4 million to Fenwick Development Corporation. This loan will be secured by 100% of the stock of the Fenwick Development Corporation in addition to 66.89 acres of land and the partially completed improvements thereon known as Heron Harbour....

Brown went on to state:

> This approval is granted with the understanding the Heron Harbour Property has a Fair Market Value of Twenty-two Million Seven Hundred Fifty Four

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[48] Klein-Gibbs November 12, 1984 and November 30, 1984 Agreements, Exhibit IIIC16.

[49] Brown's November 23, 1984 letter to Milton Sommers, Merritt President, Exhibit IIIC17.

> Thousand Dollars ($22,754,000) and that any and all liens...will not exceed the loan-to-value ratio set forth in regulations of the Division.[50]

Brown also confirmed that all of the outstanding stock of Merritt would be pledged by Middle States to the association not as security for the loan, but merely to show good faith, and that the entire loan would be personally guaranteed by Klein. Brown had earlier required the personal guarantee of both Klein and his wife but Klein refused.[51]

Finally, Brown wrote that:

> [i]t is my understanding the proceeds of the $4 million loan will be used to purchase the stock of Middle States Financial Corporation now owned by Robert V. Gibbs and the balance of the purchase price of $3 million will not be funded by Merritt Commercial but will be obtained by Gerald S. Klein from other sources. (emphasis supplied).[52]

Klein ignored this supervisory requirement. Merritt, its affiliates and subsidiaries were responsible for supplying $2,000,000 of the remaining $3,000,000 purchase price, and the majority of the final million. Klein obtained the $2,000,000 as follows.

3. Source of the $2,000,000

On August 6, 1984 Merritt loaned $12,000,000 to BBRC of Maryland, Inc. (BBRC). BBRC was made up of four partners including Samuel Rose and Stewart Greenebaum. This loan consisted of two $6,000,000 promissory notes to purchase land and a utility company (Maryland Marine Utilities (MMU)) in Ocean Pines,

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50 Id.

51 Exhibit IIIC18.

52 Exhibit IIIC17.

Maryland.[53] This transaction was authorized by the interim Merritt Board of Directors on August 3, 1984. The minutes of the special board meeting called to approve the loan reflect that a preliminary appraised value of the property was $44,075,000.[54]

The proceeds of the $12,000,000 loan to BBRC were disbursed as follows:

a) $6,400,000 - purchase of land from At-Pac Land Company,[55] (after settlement fees, $6,384,566.36 was actually disbursed to the seller);[56]

b) $600,000 - purchase of land from Transcontinental Development Company,[57] (after settlement costs, $598,306.21, was actually disbursed to the seller);[58]

c) $2,586,260.93 - was placed in two loan-in-process accounts to pay interest on the entire loan;[59]

d) $449,866.50 - attorney's fees, settlement costs, and $240,000.00 in loan fees charged to BBRC;[60] and

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53 Promissory Notes dated August 6, 1984, Exhibits IIIC19 and 20.

54 See Merritt Board minutes, August 3, 1984, Exhibit IIIC21.

55 At-Pac Land Co. Deed, August 1, 1984, Exhibit IIIC22.

56 At-Pac Land Co. Settlement Sheet, August 6, 1984, Exhibit IIIC23.

57 Transcontinental Development Company Deed, August 1, 1984, Exhibit IIIC24.

58 Transcontinental Development Company Settlement Sheet, August 6, 1984, Exhibit IIIC25.

59 Exhibits IIIC26 and 27 which show two deposits of respectively $1,283,630.47, and $1,283,630.46.

60 Summary of Loan Disbursement Sheet, Exhibit IIIC28.

e) $2,000,000 - BBRC loaned this money on August 6, 1984 to Institutional, a wholly-owned Merritt subsidiary, to enable Institutional to purchase a utility company known as MMU.[61]

On November 27, 1984, Merritt loaned its wholly-owned subsidiary, Institutional, $2,063,000 to pay off Institutional's loan from BBRC, plus interest. In return, Institutional gave Merritt a demand note loan for $2,063,000. A memorandum attached to the documents underlying this transaction instructed Merritt's real estate accounting department to transfer the funds from Institutional's checking account (160027900) to BBRC's checking account (160032520).[62] The Office of Special Counsel has found no evidence of any security or collateral for this loan. Nor is there any evidence that this loan was approved by Merritt's Board of Directors. Zelig Robinson, a board member at the time, has testified under oath that he does not recall whether or not the loan was ever approved.[63]

BBRC did not use the $2,000,000 received from Institutional to pay down BBRC's $12,000,000 loan from Merritt.[64] Exhibits IIIC31 and 32 show the payments on BBRC's $12,000,000 loan and do not indicate a decrease in the balance, much less the interest payments, that would result if a $2,000,000 pay down were made. Therefore, $2,000,000 of the original Merritt $12,000,000

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61 $2,000,000 Promissory Note from Institutional to BBRC, signed by Milton Sommers on behalf of Institutional, Exhibit IIIC29.

62 Merritt office memorandum, November 27, 1984, Exhibit IIIC30.

63 Robinson transcript at 17-18.

64 Exhibits IIIC31 and 32.

loan to BBRC that was earmarked for the purchase of MMU[65] was now unfettered. Since Merritt also funded Institutional's payback of its loan from BBRC,[66] it funded the purchase of MMU twice -- once by BBRC and once by Institutional. This allowed BBRC to avoid depletion of its $12,000,000 loan from Merritt and freed up the $2,000,000 designated for MMU.

This "extra" $2,000,000 was then transferred on November 26, 1984, by BBRC to S&S Finance, Ltd. (S&S).[67] Exhibit IIIC34 is S&S's deposit ticket for the $2,000,000 check from BBRC and S&S's account history sheet.[68] This deposit was not made until November 30, 1984. Nevertheless, on November 26, 1984 S&S wrote a $2,000,000 check (check no. 108) to Gerald S. Klein. This check was also drawn on Merritt and signed by Stewart Greenebaum.[69]

Exhibit IIIC36 is a photocopy of both sides of the S&S check to Klein. The back indicates "for deposit only" and is endorsed by Klein's signature and his Merritt account number (160011672). Klein's deposit ticket for November 30, 1984 indicates the deposit of the S&S check in his account.[70]

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65 See Exhibit IIIC28.

66 Exhibit IIIC30.

67 BBRC check no. 105, drawn on Merritt and signed by Stewart Greenebaum, Exhibit IIIC33.

68 Exhibit IIIC34.

69 Exhibit IIIC35.

70 Exhibit IIIC37.

Klein then used this money to help fund the remaining $3,000,000 of the purchase price for control of Merritt. On November 30, 1984, Klein transferred the S&S $2,000,000 deposit out of his account with a $2,000,000 check he wrote to Middle States Holding Company (MSHC), an entity he formed to purchase Middle States.[71] Exhibit IIIC41 is Klein's account history sheet indicating the receipt and payout (by check no. 6-610) of the $2,000,000 on November 30, 1984.

Independent confirmation of the source of the $2,000,000 portion of the buyout has been obtained through an interview with C. Thomas Williamson, III, Klein's former law partner, and by the testimony, under oath, of Gerald S. Klein.[72]

4. Sources of the Remaining One Million Dollars

After combining the $4,000,000 received directly from Merritt and the $2,000,000 received indirectly, Klein still needed another million to fund his purchase. This money was obtained as follows. On November 30, 1984, two other checks were deposited to MSHC's account, one for $650,000 and one for $250,000.[73] The $650,0000 was transferred to MSHC from the account of Gerald S. Klein, Chartered (16001176-3) via check no. 7429. The check is

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[71] Klein's check no. 6-610 dated November 26, 1984, Exhibit IIIC38; MSHC's account history sheet indicating a $2,900,000 deposit, and MSHC's deposit ticket indicating the $2,000,000 deposit along with two other deposits for respectively, $650,000 and $250,000, Exhibits IIIC39 and 40.

[72] Klein transcript at 44-46, Williamson interview.

[73] MSHC's deposit ticket, Exhibit IIIC40.

marked "GSK/RVG Buyout."[74] The bulk of these funds was obtained by Klein from a two check deposit to his account at Merritt. Both checks, #90004420 ($422,918.50) and #90004421 ($32,915.75) were payable to Klein from the Merritt "general expense fund" (10-4231-000), which was used for payment of legal fees.[75]

A review of these two transaction amounts revealed the following. Check no. 90004420 was marked "10-4231-000 1981 thru July 31, 1984."[76] Back up documentation supporting these fees ($422,918.50) was not obtained by Merritt until May or June 1985.[77] In Exhibit IIIC44 Bruce Penczek, Merritt's controller, stated that $241,139 of the legal fees were undocumented even as of the date (June 11, 1985) of his memorandum discussing the allocation of the fees. Additionally Gerald S. Klein, Chartered, on October 7, 1983, had received $100,000 for similarly undocumented legal work.[78] The Penczek memorandum also noted that the fees paid on November 26, 1984 were for work done for a two year period from 1982 to July 31, 1984. The bill itself, however, stated it was for the period "1981 thru July 31, 1984."[79] During the 1982 to July 31, 1984 period Klein's firm received at least

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[74] Exhibit IIIC42.

[75] Exhibit IIIC43.

[76] Id.

[77] Penczek memorandum, June 11, 1985, Exhibit IIIC44.

[78] October 4, 1984 bill and October 7, 1984 check, Exhibit IIIC45.

[79] Exhibit IIIC44.

$221,587.70 in additional legal fees from Merritt.[80] These fees, as well as the fees described in the Penczek memorandum, were for services that inured to the benefit of Gerald S. Klein.

Check #9004421, in the amount of $32,915.75, was noted "2499-000 Ocean Dev. June 1, 1982, thru July 31, 1984."[81] To date, investigation has not disclosed the source of these funds.

The $250,000 check was a result of a loan from Fairfax Savings Association (Fairfax) to MSHC which was secured by 100% of the stock of Middle States, according to Malcolm Berman, Fairfax President, and his attorney, Stanford Hess.[82]

A final $100,000 was received from Delmarva Venture Corporation (DVC).[83] As noted above, DVC was a wholly-owned subsidiary of Middle States, Merritt's parent company. Additionally, DVC was heavily in debt to Merritt.[84]

On November 26, 1984, C. Thomas Williamson, III, then a partner in Klein's law firm, wrote a memorandum to Regina Lee, Merritt's Secretary-Treasurer enclosing "[e]xecuted checks in the amounts of $2,000,000.00 and $250,000.00, respectively drawn on the account of Gerald S. Klein (0160011672)." His memorandum

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80 Exhibit IIIC46 and 47.

81 Exhibit IIIC43.

82 Hess interview; Promissory Note, Exhibits IIIC48; Loan and Security Agreement, IIIC49; Pledge Agreement, IIIC50; and 51 Fairfax check no. 8081.

83 Savings Transaction Ticket - transferring $100,000 from DVC's Merritt account to MSHC's account (#160032710), Exhibit IIIC52; see also MSHC's account history sheet showing receipt of the $100,000, Exhibit IIIC39.

84 Exhibits IIIC7 and 8; see infra at 268-269.

further stated, "I will advise you to whom the Klein checks should be payable."[85] These are two of the checks that were deposited in the MSHC account, along with the $650,000 discussed above.[86]

To summarize, the source of Klein's $7,000,000 buyout of Gibbs was as follows:

a) $4,000,000 received directly from Merritt;

b) $2,000,000 received indirectly from Merritt;

c) $650,000 from Kleins' law office, of which at least $422,918 was received from Merritt for legal fees purportedly incurred and never paid, during the preceeding two or three years;

d) $250,000 from Fairfax, and

e) $100,000 from DVC, a wholly-owned subsidiary of Middle States.

5. Payment to Gibbs

The $7,000,000 was ultimately transferred to Gibbs as follows:

The $3,000,000 portion of the buyout that was placed in MSHC's account on November 30, 1984,[87] was then transferred on December 3, 1984, to a Merritt account maintained at Equitable Bank (190-1058-7).[88] This money, plus the $4,000,000 received

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85 Exhibit IIIC53.

86 Exhibit IIIC40, MSHC deposit ticket-note also that the account number referred to in the Williamson memorandum is the same account number on the back of the S&S check to Klein, Exhibit IIIC36.

87 Exhibit IIIC39.

88 The $3,000,000 was transferred along with $303,346.12 in other funds according to Barbara Morris, Merritt's assistant controller; Exhibit IIIC54.

"directly" by MSHC from Merritt, was then offset by an Equitable certified check (9004448) totalling $7,000,000 on Equitable account #190-0827-3.[89] This check was dated November 26, 1984, but funds were not available to cover this transaction until December 3, 1984.[90] During this period, funds needed to cover the buyout check ($7,000,000) were obtained from two adjusting entries to the Merritt account at Equitable:

1) $5,000,000 - entry dated November 23, 1984, originated from fifty jumbo certificates deposited by Fairfax[91] and

2) $2,000,000 - entry dated November 26, 1984, was initiated by Barbara Morris, assistant controller, to compensate Merritt's Equitable account for the predetermined shortage.[92]

The initial buyout check for $7,000,000 was not used for its intended purpose.[93] Instead check numbers 90004475 and 90004476, respectively, for $4,000,000, and $3,000,000 were issued.[94] These are Merritt checks drawn on Equitable made payable to Robert V. Gibbs and International Consolidated Industries, Inc. The checks are certified by the signatures of

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89 Exhibit IIIC55.

90 Interview with B. Morris, Merritt's assistant controller.

91 Exhibit IIIC56 at 9.

92 Exhibit IIIC57 and Interview with B. Morris.

93 Exhibit IIIC55.

94 Exhibits IIIC58 and 59.

Bruce Penczek and Milton Sommers.[95] Both Penczek and Sommers have elected to assert their fifth amendment privilege against self-incrimination rather than testify concerning the origin of these checks.[96] Both checks were dated November 27, 1984, and later endorsed to a third party, Miles and Stockbridge, Attorneys. As noted above, both Klein and Williamson, have confirmed Merritt's advance of November 27, 1984, as the source of the $2,000,000 portion of the buyout received from S&S.[97] Additionally, Klein, under oath, has testified that S&S did not receive any security or collateral other than Klein's personal guarantee.[98]

6. Division Approval of the $4,000,000 Portion of the Buyout

Charles Brown, Division Director, approved Merritt's loan of $4,000,000 to Klein on the basis of Klein's representation of the value of the security for the loan - "100% of the stock of Fenwick Development Corporation" and Heron Harbour.[99] Klein was the beneficial owner of fifty percent of Fenwick Development Corporation (Fenwick) which was apparently wholly-owned by Middle States.[100] Fenwick's major asset was Heron Harbour, a condominium development in Ocean City.[101]

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[95] Id.

[96] Exhibits IIIC60 and 61.

[97] See supra at 260.

[98] Klein transcript at 52.

[99] Exhibit IIIC17.

[100] Exhibit IIIC7.

[101] Klein-Gibbs Agreement, at page 2, § 4, Exhibit IIIC16; Paul Trice, May 2, 1985 letter to Klein at 4, Exhibit IIIC62; Klein's transcript at 5.

Brown's approval was predicated on his "understanding" that Heron Harbour, had "a Fair Market Value of Twenty-Two Million Seven Hundred Fifty-Four Thousand Dollars ($22,754,000)."[102] The $4,000,000 was actually transferred to Klein's control by a loan from Merritt to MSHC.[103] This loan was approved by the Merritt Board of Directors on November 26, 1984. The board minutes state that the loan was secured by an Indemnity Mortgage from Fenwick, and a pledge by MSHC, of all the stock of Fenwick. A pledge by Middle States of all of its stock in Merritt, as good faith, not as security, was also mentioned in the board minutes. All members of the board, Milton Sommers, Eugene Hettleman, Regina Lee, Patricia A. Aluisi and Zelig Robinson, approved this transaction.[104] The resignations of board members Lowell R. Bowen, Alan I. Baron and J. Jay Boland were accepted four hours before the approval of the loan, and Patricia Aluisi and Regina Lee were elected as new directors.[105]

Klein knew when he obtained the $4,000,000 that the Heron Harbour property could not sustain the $22,000,000-plus appraised value relied by Charles Brown.[106] Fenwick bought the Heron Harbour property for $2,200,000 in 1981, with financing from

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[102] Exhibit IIIC17.

[103] Exhibit IIIC63.

[104] Merritt Board minutes, November 26, 1984, 2:00 p.m., Exhibit IIIC64.

[105] Merritt Board minutes, November 26, 1984, 10:00 a.m., Exhibit IIIC65.

[106] Klein's transcript at 23-24.

Sharon Savings and Loan (Sharon).[107] Harry E. Gilbert, Jr., MAI, appraised this property on September 27, 1982, at $5,200,000.[108] He received a $1250 fee for this appraisal.[109] On May 31, 1984, Cunningham, Floam and Coleman, Certified Public Accountants, (Cunningham Floam) provided an unaudited balance sheet of Fenwick indicating total assets of $5,773,353.80. An entry described as "land, construction in progress and capitalized costs," was valued at $5,755,427.91.[110] This entry referred to Heron Harbour.[111] Additionally, when the Fenwick stock was contributed to Merritt, it was valued by Merritt accountants, Alexander Grant at "approximately $5-1/2 million."[112] On November 30, 1984, when the Merritt Board agreed to accept the Fenwick stock contribution, its value was recorded as $5,639,153 and the directors resolved that "said value [is] the actual value of said capital stock." This resolution was based on three factors: 1) a November 12, 1984 Gilbert appraisal; 2) the most recent financial statements of Fenwick; and, 3) "prior discussions with Mr. Jimmie T. Noble of Alexander Grant & Company."[113]

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107 Id. at 5, 6; Digiondomenico memorandum, March 1, 1985, to Trice, Exhibit IIIC11.

108 Exhibit IIIC66.

109 Gilbert letter to Office of Special Counsel, October 21, 1985, Exhibit IIIC67.

110 Exhibit IIIC68.

111 Klein's transcript at 13.

112 Alexander Grant letter to Klein, December 14, 1984, Exhibit IIIC69.

113 Merritt Board minutes, November 30, 1984, Exhibit IIIC70.

On July 24, 1984, not quite two months after the Cunningham balance sheet submission and four months before Middle States contribution of the Fenwick stock to Merritt, Gilbert did another appraisal of Heron Harbour, this time valuing it at $17,725,000.[114] Gilbert received $2000 for this appraisal.[115] The $17,725,000 valuation "excluded" the value of the "several groups of buildings which are located on the land and are presently in various stages of completion."[116]

On November 7, 1984, the Merritt Board held a special meeting to consider and approve a $10,400,000 loan to Fenwick. At this meeting, Parker Heckner, described as the construction engineer for the Heron Harbour project, gave his opinion that the project's "present value" was $12,500,000. Additional impetus for the board's approval of this loan was "the fact that the major creditors of Fenwick were subsidiaries of Delmarva Venture Corporation to which the Association has outstanding loans totalling $9,500,000." Several board members expressed their concern that if Fenwick went bankrupt, DVC subsidiaries would do the same and Merritt's $9,500,000 loan to DVC might be jeopardized.[117] Not discussed at this meeting was the fact that DVC was a wholly-owned subsidiary of Middle States, Merritt's

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[114] Exhibit IIIC71.

[115] Exhibit IIIC67.

[116] Exhibit IIIC71 at 3.

[117] Merritt Board minutes, November 7, 1984, Exhibit IIIC72; _see also_ $10,400,000 note loan to Fenwick signed by Klein as President of Fenwick, Exhibit IIIC73.

parent company.[118]

On November 12, 1984, Harry Gilbert did a third appraisal of the Heron Harbour property, this time giving it a $22,754,000 value.[119] The appraisal specifically "includ[ed] the value of the several groups of buildings... located on the land...." Gilbert received $5000 for his third appraisal.[120]

Using this appraisal, Klein then wrote to William LeCompte on November 16, 1984, enclosing "the accountant's financial statement for Fenwick Development Corporation as of May 31, 1984, and a pro forma balance sheet for Fenwick as of November 26, 1984 (the settlement date)."[121] Klein constructed Fenwick's "pro forma" balance sheet by replacing the Cunningham Floam $5,755,427.91 "land, construction in progress" entry,[122] with a $22,754,000 entry based on the third Gilbert appraisal. It was on this basis that the $22,754,000 figure became part of Charles Brown's "understanding" as to the value of the security for Merritt's $4,000,000 loan to Fenwick.

At the time of Brown's letter approving the Merritt $4,000,000 loan to Fenwick/Klein, the Heron Harbour property was already encumbered by a Sharon mortgage in the amount of

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118 Exhibit IIIC7.

119 Exhibit IIIC74.

120 Exhibit IIIC67.

121 Exhibit IIIC75.

122 Exhibit IIIC68.

$7,250,000.[123] According to Klein, a mortgage was recorded securing Merritt's $10,400,000 loan on November 14, 1984. A portion of that loan was intended to pay off Sharon, if necessary. Klein also stated that a $4,000,000 encumbrance was added on as an indemnity mortgage to secure the Merritt loan to MSHC on November 26, 1984.[124] Finally, on May 28, 1985, an additional $4,000,000 mortgage was recorded in favor of Merritt on the Heron Harbour property.[125]

7. Disclosure to the Division and MSSIC

Klein has claimed, under oath, that he and his attorneys fully disclosed to the Division and MSSIC, the source of the $2,000,000 portion of Klein's $7,000,000 payment to Gibbs.[126] When questioned about the $2,000,000 he received from S&S,[127] Klein said,

> [E]verybody was told about it and we immediately went to tell the Division and MSSIC about it in great detail.
>
> * * *
>
> They were very interested in making sure that this thing went through properly because of our concerns and their concerns about what would happen to Merritt if it didn't...and we wanted to make a full disclosure of exactly what had occurred.[128]

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[123] Exhibit IIIC72.

[124] Exhibit IIIC63; see also Exhibit IIIC76, Klein October 16, 1985 letter to Office of Special Counsel.

[125] Exhibit IIIC76.

[126] Klein's transcript at 19, 46, 49, 54-61.

[127] Exhibit IIIC35.

[128] Klein's transcript at 54-55.

Klein went on to say:

> [W]e had the meeting, we wanted to make sure that everybody understood it in light of Mr. Brown's letter. It was diagrammed for them on the board exactly who lent what to who and how and everybody said fine and went home.[129]

Paul Trice, Charles Hogg, and Martin Becker of MSSIC were present at this meeting along with Charles Brown. George Pierson, MSSIC Board Chairman, attended as well as most of the Merritt Board - Zelig Robinson, Patricia Aluisi, Eugene Hettleman and Milton Sommers. The meeting, however, was not held until December 17, 1984, almost three weeks after the transaction had been consummated.[130] "Brown's letter" referred to by Klein, was Brown's letter of November 23, 1984, to Milton Sommers, restricting Merritt's funding of the Klein-Gibbs buyout to $4,000,000.[131]

According to Klein, Zelig Robinson explained the whole transaction and "the purpose of it was that if somebody had had an objection to it or if they felt it offended Mr. Brown's letter we would have done something else."[132] Klein testified he could not remember every detail about what was explained in part because the explanation was:

> drawn on...a paper easel on an easel that had a pad of paper. Subsequent to that meeting I said, gentlemen, where is that paper, we're going to need it some day, and as far as I know, it was torn up

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129 Id. at 55-56.

130 Trice interview, and Hogg's handwritten notes, Exhibit IIIC4.

131 Exhibit IIIC17.

132 Klein transcript at 56-57.

> and thrown away that day. We did not take it with us....[t]here was a long detailed explanation. It went on for about a half hour.[133]

Klein further testified that he did not understand Brown's letter to mean that a borrower from Merritt could not loan him the money - "[w]hat we understood that letter to mean was that Merritt would not make a loan."[134] Klein stated that he could have gotten the money from Merritt by a dividend, or from Fairfax, concluding that:

> had I dreamed for a minute that anyone thought this was a violation or had anybody indicated that to me I would have immediately either gone out to complete the Fairfax loan, gotten some other loan or made some other arrangement and paid back the $2 million dollars.[135]

Nobody "indicated" that Klein's conduct violated Brown's letter because the true source of the $2,000,000 was never disclosed to MSSIC or the Division.[136] The paper easel chart does not "indicate" that BBRC had any involvement in the funding, although it was part of the initial conduit of the money from Merritt to Klein.[137] Nor is Institutional's role drawn on the chart. This omission comports with the recollection of others at the meeting who have stated that rather than an explanation indicating that the $2,000,000 came from Merritt to BBRC to

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133 Id. at 57-58.

134 Id.

135 Id. at 58-59.

136 Trice transcript at 6-9; The "paper easel" chart of the transaction drawn by Zelig Robinson, Exhibit IIIC77; Interviews with M. Becker; Brown transcript at 87-95; Hogg's handwritten notes, Exhibit IIIC4.

137 Exhibit IIIC77.

Institutional (and from Merritt to Institutional), back to BBRC, then to S&S, then to Klein; an affirmative representation was made that the ultimate source of the money was other than from Merritt.[138]

Klein's recollection about this issue is to the contrary:

> Question: At that meeting [the December 17, 1984 meeting] did anyone say that the $2 million dollars lent to you by S&S was not Merritt funds?
>
> Answer: Oh, no, it was clear that the $2 million dollars - it was explained to them that the $2 million came from Merritt in the sense that it was part of a previous loan, which it was. They absolutely knew the relationship between BBRC and Merritt and S&S. It was put on the board. That's what the diagram was.[139]

When questioned about this transaction Zelig Robinson testified that on December 17, 1984, he diagrammed, on an easel pad, the identity of the lender of the $2,000,000 to Klein.[140] When asked whether this $2,000,000 was part of the $12,000,000 Merritt loan to BBRC, Robinson initially responded:

> Yeah. And, the manner, and the fact that the $2 million dollars had been paid by or repaid by ISC [Institutional Service Corporation] to BBRC and the affiliation between ISC and Merritt. The document, not the document but <u>the chart that I drew would have shown the flow of funds from Merritt to BBRC to ISC back to BBRC to S&S and to the borrower</u>.[141] (emphasis supplied).

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[138] Trice transcript at 6-9; Interviews with M. Becker; Brown's transcript at 90-94.

[139] Klein transcript at 67-68.

[140] Robinson transcript, October 14, 1985, at 15.

[141] <u>Id</u>. at 15-16.

However, when asked again if he included in his explanation, "that Merritt on or about November 26, 1984, loaned $2 million dollars to ISC to repay BBRC," Robinson replied that he was not aware of that loan when he made his explanation.[142] Robinson also testified that Brown was "annoyed to learn that Merritt, Merritt had funded that $2 million dollars."[143] Furthermore, according to Robinson:

> I explained to him [Brown] and to the rest of the [MSSIC] board that, as I understood it, the 2 was a result of or was part of a 12 million dollar loan that Merritt had made in July or August of '84 at a time when, to my knowledge, nobody contemplated, nobody could have known what the outcome of the matter, the dispute between Klein and Gibbs would be. And, that... nobody intended, to the best of my knowledge, in July of '84, that any part of that loan would ultimately be made available to either Klein or Gibbs in connection with the resolution of their dispute that occurred five months later.[144]

These statements and Klein's statements, quoted above, conflict with the recollection of the man they were directed to, Charles Brown. During Brown's testimony, the following exchange occurred after Brown was shown Exhibit IIIC77, the Robinson chart:

> Question: In other words, it was represented to all those present that the S&S $3 million loan did not in any way come from Merritt.
>
> Answer: Right.
>
> Question: And who made that representation? Zelig Robinson?
>
> Answer: I would assume he was the one. He was the one making the sketch, doing the speaking. I don't think Klein himself had a whole lot to say that day. Zelig was the spokesman.

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142 Id. at 16.

143 Id.

144 Id. at 16-17.

> Question: When you left that meeting, were you satisfied that the additional $3 million had not come in any way from Merritt?
>
> Answer: Well, yes.
>
> Question: That Klein did not borrow from the association?
>
> Answer: He might have borrowed from a customer of the association and it was not a current loan. Yes. I was satisfied.[145]

Brown's recollection is supported by similar assertions he made to the December 1984 and January 1985 Executive Sessions of the Board of Commissioners concerning the non-Merritt source of Kleins' funding.[146] Klein himself told those present at the January 1985 Executive Session meeting, that "he personally put up $3 million" for the purchase.[147]

Under oath, Paul Trice has confirmed Brown's testimony. He also recalls that a specific representation was made by Zelig Robinson at the December 17, 1984 meeting, that the source of the S&S money was not from Merritt. Institutional and BBRC were not mentioned.[148] Charles Hogg's handwritten notes of the meeting indicate that the source of the money was a loan from an "outside source."[149]

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[145] Brown transcript at 92-93.

[146] Exhibits IIIC105 and 106, see *infra* at 285-286.

[147] Exhibit IIIC106, *infra* at 286.

[148] Trice transcript at 6-9.

[149] Exhibit IIIC4.

To summarize, Zelig Robinson claims to have disclosed to Brown and MSSIC that the ultimate source of a $2,000,000 portion of the Klein/Gibbs buyout was Merritt, even though Robinson testified that he was not aware, in November or December of 1984, that Institutional was loaned $2,000,000 by Merritt on or about November 26, 1984.[150] Klein states that "exactly who lent what to who and how" was fully disclosed.[151] Brown, although he believes that some mention may have been made about Klein borrowing from a customer of Merritt, recalls nothing about Institutional or BBRC. Brown does recall, however, that a specific representation was made that no Merritt funds were used in the transaction.[152] Neither Institutional nor BBRC appear on the actual easel pad chart.[153] Paul Trice and Martin Becker, also present at the December 17, 1984 meeting, remember an affirmative representation that the S&S $2,000,000 loan to Klein was funded with non-Merritt money.[154] Hogg's handwritten notes are in accord.[155] Eugene Hettleman, who was also present at the meeting claims that he did not know the source of the $2,000,000 at the time of the meeting. He subsequently learned that the "sale of MMU to ISC" was the source and he assumes "that ISC received the money to buy MMU from Merritt." According to Hettleman, the meeting was not to get

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150 Robinson transcript at 15-17.

151 Klein transcript at 56.

152 Brown transcript at 92-95.

153 Exhibit IIIC77.

154 Trice transcript at 6-9, Interviews with M. Becker.

155 Exhibit IIIC4.

"anyone's approval" but was merely for educational purposes.[156] Patricia Aluisi, also present on December 17, 1984, claims to have no recollection of the source of the $2,000,000.[157]

Both Milton Sommers and Regina Lee have elected to assert their Fifth Amendment privilege against self-incrimination rather than testify concerning the source of the funds.[158]

Finally, Merritt's 1984 board minutes do not reflect any board mention, approval or any other action authorizing the November 1984 $2,000,000 loan to Institutional to pay back BBRC.[159]

Other Practices

1. Dividends Paid to Klein

After Klein bought out Gibbs, he received, with Merritt board approval, the following dividend payments:

1.	February 10, 1985	$ 51,212.00
2.	March 7, 1985	261,181.20
3.	April 16, 1985	750,000.00

On May 23, 1985, Klein repaid some of these dividends by making a capital contribution in the amount of $470,000.[160] These dividends were authorized by Merritt's Board of Directors at Klein's request. In the opinion of Special Counsel, Merritt's financial condition clearly did not permit their payment.

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156 Interview with Eugene Hettleman.

157 Interview with Patricia Aluisi.

158 Exhibit IIIC61; Exhibit IIIC78.

159 Merritt Board minutes, Exhibit IIIC79.

160 Exhibits IIIC80, 81, 82, 83.

2. Acquisition of I. W. Long

Heron Harbour was not the only property where Merritt used questionable appraisals and accounting practices to enhance its net worth. For example, on December 27, 1982, Gerald S. Klein, as Chairman of the Merritt Board, wrote to Regina Lee, Merritt Treasurer, describing the acquisition by Merritt of I. W. Long & Son, Inc.:

> First, there will be formed a Delaware Corporation.... All of [its]...stock will be contributed to Merritt Capital Corporation. There will be an appraisal on the assets being purchased that will be substantially higher than the purchase price, and when that appraisal is available for review, we will book the difference as deferred income. (emphasis supplied).[161]

Klein also informed Ms. Lee that:

> I do not particularly wish to encumber specific assets to secure Merritt because I wish to have the company in a position that it can seek lines of credit from other banks and be bonded in order to relieve Merritt, at least to some extent, of these responsibilities or to provide capital flexibility when money is tight in the future. However, Mr. Hettleman may wish to state otherwise.[162]

Copies of this letter were mailed to Robert V. Gibbs, Pamela R. Newman, C. Kenneth Carter, Milton Sommers, Eugene Hettleman, Esquire, William Dubit, Controller, Stephen J. Cunningham, CPA, James Noble and Zelig Robinson, Esquire.

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161 Exhibit IIIC84.

162 Id.

Regulatory Knowledge of Merritt's Problems

Many, if not all, of the violations of Maryland law, Division rules and regulations, and MSSIC rules and regulations, detailed in the preceding sections were known to the regulators - MSSIC and the Division. All Division examination comments were sent to MSSIC, and MSSIC and the Division shared the SL200's which contained reports of rule violations.[163]

Merritt's SL200's regularly showed violation of MSSIC rules, and Merritt was described in MSSIC Board meeting minutes as a "habitual rule violator."[164] When MSSIC confronted Merritt management with these rule violations, Merritt's frequent response was that MSSIC's rules were invalid or that "the association takes exception to the rule."[165]

Although this posture by Merritt was deemed "unacceptable," at the July 16, 1984, Membership Committee meeting and Board Chairman George Pierson said that "a satisfactory response is to be received by the July 25th Board of Directors meeting" or he "would recommend a cease and desist order be issued," further action was apparently forestalled because Merritt threatened to litigate the validity of MSSIC's regulations.[166]

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163 Division examinations with supervisory letters showing copies to MSSIC, Exhibits IIIC2 and 5; Rules Violation Notices, Exhibit IIIC85.

164 MSSIC Board minutes of July 25, 1984, Exhibit IIIC86.

165 MSSIC violations status report, April 30, 1984, Exhibit IIIC87; MSSIC Membership Committee minutes, July 16, 1984, IIIC88.

166 MSSIC Membership Committee minutes, August 13, 1984, Exhibit IIIC89, 88.

A motion was passed however, at the August 13, 1984 Membership Committee meeting to "notify the Director of the Division of Savings and Loans of the recommendation of the Corporation to disapprove three pending [Merritt] savings branch applications due to noncompliance...." The next day, August 14, 1984, a Merritt branch in Easton was approved by the Division.[167] A second Merritt branch in Highlandtown was denied much later, but only because information requested by the Division had not been received.[168]

At this same Membership Committee meeting, Martin Becker, MSSIC Staff Analyst, reported that he was "in the process" of reviewing the Division's work papers from its most recent Merritt examination. Paul Trice reported that Gibbs and Klein were in the midst of a stock dispute.

Nine days later, at the next full MSSIC Board meeting, Trice asked for "Board ratification of staff's issuance of staff cease-and-desist letters to Merritt Commercial Savings and Loan...which require that [Merritt] make no further loan commitments." Before the matter was voted on, Terry Hall, MSSIC counsel, expressed his view that "the staff should be absolutely certain that the Board will support their action and that he hopes the associations involved will react properly and make

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[167] Division order no. 591, Exhibit IIIC90.

[168] Brown letter to Sommers, January 8, 1985, Exhibit IIIC91.

every effort to effect compliance." Trice's proposition passed by a majority vote with Board members Carroll and Faulkner abstaining.[169]

Merritt continued to violate lending, net worth and liquidity rules.[170] Earlier efforts to force compliance, according to MSSIC minutes, consisted of Hogg reporting that Merritt "intends to submit quarterly updates on their plan for compliance with MSSIC's Lending Regulations." (emphasis supplied).[171] A month later, at the next regular MSSIC Board meeting, Hogg reported his continued monitoring by noting "Merritt is to submit a plan to curtail lending and are [sic] making a strong effort to comply."[172]

As noted above, by November 14, 1984, the violations were unabated. In a later November meeting, Board minutes reflect that Merritt's net worth and liquidity were continuing to decline, while its construction, loan-in-process and lending violations were increasing.[173]

The December 12, 1984 Membership Committee minutes reflect that a meeting with Merritt's Board of Directors was set for December 17, 1984 and the association had "indicated that it will comply with the liquidity rule by the end of December." It

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169 MSSIC Board minutes, August 22, 1984, Exhibit IIIC92.

170 MSSIC Membership Committee minutes, November 14, 1984, Exhibit IIIC93.

171 MSSIC Board minutes, September 26, 1984. Exhibit IIIC94.

172 MSSIC Board minutes, October 24, 1984, Exhibit IIIC95.

173 MSSIC Board minutes, November 28, 1984, Exhibit IIIC96.

was also recorded that "[t]he association continues to comply with their previously submitted and accepted plans regarding lending rule violations."[174] (emphasis supplied). MSSIC's rules violation report indicates a decrease in Merritt's lending and construction violations in December 1984. By March 1985, however, most of Merritt's violations were steadily increasing.[175]

After the December 17, 1984 meeting with the Merritt Board, the Membership Committee reported to the full MSSIC Board on December 19, 1984. The Committee expressed concern about Merritt's net worth decrease and asked that the Heron Harbour and King's Landing projects be reviewed. Another item of concern to the Board was the "leak of confidential information to the press" that put MSSIC "on the defensive at a recent meeting with Merritt... because Merritt's representatives were concerned about this same leak of confidential information." Terry Hall then "spoke of the liabilities of MSSIC should this information lead to bad publicity for specific associations or for all associations."[176]

Brown also attended this meeting. He and Hogg discussed Merritt's compliance with MSSIC net worth requirements. Hogg believed that Merritt was in compliance if "the capitalization arising from [the] Heron Harbour donation toward

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[174] Membership Committee minutes, December 12, 1984, Exhibit IIIC97.

[175] Exhibit IIIC85.

[176] See MSSIC Board minutes, December 19, 1985, Exhibit IIIC98.

net worth is included."[177] Brown stated that the "donation" should not be included in a net worth calculation. He expressed his view that he expected that MSSIC would defer to him. The MSSIC staff was directed to analyze the matter and report to the Membership Committee.

By the February 13, 1985 Membership Committee meeting, nothing had been resolved concerning the Heron Harbour donation.[178] After discussion, however, a motion to issue a formal cease and desist order requiring Merritt to stop all commercial lending activity was unanimously passed. The MSSIC Rules Violation Report indicates a commercial lending violation decrease in January 1985 (42.41%) from December 1984 (51.95%), but the violation percentage was back up to 45.37% in February and up to 57.44% in March 1985.

MSSIC Board minutes reveal one explanation for Merritts' worsening violations. The formal cease and desist order was never issued "due to previous commitments regarding a time table for Merritt Commercial's compliance."[179] Enforcement steps were again deferred at the March Membership and Board meetings although Trice reported to the Membership Committee that

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177 Id., see also Merritt November 30, 1984, Board minutes accepting the donation of Fenwick stock, Exhibit IIIC70.

178 Membership Committee minutes, February 13, 1985, Exhibit IIIC99.

179 MSSIC Board minutes, February 27, 1985, Exhibit IIIC100.

"Merritt may...be in violation of certain statutes and other generally accepted safety and soundness standards."[180] Hoggs' response was that the staff "continues to monitor Merritt."[181]

Based on Board or Membership Committee minutes, no further action was taken to force Merritt to comply with MSSIC rules and regulations. At a special Board meeting on May 13, 1985, it was reported that the Merritt Board of Directors would be meeting shortly to discuss a resolution requesting that the Board of Commissioners place the association in conservatorship.[182]

The Board of Commissioners, unlike MSSIC, did not regularly receive copies of Division examinations, nor was the substance of the examinations discussed at Board meetings. Merritt was occasionally discussed at the meetings, as the minutes reflect.

For example, Thomas Gisriel, Chairman of the Board expressed concern over Merritt's $38,000,000 investment in the Merritt Tower, at the October 11, 1984 Executive Session of the Board of Commissioners. Charles Hogg was also present and he

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180 Exhibits IIIC101, 102, respectively, Membership Committee minutes, March 13, 1985, Board minutes, March 25, 1985.

181 Exhibit IIIC102.

182 Trice transcript at 27-30, Exhibit IIIC103, MSSIC Special Meeting minutes, May 13, 1985.

shared Gisriel's concern about the Tower. Hogg also reported that Klein and Gibbs were resolving their stockholder dispute in "a very professional manner."[183]

Two months later, Brown reported that the Klein-Gibbs stockholders dispute was settled by Klein's purchase of Gibbs' interest for $7,000,000. Brown said that "Mr. Klein had obtained <u>$3 million from outside sources</u> and had borrowed $4 million from Merritt secured by a real estate project in Ocean City known as Heron Harbour which has ample net value to cover the loan amount."[184] (emphasis supplied).

Merritt was discussed extensively at the January 10, 1985 Executive Session of the Board. Brown again described the funding of the Klein-Gibbs buyout and reiterated that Klein put "up $3 million from outside sources." Brown noted that Heron Harbour, the security for the $4,000,000 portion of the buyout, appeared to have "some $9 to $12 million in net equity." Brown said that he approved the buyout and its funding "in part due to the fact that the overall situation at Merritt was viewed as deteriorating."

Hogg, who was present on behalf of MSSIC, said that MSSIC was taking a "wait and see" posture concerning Merritt. He said that they would "get back to Mr. Klein in 60 days or so and then evaluate whether under Mr. Klein's management these issues appeared to be moving to a resolution." Hogg also reported that

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183 Exhibit IIIC104.

184 Executive Session minutes, December 13, 1984, Exhibit IIIC105.

Merritt was "in excess" of some of MSSIC's lending regulations and that Merritt's commitments appeared high compared to their liquidity.

After these preliminary remarks, Gerald Klein, Patricia Aluisi, Eugene Hettleman, Milton Sommers, and Regina Lee entered the meeting. Discussion initially focused on Merritt's new office buildings downtown, in Timonium, and in Ocean City. Klein admitted that he owned the company that was building the Ocean City office. Klein also discussed his purchase of Gibbs' interest in Merritt stating that he "personally put up $3 million." In response to concern about Merritt's speculative projects Klein replied that based on "cost versus value considerations" there was no reason to be concerned.[185] At this meeting and at the next Executive Session on February 14, 1985, several Board members questioned the value of Klein's donation of Heron Harbour to the association.[186] Concern was voiced about the donated value of $5,000,000 compared with Klein's representation of the appraised value of $23,000,000. One Board member expressed his opinion that the Board "should take a harder look at these appraisals involving donated assets" but the minutes do not reflect that any action was taken.[187]

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[185] Exhibit IIIC106.

[186] Exhibits IIIC106 and 107.

[187] Exhibit IIIC107.

For the next two months, the major concern of the Board directed towards Merritt, was Merritt Tower's leasing situation.[188] Brown continued to report that there were no signed leases, but according to Klein, there were several "hot prospects."[189] Brown suggested but did not require that Merritt sell the Tower "to improve the image of the association and for public relations purposes."[190]

Finally, at the May 9, 1985 Executive Session of the Board, Attorney General Sachs recommended immediate conservatorship for Merritt. Lowell Bowen, who "was at the meeting as an Advisor for the Governor" concurred with Sachs' recommendation. The minutes also reflect that Lowell Bowen's representation of Robert V. Gibbs in his stockholder's dispute with Gerald S. Klein was disclosed, as was Bowen's service as a member of Merritt's Board of Directors.[191]

On May 13, 1985, MSSIC was appointed Merritt's conservator and in late October 1985, Merritt was sold to Chase Manhattan Bank.

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188 Exhibits IIIC108, 109, Executive Session minutes, March 14, 1985 and April 4, 1985.

189 Exhibit IIIC109.

190 Id.

191 Exhibit IIIC110.

D. COMMUNITY SAVINGS AND LOAN ASSOCIATION

Introduction

With the takeover of Community Savings and Loan Association (Community) in 1982 by EPIC Acquisitions Inc., Community began its transformation from a typical savings and loan association to the bank for a national tax shelter business known as the "EPIC Program."[1] The assets of Community financed and maintained the expansion of the "Epic Program." Because of stagnant appreciation in home prices, diminishing purchases of the EPIC tax shelters, and gross mismanagement, EPIC became a major contributor to the demise of Community in 1985.

Community, a stock savings and loan, was formed in 1958 as Republic National Building & Loan Association, Inc. (Republic National). Republic National was one of five stock savings and loan associations which Alvin Lapidus formed in the late 1950's.[2] Lapidus formed these stock associations just before Maryland outlawed the formation of any new stock associations. Subsequently, Lapidus sold the stock of the association. In 1971, the association was moved to Montgomery County and opened for business in 1973. With its move to Montgomery County, the association changed its name to "Community."

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[1] The "EPIC Program" involved the purchasing, leasing, management, and syndication to investors of homes.

[2] See Section II of this Report.

In October, 1982, Tom Billman (Billman) and Clayton McCuistion (McCuistion), through Equity Acquisitions, Inc., offered to purchase all of Community's stock for $3.50 a share.[3] The Community Board reviewed and accepted the offer by Billman and McCuistion. By the end of October 1982, Equity Acquisitions had acquired eighty-five percent of Community's stock. On March 1, 1983, that percentage had increased to 99.4%. Upon obtaining control of Community, Billman and McCuistion were able to use Community as the source of funds to expand and maintain EPIC's real estate tax shelter limited partnerships.

EPIC began with the formation of Equity Program Investment Corporation (EPIC) in 1974. In its first full year of operation, 1975, EPIC purchased sixty-eight model homes at a total capitalized cost of approximately $4,000,000.[4] EPIC had developed a novel idea of promoting the purchase and syndication of model homes. It perceived that home builders would be interested in selling their model homes to EPIC and leasing them back at an agreed upon rent. EPIC entered these sale-leaseback transactions with the intent to syndicate the homes into real estate limited partnerships. The limited partners would realize tax benefits and the possibility of appreciation in the properties. The EPIC system was described as a six step process:

(1) evaluate builders' model homes;

(2) enter into sale-leaseback agreements with builders;

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3 Community's Special Board of Directors Meeting, Exhibit IIID1.

4 EPIC Financial Statements as of December 31, 1985, Exhibit IIID2.

(3) arrange for financing of model home purchases;

(4) syndicate the limited partnership interests to the public;

(5) manage the properties during the partnership; and

(6) arrange for disposition of the properties upon dissolution of the partnerships.

The liability of limited partners for partnership debts was limited to the capital contributions and undistributed profits (i.e., appreciation of the homes). EPIC, as general partner, was liable for all debts above the limited partners' contributions and undistributed profits.

In 1976, EPIC purchased approximately $10,700,000 worth of "builder model homes" on behalf of thirteen limited partnerships and one general partnership.[5] EPIC also formed two wholly-owned subsidiaries, EPIC Realty Corporation, and EPIC Securities. EPIC Realty was to act as a commissioned broker/agent in real estate transactions among EPIC, EPIC partnerships, other entities and the general business public. EPIC Securities was to deal in securities.

In 1977, EPIC Mortgage, Inc. was formed to borrow and lend money. During 1977, EPIC purchased approximately $16,500,000 in builder homes and lots.[6] In addition, a wholly-owned subsidiary, Tunlaw Models, Inc., entered into a seven year purchase/lease arrangement of $11,300,000 on builder model homes. During 1978 and 1979, EPIC created additional wholly-owned

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[5] EPIC Financial Statements as of December 31, 1976, Exhibit IIID3.

[6] EPIC Financial Statements as of December 31, 1977, Exhibit IIID4.

subsidiaries: EPIC Financial, Inc., ESI Securities, Inc., Model Home Holding Corp., Sledom Homes, Inc., Wolrab Models, Inc. and Dodge Models, Inc.[7] As of December 31, 1979, EPIC was a managing general partner in two partnerships and a managing general partner for eighty-one limited partnerships.

The 1979 annual report for EPIC noted that twenty-five new limited partnerships were formed and over $39,000,000 in model homes were acquired for investment. Projecting acquisitions and prices in the 1980's based on its experience, EPIC concluded that:

> During the 80's prices for new homes will increase dramatically...Our experience indicates that pricing momentum...in the early '80's and on a year to year basis could easily exceed 15%. This would mean that housing prices in 1985 would be double what they are at the end of 1979.
>
> The question that we hear most from lenders and investors is, 'Where will it (the increase in prices) end? It has to stop sometime.' It is far from certain that such will be the case.

In 1980, EPIC acquired over $55,000,000 of model homes and formed twenty-eight new limited partnerships.[8] The annual report noted that:

> During 1980, EPIC began a program of non-recourse fully insured mortgage financing. In prior years significant contingent liability was created for the corporation when recourse mortgage financing was utilized although mortgage loan value was typically lower in these prior transactions... EPIC's policy toward advances to prior partnerships is to advance operating funds as required up to the fair market value less the estimated net sales cost of the property.

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[7] EPIC 1979 Annual Report, Exhibit IIID5.

[8] EPIC 1980 Annual Report, Exhibit IIID6.

Tom J. Billman, President, noted that "meeting EPIC's needs in the '80s will be complex." He recognized that EPIC must develop new financing instruments for nonowner occupied property.

In 1981, EPIC acquired approximately $131,000,000 in real estate.[9] In its 1981 Annual Report, EPIC stated that it had modified its model home sale-leaseback program to take advantage of tax benefits created by changes in the 1981 tax law. Billman stated that EPIC could effectively manage property for terms longer than the original builder's lease. Billman wrote that "we began to view each house as a financial asset generating an income stream made up of numerous components such as lease income, tax benefits (improved by the 1981 Economic Recovery Tax Act), as well as appreciation over time."

Acquisition of EPIC by Community - 1983

On December 1982, Billman and McCuistion controlled Community and EPIC. By that date, Community's net worth had fallen below the regulatory requirements of MSSIC.[10]

On January 4, 1983, Charles H. Brown, Jr., Division Director, was advised by counsel for EPIC, Robert F. Freedman, of Community's intention to acquire EPIC.[11] Commenting on the proposed acquisition, Freedman noted that Billman and McCuistion were "donating" their interests in EPIC to Community in return for Community's preferred stock. In addition, Freedman stated

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[9] EPIC 1981 Annual Report, Exhibit IIID7.

[10] Community SL200, December 31, 1982, Exhibit IIID8.

[11] Letter from Robert F. Freedman, Exhibit IIID9.

that the acquisition "will enable Community to be a more profitable association and will give it the means to support growth and serve its market area to an even greater extent than it does at the present time."

By letter dated January 18, 1983, McCuistion, Community's Chairman of the Board, and John D. Faulkner, President of Community, served formal notice on the Division and the Board of Commissioners of the intention of Community Savings and Loan Service Corporation (Service Corporation), a wholly-owned subsidiary of Community, to acquire EPIC by means of a stock exchange.[12] The result of this proposed acquisition would be that Community, through its service corporation, would own 100% of EPIC. The existing stockholders of EPIC would in turn own equivalent shares of the preferred stock of Community. In outlining the benefits of the acquisition, Billman and McCuistion stated that through use of EPIC's securities subsidiary, Community would have access to a national market to attract deposits. Also, EPIC's national exposure would provide Community access to a "controlled stream of safe, high yielding financial instruments for its retention or sale to other institutions." The letter further noted:

> Basically, EPIC will continue to function as it has in the past, providing the Association with significant earnings, profits and growth. EPIC has been successful in times when savings and loans can normally operate profitably, but more importantly, it is able to earn significant profits in times that savings and loans normally experience difficulty in being profitable. This stable growth in earnings and net worth will

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12 Letter from Clayton C. McCuistion, Exhibit IIID10.

permit the Association to expand its abilities to serve and protect the interests of its depositors and borrowers.

Exhibits to this letter offered further assurances and justifications to the Division. In the financial section, it was represented that the merger would immediately bring Community into regulatory compliance on a consolidated basis on all operating ratios.[13] Additionally, the acquisition was represented to "provide a greater degree of strength and stability in earnings which will be the basis for protecting the safety of depositor's funds." (emphasis supplied.)

In addition, McCuistion and Faulkner represented that EPIC would benefit Community because "[o]nly a significant capital infusion can provide the base for growth in services to the local community, a solid foundation to add safety for depositors funds and an opportunity to participate fully in filling the increasing loan demand that will occur as the economy improves."[14]

On February 28, 1983, Brown responded to Community's letter of January 18, 1983.[15] Characterizing the proposal as a "very complex transaction," Brown's preliminary approval of the acquisition was subject to six conditions:

1. Submission of EPIC's two most recent audit reports.

2. An opinion from Community's auditors concerning the recognition and accounting of the EPIC investment in Community's books.

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13 Appendix B - Financial, Exhibit IIID11.

14 Appendix C - Operations, Exhibit IIID12.

15 Letter from Charles H. Brown, Exhibit IIID13.

3. Compliance with all state and federal laws by any subsidiary of EPIC.

4. A letter from counsel concerning any conflict of interest under the Financial Institutions Article between <u>any</u> EPIC subsidiary and any officer of the company.

5. Submission of amended articles of incorporation.

6. Additional information on the preferred stock to be issued by Community.

On March 4, 1983, James B. Deerin, Jr., Senior Vice President and General Counsel to EPIC responded to Brown's letter.[16] Initially, Deerin pointed out that Brown incorrectly had stated that none of the activities of the EPIC subsidiaries required Brown's approval. In fact, Deerin pointed out that the activities of ESI Securities, Inc. and EPIC's role as a general partner in the tax shelter real estate limited partnerships required his approval. Deerin agreed to the subsidiaries compliance with applicable laws, forwarded additional information on the preferred stock and sent copies of the amended articles of incorporation. With respect to conflict of interest rules, Deerin stated that there have been "basically immaterial" transactions between EPIC and its officers, directors and stockholders which would have required approval by the Division Director. Deerin represented that any future such transactions would fully comply with all laws and regulations. No details were provided concerning the scope or type of these transactions.

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16 Letter from James B. Deerin, Jr., Exhibit IIID14.

By March 8, 1983, Community had been advised that the acquisition would be approved on March 10, 1983.[17] Final approval was granted on March 10, 1983.[18]

The Division and Board of Commissioners considered approval of the merger without a complete understanding of the nature of the conflict of interest situations referred to in the March 4, 1983 letter to Brown. Such information was not delivered to the Division until 4:38 p.m. on March 10, 1983.[19] Billman and McCuistion detailed their personal transactions with EPIC. Three broad categories were described: taking partnership interests in EPIC partnerships, the leasing of equipment of EPIC, and personal loans. Billman and McCuistion partnership interests which had been represented to be "basically immaterial" in fact exceeded $17,000,000. Leasing activity with EPIC and Community exceeded $750,000. In addition, personal loans in excess of $465,000 were outstanding. Billman and McCuistion represented that "we realize that bringing EPIC, as a subsidiary of Community Savings and Loan, into regulated environment will require changes in the level for personal involvement." As later events showed, Billman and McCuistion did not change their personal involvement; instead they engaged in a series of transactions which conflicted with Division rules and laws of Maryland to the detriment of Community and its depositors.

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17 Letter from Gary W. Swindell, Exhibit IIID15.

18 Articles of Amendment, Exhibit IIID16.

19 Letter from Tom J. Billman, Exhibit IIID17.

MSSIC also reviewed the pending acquisition of EPIC by Community. On February 17, 1983, Charles Hogg, Ralph Holmes and Terry F. Hall, MSSIC's legal counsel, attended a meeting with Division representatives, Brown and LeCompte and Community's representatives, McCuistion, Faulkner and Deerin. Hogg inquired whether the activities of EPIC were suitable for service corporations, and the limitations of investments by savings and loan associations. Notes of that meeting state that the "EPIC product" was described as setting up a limited partnership to buy model homes; holding the property for four years (two years rented to the builder and two years to a private party); and, then, selling the model homes.[20]

On February 23, 1983, Hogg reported the EPIC and Community "restructuring plan" to MSSIC's Board of Directors.[21] Hogg stated that Community, on a consolidated basis, would receive additional net worth of $5,400,000 and that EPIC would serve to "further enhance Community's deposit gathering and mortgage making abilities." Hogg noted that this information was a "matter of notification" because this transaction did not need Board approval.

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[20] Notes of Terry F. Hall, Exhibit IIID18.

[21] MSSIC Board of Directors minutes, February 23, 1983, Exhibit IIID19.

Division Examination as of October 31, 1983

An examination of Community, only six months after the EPIC merger, raised substantial concerns with Division examiners concerning the operations of Community and Epic. On September 7, 1984, the Community examination as of October 31, 1983 was sent to Community's Board, almost eleven months after the as of date.[22] Four examiners spent a total of 109 examiner-days conducting the examination. The examiners were Charles F. Endres, Cynthia C. Barnickel, Jeffrey S. Fine, and Gregory L. Watkins. As of October 31, 1983, the directors and officers of the association were Clayton C. McCuistion (Chairman of the Board and Treasurer), Tom J. Billman (Vice Chairman of the Board), John D. Faulkner, Jr. (President and Director), Michael L. Shomper (Vice President and Chief Financial Officer), James B. Deerin, Jr. (Vice President, Secretary, General Counsel and Director), Joseph Cunningham (Director), and Robert M. Kemp, Jr. (Vice President and Director).

Endres, examiner-in-charge, found that Community was unlike any other association that he had examined in his seven years with the Division.[23] By the conclusion of the examination, Endres concluded that they had just "scratched" the surface of the relationship between Community and EPIC. Community's management recognized the complexity of its organization by requesting a meeting with the Division prior to commencement of the examination. Endres believed that the Division would have

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22 Community Division examination, Exhibit IIID20.

23 Interview of Charles F. Endres.

had to commit an unlimited number of examiners to attempt to fully understand and analyze the inner workings of Community and EPIC. During the course of the examination, Endres made reports to Brown, LeCompte, and Joseph Barbera about the "complexity" and difficulty of the examination process. Although advised of these concerns, the management of the Division took no further steps. In retrospect, Endres questioned whether with the existing manpower and expertise, the Division ever could have successfully examined Community. In many ways, Endres viewed Community more as a "real estate company" than a savings and loan.

Despite the admitted limitations on the Community examination, the examiners pointed out a series of problems at Community.

The first comment addressed the "EPIC product" and stated that as of October 31, 1983, Community had purchased 197 loans totalling $331,765,074 for EPIC and still had $87,000,000 of these loans on Community's books. The examiner concluded that such a loan concentration violated the ten percent limitation on concentration of loans. The examination noted:

1. Limited partners had limited liability. Therefore, the general partner (EPIC) was ultimately liable for the partnership debts.

2. While Community had obtained a legal opinion that Regulation .30A did not apply to EPIC, the opinion expressly stated they could not find any support for this position in prior laws or explanations of the regulations.

3. EPIC financed the operating deficits of the limited partnership.

4. The "EPIC program" loans were made by EPIC Mortgage, Inc (through funds supplied by Community) by non-recourse ninety-five percent loans in violation of Division regulations.

Additional problems included:

1. Loans on homeowner residential property represented only 12.8% of the association's total assets which was well below the requirements of Division regulations.

2. Community was owed over $2,800,000 from Equity Programs Investment Corporation for points due on mortgage purchases. While the mortgages had been financed, EPIC was not going to transfer the funds to Community until the close of the fiscal year.

3. While Community was not paying six of its officers and directors any salary, EPIC was paying compensation ranging from $61,000 to $330,000.

4. Billman and McCuistion received no salaries from either Community or EPIC, but a corporation owned by them, EPIC Holdings, was receiving a monthly fee from Community. The fee was then $50,000 per month.

5. Community's investment in EPIC exceeded the limitations imposed by Division regulations.

In reviewing Equity Programs Investment Corporation, the examination commented on "advances" to officers and directors, certain related party transactions involving companies controlled by Billman and McCuistion, the debt of service corporations in excess of Division regulation limits, the leasing of a boat from a partnership comprised of officers and directors, and the use of an airplane by EPIC.

A comparison between total savings and total mortgage loans prior to Billman and McCuistion's purchase of Community and the changes one year later illustrated the EPIC impact on Community. Between August 31, 1982 and October 31, 1982, total savings increased from $71,000,000 to $252,000,000, a 252.6% increase. Total mortgage loans increased from $57,000,000 to $266,000,000, a 365.6% increase.

During the examination, Endres had several lengthy meetings with John D. Faulkner, President of Community. Endres recalls Faulkner expressing concern about the operations of Community indicating that he was "not happy" with some of the papers he was signing.[24]

On December 3, 1984, the Division received Community's fourteen page response to the examination report.[25] With respect to the comments concerning the operation of EPIC, the association stated that it had relied in "good faith" on a proposed regulation that was never formally adopted. In addition, the association stated that while the comments about EPIC were

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[24] Interview of Charles F. Endres.

[25] Letter of Clayton C. McCuistion, November 26, 1984, Exhibit IIID21.

"factually correct when considered in a vacuum," they were irrelevant given the nature of the non-recourse debt and the method of operation of the separate partnerships.

Community stated that under Section 9-419(c) of the Code, the Division had no authority to limit an association from making a ninety-five percent loan or to require a certain percentage of homeowner loans. With respect to the "advances" by EPIC to certain officers and directors, the association responded that the "listed loans" have either been paid in full or now were evidenced by a note.

In late December 1984, Endres was asked by Barbera, the Chief Examiner, to review the comments and responses. Endres' initial reaction to the comments was that Community simply begged the issue.[26] On December 26, 1984, Endres wrote a two page memorandum to Barbera analyzing the responses concluding that Community was still in violation of the loan concentration rule.[27] With respect to Community's position regarding federal regulations, Endres concluded that the Division had to formulate its position. Endres suggested to Barbera that a meeting be held with Brown and LeCompte to review the Community comments and responses.[28] No such meeting was held. In addition, there is no record concerning any steps the Division took to respond to Community's comments.

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[26] Interview of Charles F. Endres.

[27] Memorandum of Charles F. Endres, Exhibit IIID22.

[28] Interview of Charles F. Endres.

On December 20, 1984, Martin W. Becker, a MSSIC analyst, received the examination and responses and reviewed them in a three page memorandum to Paul V. Trice, a MSSIC Vice President.[29] In a note to Trice, Becker noted that "[o]n whole, the exam seems to concentrate on the legal form of operations as opposed to activities that could result in realized losses." MSSIC took no action based on the Community examination.

Discussions of MSSIC Board and Board of Commissioners

Community was not a frequent topic of discussion at the MSSIC Board of Directors or Membership Committee meetings. On March 23, 1983, the MSSIC Board was advised that the "stock swap" between Community and EPIC should bring Community into net worth compliance by March 31, 1983.[30] In 1984, the MSSIC Board discussed various subordinated debentures that Community was considering issuing. At the August 22, 1984 Board meeting, James Deerin, General Counsel to Community, told MSSIC that "subject to discussion with MSSIC staff, concerning a correct interpretation of the rule, the association will make every effort to effect compliance promptly."[31]

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29 Memorandum of Martin W. Becker, Exhibit IIID23.

30 MSSIC Board of Directors minutes, March 23, 1983, Exhibit IIID24.

31 MSSIC Board of Directors minutes, August 22, 1984, Exhibit IIID25.

The Board of Commissioners did not address the issue of Community's compliance with regulations. The two discussions were limited to proposals by Community to issue preferred stock and a subordinated debenture.

The 1985 Reorganization

Beginning in December 1984, Billman and McCuistion began a massive corporate reorganization. In December 1984, Billman and McCuistion formed a new corporation, Epicenter Consolidated, Ltd. (Epicenter). Upon formation of Epicenter, Billman and McCuistion donated their stock in Epic Holdings to Epicenter. As a result, Epicenter became the senior - most holding company. On February 7, 1985, Community paid a dividend on its common stock of $8,000,000.[32] Eight months earlier, in May and June 1984, Community had paid a $6,762,438 dividend on common stock.[33] Billman and McCuistion, as stockholders of Epicenter Consolidated, were paid a $14,000,000 dividend on January 9, 1985.[34] In addition to common stock dividends, Community paid $977,617, primarily to Billman and McCuistion, in preferred stock dividends from March 14, 1983 to March 31, 1985.[35] The cumulative effect of $15,740,055 in dividends was to

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[32] Written Record of Action of the Board of Directors, February 6, 1985, Exhibit IIID26.

[33] Written Record of Action of the Board of Directors, July 23, 1985, Exhibit IIID27.

[34] Executive Summary Agreement, Exhibit IIID28.

[35] Written Record of Action of the Board of Directors, May 1, 1985, Exhibit IIID29.

impair the safety of depositors' accounts. A review of Community's Board of Directors' minutes illustrated the cavalier way that the dividends were approved. On May 1, 1985, the board retroactively approved the preferred stock dividends. Only one preferred stock dividend was approved contemporaneously by the board.[36] The minutes of the board approval of $6,762,478 in common stock dividends were "lost." The Office of Special Counsel believes that Community's financial condition was such that it could not legally have declared $15,704,055 in dividends in two years. With these dividends, Billman and McCuistion enriched themselves at the expense of Community's depositors.

On February 27, 1985, Equity Acquistions was merged out of existence into its immediate parent, EPIC Holding. Therefore, Community's immediate parent became EPIC Holding and its ultimate parent, Epicenter.

On February 28, 1985, Billman exchanged his eighty percent stock interest in Epicenter for eighteen corporations having a total book value of $31,800,000, including $14,000,000 in cash.[37] In addition, Billman received a guaranteed annual remuneration of $421,000 from Community for consulting, management, and trademark fees and other consideration. This reorganization, coupled with corporate losses, left the holding

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[36] Written Record of Action of the Board of Directors, December 31, 1984, Exhibit IIID30.

[37] *See* Exhibit IIID28.

company structure with a deficit net worth, i.e., Epicenter ($13,009,204) and EPIC Holdings ($13,043,718) as of April 30, 1984.

Savings Account Withdrawals

On April 25, 1985, the Executive Committee of the Board of Directors of Community met to discuss the impact of the Ohio savings and loan crisis.[38] The members of that Committee were McCuistion, Billman, Michael L. Shomper, Leonard Meltz, Jr., James B. Deerin, Jr., and Barbara A. McKinney. The minutes note that "[i]t is important that accounts (including certificates of deposits) of senior management continue to be maintained in the [a]ssociation to avoid causing unnecessary concern." Michael L. Shomper was directed to prepare "a contingency plan to insure that those accounts are available to such executives prior to any problem occurring."

Immediately after expressing these noble sentiments, the members of the Executive Committee systematically withdrew their funds from Community based on their insider information. Between the April 23, 1985 meeting and Governor's freeze order of May 14, 1985, Billman and McCuistion withdrew $239,809 and $578,448, respectively.[39] In addition, companies owned and controlled by Billman and McCuistion withdrew a total of over $2,500,000 during the same period. Meltz withdrew $117,271 on

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[38] Minutes of the Executive Committee, April 25, 1985, Exhibit IIID31.

[39] Affidavit of W. Bruce McPherson, Exhibit IIID32.

May 10, 1985. Deerin withdrew $381,265 on the same day. McKinney withdrew $201,000 on April 25, 1985. In short, the members of the Executive Committee withdrew millions of dollars prior to the freeze of all depositors accounts.

In retrospect, the Division failed to effectively regulate Community. Brown acknowledged that Community's acquisition of EPIC represented a "very complex" transaction. Brown's examiner reported to Division management his concerns that EPIC was simply too "complex" to be effectively examined. Even with that concern, the examiner pointed out how interwoven Community and EPIC had become. He detected that EPIC had to advance money to the limited partnerships to keep them going. He recognized that these advances were from Community.[40]

After the examination report containing numerous comments was sent and management's response received, the Division took no further action. The responses were patently frivolous, showing an arrogant disregard for the regulators. The regulators completely failed to respond to the challenge.

When the Division examiners indicated the "complexity" of Community, the Division could have used its power to employ auditors, at the association's expense, to review the service corporations. In addition, the SL200's submitted to the Division and MSSIC showed the millions of dollars in dividends being declared by Community, but they were never questioned.

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40 Interview of Charles F. Endres.

MSSIC did not view Community as a "problem association." It failed to grasp the seriousness of having a savings and loan association become captive to a real estate tax shelter business despite receiving copies of the Division examinations. Faulkner, Community's President, was MSSIC's Chairman of the Board from 1983 to 1984 and remained on the Board until 1985.

In fact, it is not clear that either MSSIC or the Division ever knew that Billman, McCuistion, and others had corporations outside the control of Community, providing services to EPIC. For example, EPIC Realty Services, Inc. received thirty-five dollars per month for each house owned by the partnerships. Based on 20,000 homes, these fees translated to $700,000 per month before expenses.

Conservatorship

On May 14, 1985, the Governor issued an Executive order limiting withdrawals from MSSIC-insured savings and loan associations, including Community, to $1000 per month.[41] In late July 1985, Community was informed of the results of the FSLIC examination requiring divestiture of EPIC.[42] Commencing in early August, 1985, EPIC's limited partnerships began defaulting on mortgage payments owed to its mortgage holders.[43] McCuistion, as

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41 Proclamation, Exhibit IIID33.

42 Letter from McCuistion, Exhibit IIID34.

43 The private mortgage insurers faced the risk of substantial losses because of EPIC's mortgage defaults. See Wall Street Journal, August 30, 1985, Exhibit IIID35.

President of Community, requested the Governor to freeze all deposits at Community due to continuing withdrawals.[44] On August 19, 1985, the Governor ordered that all deposits at Community be frozen for a twenty day period.[45] On August 30, 1985, the Wall Street Journal wrote an article detailing the risks to the EPIC limited partners, the private mortgage insurance companies, and holders of mortgage securities secured by EPIC properties.[46]

On September 5, 1985, EPIC, as general partner, filed federal bankruptcy petitions on behalf of 341 limited partnerships in the United States District Court for the Eastern District of Virginia. On the same day, the Board of Commissioners and MDIF filed a complaint against Community seeking to have MDIF appointed as conservator for Community, and the court issued such an order.[47] In the middle of September, 1985, MDIF filed bankruptcy petitions for sixteen additional limited partnerships.

On November 22, 1985, MDIF and Community filed a lawsuit against Billman, McCuistion, Barbara A. McKinney, James B. Deerin, Jr., Leonard Meltz, Jr., Joseph C. Cunningham, John D. Faulkner, Jr., EPICENTER Consolidated, Ltd., EPIC Holdings, Ltd.

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[44] See Exhibit IIID34.

[45] Executive order, Exhibit IIID36.

[46] See Exhibit IIID35.

[47] Complaint and Order, Exhibit IIID37.

and CRYSOPT corporation, alleging breaches of fiduciary duty, unlawful payment of dividends, fraudulent conveyances, waste of corporate assets and usurpation of corporate opportunities.[48]

As of the writing of this report, the freeze on deposits at Community is still in effect, prohibiting depositors from withdrawing their money many months after the corporate reorganization, dividend declarations and insider withdrawals by which officers and directors plundered the association.

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[48] Complaint, Exhibit IIID38.

E. FIRST MARYLAND SAVINGS AND LOAN, INC.

Introduction

First Maryland Savings and Loan, Inc. (First Maryland) was a stock association incorporated in 1974 and headquartered in Silver Spring, Maryland. President Julian Seidel was the largest single stockholder with 29.4% of the stock. The association owned numerous subsidiaries, in whole or in part, including First Maryland Financial Service Corporation, First Investment Corporation and Olde Line Associates, Inc.

Although Division Director Charles H. Brown, Jr. was concerned about First Maryland prior to 1983, his concerns were put to rest after a Division meeting with First Maryland management in 1983. After this meeting, First Maryland "engaged some additional experienced people" and "turned their operation around." Brown was not concerned that First Maryland's President, Julian Seidel, had declared personal bankruptcy because "[h]e had the knowledge to run the [the Association]."[1] Brown's examiners did not share his opinion. Numerous problems were revealed by the Division examinations both as of August 31, 1983 and as of August 31, 1984.

Division Examination as of August 31, 1983

The Division examination as of August 31, 1983, was mailed to the association on April 13, 1984.[2] Comment 5 to this

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[1] Brown transcript at 109.

[2] Division examination of First Maryland as of August 31, 1983, Exhibit IIIE1.

report deserves particular attention. It details a First Maryland request to the Division, dated June 15, 1983, to invest up to $1,000,000 in certificates of deposit in State Savings and Loan in Stockton, California. This request was denied by the Division by letter dated July 26, 1983 which, in pertinent part, stated:

> Regulation .37 prohibits deposits in any one association that are not insured by one of the insuring corporations as set forth in the regulation. Additionally, the Board is concerned over your low net worth and delinquencies. Considering the losses some associations will sustain in connection with the Penn Square Bank, the Board is of the opinion a deposit in such amount is an unsafe and unsound investment. Accordingly, your request was denied.[3] (emphasis in original comment).

When the examiners reviewed the association's investments, they discovered that on June 10, 1983, a $1,000,000 certificate at State Savings and Loan was part of its portfolio - in violation of Division Regulation .37 and the Division's unequivocal directive of July 26, 1983. The examiner concluded, "[i]t is evident that the association had made this investment prior to drafting the letter requesting approval of same."[4]

Division Examination as of August 31, 1984

On April 16, 1985, the First Maryland Division examination as of August 31, 1984 was sent out almost eight months after the as of date. The examination lasted from September 4, 1984 to November 1, 1984 and four examiners spent a total of 110

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[3] Id., Comment 5.

[4] Id.

examiner-days. The examiners were Jeffrey Fine, Thomas Burger, Linda Chmielewski, and Charles F. Endres. During this examination period, the major officers and directors of the association were Julian Seidel (President and Chairman of the Board of Directors), Edward A. Dacy (Treasurer, Director and Counsel), Robert Corletta (Secretary and Director), James Porter (Senior Vice President, Real Estate), Frank J. Calcara (Director), Michael Finci (Director), Linda Nusinov (Vice President, Operations), David Cole (Vice President Real Estate and Compliance Officer), Jay Smat (Vice President Commercial Lending), Gloria Meyers (Assistant Secretary) and Benjamin Maisel (Director).[5]

Problems pointed out in the exam were as follows.

1. Mortgage files were missing appraisals, applications, mortgage instruments, or title certificates, all in violation of Division regulations.

2. Fifty-six delinquent mortgage accounts had a combined outstanding balance over $12,500,000. The delinquent and unpaid interest on these loans was over $1,200,000. Subsidiary consumer and commercial loan accounts had an outstanding balance of $1,500,000 in delinquent accounts.

3. Numerous loans in excess of loan to net worth ratios were on the association books.

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[5] Division examination of First Maryland as of August 31, 1984, Exhibit IIIE2.

4. Letter of credit files contained insufficient documentation - no applications, no financial statements or credit information, no settlement sheets and no promissory notes.

5. Letters of credit were issued on behalf of Ronald Freudenheim, Vice President of First Maryland Financial Service Corporation, a wholly-owned subsidiary of First Maryland. These letters of credit were issued without Division approval, in violation of Section 9-307(b)(2) of the Code.

6. Commercial and consumer loan files in general were in disarray and loans were not kept in separate files. Lists indicating unused loan commitments and total amounts of loans to one person were not maintained. Some loans were charged points or other fees, including legal fees, apparently without settlement sheets.

7. Unsecured loans to officers and directors were made in violation of Section 9-307(b)(2)(iii) of the Code. Beneficiaries of these loans included James J. Smat (Vice President), James Porter (Vice President), Ronald Freudenheim (Vice President), Raj Boueja (Internal Auditor) and Vermont Avenue Limited Partnership, which was controlled by Frank Calcara, Julian Seidel, James Porter, Ronald Freudenheim, and Michael Finci. This partnership received a $801,200 loan from the association which was not approved by the Division.

8. Loans by First Maryland to its wholly-owned subsidiaries exceeded by over $1,000,000 the amount shown on the subsidiaries' books.

9. First Maryland had not disclosed its "Mortgage Loan Commitments" on nine of its last twelve SL200's.[6]

Our investigation has disclosed that First Maryland's net worth, as of July 26, 1985, was negative $19,900,000. By October 22, 1985, this figure had reached negative $22,600,000. These figures resulted from financial policies instituted or executed by First Maryland management that were ill-advised, unsafe and inextricably coupled with an excessively high risk operating posture. Compensation and expense policies for management were excessive. These policies also included an excessive amount of loans to affiliated persons in flagrant violation of regulations, and replacement of the association's former independent auditors with another firm, one of whose partners was Julian Seidel's personal accountant.

Senior Vice President, James R. Porter, was a prior subject of a federal investigation into personal loan brokerage fees he received from borrowers while he was elsewhere employed. Approximately ninety percent of Porter's known previous borrowers followed him to First Maryland, and all were on First Maryland's delinquent loan list.

Additionally, over seventy percent of First Maryland's mortgage portfolio was invested in loans secured by non-residential properties, in violation of Division regulations requiring a fifty percent non-residential limit.

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6 Id., Comments 1, 2, 6, 6B, 6B(4), 6(C), 6(C)(10) and (11), 7, and 12.

Loans to institution personnel and affiliates, according to federal sources, included:

1. $1,750,000 to Liberty Towers Limited Partnership, in which Julian Seidel (President), Edward Dacy (Director) and Vee M. Bundy (shareholder) had an interest;

2. $7,000,000 to "East 86th Street" in which Seidel and eight other officers, directors or stockholders (Calcara, Dacy, Corletta, Finci, Maisel, Porter, Meyers and Cole) of First Maryland acquired an interest through a partnership known as Director Associates Limited Partnership;

3. a $15,000 line of credit to Patten Investments, a partnership in which First Maryland officer David P. Cole owned an interest;

4. a $4,500,000 loan to Indiana Avenue, in which Seidel and three other association insiders had an interest;

5. a $105,000 loan to 5006 Battery Lane Limited Partnership - in which Seidel owned an interest;

6. $500,000 to Palmer Highway General Partnership, in which association officer and director Alan S. Kerxton had an interest;

7. a $100,000 line of credit for Travel Services, Inc., which was owned by Maureen Dacy, wife of association director and attorney Edward A. Dacy; and

8. a $186,000 loan at a rate below the prevailing cost of funds to Directors Associates Limited Partnership which was made up of nine affiliated persons as described in paragraph 2, above.

In response to additional inquiry into these loans by the Office of Special Counsel, the association has claimed that several of these loans did not require Division approval because insiders or affiliates owned less than ten percent of the borrowing entities.[7] Some of the association's assertions in this regard conflict with our findings. For example, the association claimed its directors only had a three percent interest in the $1,750,000 loan to Liberty Towers Limited Partnership. According to federal sources, however, the interests of Seidel, Dacy and Vee M. Bundy were 9.9% each, for an aggregate limited partnership interest of 29.7%. In addition, the loan was made without an appraisal on the property serving as security.

The association did not deny that the $186,000 Director Associates loan was a prohibited loan to insiders. Instead, it contended that the transaction received oral approval from William LeCompte, deputy director.[8]

The association admitted that David Cole was the general partner of Patten Investments, which was the beneficiary of a line of credit, but "owing to the small amount involved in this transaction, Division notification may have been overlooked."[9]

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[7] Letter of December 12, 1985 , Arnold Weiner to Office of Special Counsel and letter of January 3, 1986 from Ethan Bowman to Office of Special Counsel, Exhibit IIIE3.

[8] Id.

[9] Id.

First Maryland also contended that the Indiana Avenue transaction should not be subject to scrutiny because the four association officers and directors who participated in the deal each had interests of only 4.9%. According to the association, these interests were not acquired until after the syndication of the original deal, which was a loan to a construction company and a limited partnership comprised of an association service corporation and four limited partners who were directors of the association.[10] Office of Special Counsel investigation to date has not revealed the total aggregate interest of association affiliates.

Regardless of the percentage of insider ownership, these transactions show a pattern of self-dealing in violation of the officers' and directors' fiduciary duties.

Also of note in our investigation was a $300,000 line of credit First Maryland sought to establish for Seidel. Seidel sought to have this line of credit approved by the Division Director in December, 1984 on an unsecured basis but was rebuffed.[11] This was the second request from First Maryland and

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[10] Id.

[11] January 2, 1985 letter, Brown to David P. Cole, First Maryland Vice President, Exhibit IIIE4.

Brown's second refusal.[12] Brown supported his refusal with a letter from John C. Cooper, the Assistant Attorney General assigned to the Division.[13]

Eventually, First Maryland extended the line of credit to Seidel but on a "secured basis." The security consisted of notes payable to a major borrower of the association, Steven Madeoy. These notes were assigned to Seidel with recourse and in turn, Seidel assigned them to First Maryland without recourse.[14] First Maryland files do not reflect that Madeoy received any consideration for assigning the notes to Seidel. The association has claimed that the assignment by Seidel, without recourse, was a mistake and that the line of credit was only for $69,750.00. The association has also claimed that Seidel paid $74,000 for the notes from Madeoy.[15]

First Maryland suffered from numerous other serious deficiencies:

1. Loan procurement fees were paid to Vee M. Bundy, a twenty percent stockholder of First Maryland.

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[12] December 27, 1984 letter, Cole to Brown; Exhibit IIIE6, December 19, 1984 letter, Cole to Brown; Exhibit IIIE7, December 24, 1984, letter Brown to Cole, Exhibit IIIE5.

[13] September 14, 1984, letter Cooper to Brown, Exhibit IIIE8.

[14] Notes payable to Madeoy, assigned by Madeoy with recourse to Seidel, and assigned by Seidel, without recourse, to First Maryland, Exhibits IIIE9.

[15] February 1, 1985 Assignment and Security Agreement, Exhibit IIIE10, IIIE3.

2. Eighty-two loans, with balances in excess of $133,000,000 had the characteristics of joint ventures or direct investments as opposed to loans. In $53,000,000 of these investments the borrowers had no documentable equity and were protected from personal liability. Over $5,700,000 in income was booked by the association as a result of these loans when, in effect, this money was funded solely out of loan-in-process accounts. Proper accounting treatment of this money would create substantial losses in the association's operating income figures.

3. Almost every appraisal on file provided highly inflated values, and did not include feasibility studies.

4. Loans were made to shell corporations and limited partnerships without personal guarantees by the principals, and with little or no cash equity invested by the borrowers. Formal "take out commitments" were not obtained prior to loan approval, and limited unaudited financial statements based primarily on the borrowers' own estimated equity in other real estate ventures, were the basis for most of these loans.

5. Loans were made to eight borrowers totalling over $77,000,000, with each loan separately exceeding the association's net worth.

Regulatory Knowledge of First Maryland's Problems

As with other associations, the general condition of First Maryland and many of its specific problems were known to the Division and MSSIC. MSSIC minutes repeatedly mention First

Maryland's violations of MSSIC rules and regulations. MSSIC required First Maryland to sign an Insurance Agreement in April 1983.[16]

Under the terms of the Insurance Agreement, First Maryland and its subsidiaries were "required to submit for approval any loan commitment proposals, except for mortgage loans secured by single-family residential property...."[17] Board minutes reflect continued violations by First Maryland for the rest of 1983 and into 1984, particularly in regard to concentrations of commercial, construction, and land development loans.

These violations were reported by the Washington Times and discussed at the MSSIC Membership Committee meeting of February 8, 1984. After discussion, Charles Hogg "concluded that the [Washington Times] articles do not appear to have caused a public confidence problem in First Maryland or MSSIC."[18] Board minutes do not reflect any efforts to force First Maryland to cease its violations or to enforce the Insurance Agreement. In fact, First Maryland asked to be released from its Insurance Agreement because it claimed that its net worth ratio was now in excess of four percent. MSSIC deferred action on First

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16 April 19, 1985 MSSIC Rules Violation Notice from September 1984 to March 1985, Exhibit IIIE11; MSSIC Special Directors Meeting minutes, April 18, 1983, Exhibit IIIE12; MSSIC Rules Violation Notice from March 1984 to September 1984, Exhibit IIIE13.

17 MSSIC Membership Committee minutes, May 11, 1983, Exhibit IIIE14.

18 MSSIC Membership Committee minutes, February 8, 1984, Exhibit IIIE15.

Maryland's request, pending study of a proposal made by Paul Trice to withhold release until an affidavit verifying First Maryland's claims was received.

Five months later, in July 1984, First Maryland renewed its request for release from its Insurance Agreement despite the fact that it was still violating MSSIC lending requirements.[19] According to MSSIC's rules violation notice compilation for March 1984 to September 1984, First Maryland's July commercial lending limitation violation of 71.71% was the worst violation of any association during the reported period. The accepted limit for commercial loans was 40% of total savings.[20] Numerous other First Maryland violations were also included in the rules violation notice. Board minutes do not reflect if First Maryland was ever released from its Insurance Agreement but they demonstrate that First Maryland's violations did not cease. From the August 13, 1984 Membership Committee meeting to the March 13, 1985 Membership Committee meeting, First Maryland's repeated violations of MSSIC rules and regulations were regularly discussed.

MSSIC efforts to force First Maryland to comply consisted of the issuing of a "staff cease and desist" letter in September 1984, and requiring the submission of a business plan.[21] Although there was some discussion about voicing

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[19] Membership Committee minutes, July 16, 1984, Exhibit IIIE16.

[20] Exhibit IIIE13.

[21] MSSIC Board of Directors minutes, September 26, 1984, Exhibit IIIE17; Board minutes, November 28, 1984, Exhibit IIIE18.

opposition to a new First Maryland branch, the November 14, 1984 Membership Committee minutes reflect that First Maryland's application was approved by the Division apparently before MSSIC took any "firm" action.[22] MSSIC's rule violation notice demonstrated that First Maryland virtually ignored the cease and desist letter, and MSSIC's own minutes reflect that the business plan, first requested in September 1984, was not received until sometime in late December or early January 1985.[23]

When finally received, the plan had serious defects.[24] Later, when a revised plan was submitted, Martin Becker, the MSSIC staff analyst who originally found the defects in the plan, was not consulted.[25] In February, however, pending receipt of the revised plan, MSSIC approved issuance of a formal cease and desist order to First Maryland.[26]

When the revised plan was received in late February 1985, Paul Trice determined, without Becker's input, that it was acceptable. Therefore, he noted at a March Membership Committee meeting that a hearing called for by the cease and desist order

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[22] Membership Committee minutes, November 14, 1984, Exhibit IIIE19.

[23] MSSIC Board of Directors minutes, September 26, 1984, Exhibit IIIE17; Membership Committee minutes, December 12, 1984, Exhibit IIIE20; Membership Committee minutes, January 9, 1985, Exhibit IIIE21.

[24] Interview with M. Becker; Membership Committee minutes, January 9, 1985, Exhibit IIIE21.

[25] Interview with M. Becker.

[26] Membership Committee minutes, February 13, 1985, Exhibit IIIE22.

probably would not be necessary.[27] According to MSSIC's rule violation notices, however, First Maryland's violations continued, and in some respects worsened.

The Board of Commissioners had considerably less knowledge of First Maryland's difficulties, according to its own minutes. Although Division examiners had found many rule and regulation violations as noted above, Board of Commissioners' minutes only mentioned First Maryland once during 1984. First Maryland was never mentioned during 1985. The 1984 reference occurred at the February 9, 1984 Executive Session in response to the same Washington Times articles that concerned MSSIC.

In response to questioning by the Board concerning First Maryland's violations reported in the Washington Times, Charles Brown replied that the examiners were recently sent into First Maryland. He concluded, "[w]hen the examination is completed, we will take appropriate action."[28] As noted above, even after the examiners' report was finally transmitted to the association on April 13, 1984, "appropriate action" was never taken and the examination was not discussed at Board meetings.

As with other associations, Division examinations of First Maryland established a sufficient basis for regulatory sanctions, but none were taken. Additionally, MSSIC's monthly reporting system demonstrated a history of regulatory violations which, in hindsight, called for a strong response. The only

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27 Membership Committee minutes, March 13, 1985, Exhibit IIIE23.

28 Board of Commissioners Executive Session minutes, February 9, 1984, Exhibit IIIE24.

response forthcoming was a cease and desist order late in the game on which MSSIC did not follow through. As a consequence, First Maryland's regulatory violations and insider transactions continued unabated until a conservatorship was established in November of 1985, which continues in effect as of the writing of this report.

F. FRIENDSHIP SAVINGS AND LOAN ASSOCIATION

Friendship Savings and Loan Association (Friendship) was a stock association founded in 1913, which had its main office at 7625 Wisconsin Avenue in Bethesda, Maryland. Its stock was wholly-owned by a holding company, Friendship Group, Inc., located at the same address. At the time of the 1985 savings and loan crisis, Friendship Group, Inc. was fifty percent owned by Anthony C. Koones and fifty percent owned by E. Mitchell Fry. Koones was Chairman of the Board and Fry was President of Friendship. The savings and loan also owned three subsidiaries, Friendship Financial Group, Friendship Services, Inc. and North Park Corporation.[1]

Friendship 1984 Examination

Friendship was most recently examined by the Division as of March 31, 1984. The examination resulted in a number of comments which were of concern to the examiners.

Comment 1 referred to seventeen loans made to investors for the purchase of condominium units in a development known as "Hunting Ridge." Two notes were signed by each mortgagor. One was for ninety percent of the loan value and the second was a "commercial loan" for the balance of the loan. The two loans were secured by one deed of trust for the total amount, with the real estate as collateral. The examiners pointed out that,

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[1] Friendship Savings and Loan Association was purchased by Chase Manhattan Bank in November of 1985 in a package deal pursuant to which Chase also purchased Merritt and Chesapeake Savings and Loan Association.

because the loan was equal to the value of the collateral, Division Regulations limiting such loans to eighty percent of the value were violated.[2]

The examiners also pointed out that, from July 1, 1982 through March 31, 1984, Friendship made thirteen loans which exceeded its net worth, in violation of Division Regulations.[3] Comment 3 discussed two "warehousing loans" made on December 29, 1983, in the amount of $5,920,000, and January 4, 1984, in the amount of $5,633,000, to USGI, Inc. USGI, Inc. granted two mortgage loans on December 30, 1983 in the amount of $4,184,000 and $1,736,000 to First Victoria Limited Partnership (First Victoria) on an apartment house in Louisville, Kentucky. The two loans granted by USGI were in the exact amount of the December 29 loan from Friendship to USGI. Additionally, the two loans to First Victoria were in the exact amount needed to pay off a prior loan to First Victoria held by Friendship. The general partner of First Victoria Limited Partnership was First Victoria Corporation, which owned a five percent interest and which was wholly-owned by Koones and Fry. Limited partners of First Victoria Limited Partnership were North Park Corporation and Friendship Services, Inc., both wholly-owned subsidiaries of Friendship Savings and Loan Association. Through the transaction, Friendship brought $1,100,000 into income which represented the deferred discount on its original loan purchase. Additionally, North Park Corporation granted a third mortgage on

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[2] Md. Admin. Code Tit. 9 § 05.01.30C(3)(b) (1985).

[3] Id. § 05.01.30B(1).

the Louisville apartments in the amount of $1,500,000, bringing the total outstanding loans on the property to a point exceeding 100% of the value.

On January 4, 1984, USGI granted two loans in the amount of $5,633,000 and $1,922,000 to Northgate Limited Partnership on apartments in St. Petersburg, Florida. On January 9, 1984, the first loan in the amount of $5,633,000 was used to pay a prior Friendship loan in full. Northgate Limited Partnership consisted of First Victoria Corporation and North Park Corporation. Through the transaction, Friendship was able to bring $1,400,000 into income which represented the deferred discount on its original loan purchase. In both the Northgate Limited Partnership and First Victoria Limited Partnership transactions, Friendship simply loaned money through a third party to entities owned by its principals and by its wholly owned subsidiaries in order to generate income on its books which was totally illusory. The examiners called the generation of income "questionable."[4]

The minutes of the Board of Commissioners and MSSIC Board of Directors and Membership Committee reflect very little regulatory concern with Friendship's operation during 1983 or 1984. On December 11, 1984, Charles H. Brown, Jr., Division Director, issued Order No. 607 approving Friendship's application for permission to establish a branch office in Gaithersburg,

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[4] See Friendship examination as of March 31, 1984, Exhibit IIIF1. In fact, this method of generating income was more than "questionable"; it violated generally accepted accounting principals and gave a false portrayal of Friendship's value.

Maryland. No protests were received regarding the proposed branch office. In his order, Brown found that the office would "promote the public interest, convenience and advantage and will be efficiently operated."[5]

During Division examinations, examiners did not request to review the books and records of Friendship Group, Inc., the association's holding company. The Division's policy was to examine savings and loan associations and their subsidiaries but not parents or holding companies. The statute directing examinations of savings and loan associations specifically provides that a "savings and loan association" for purposes of its examination includes service corporations or subsidiaries.[6]

Diversion of Funds through Friendship Group, Inc.

Friendship Savings and Loan Association's holding company, Friendship Group, Inc., was wholly-owned by Koones and Fry. The Office of Special Counsel's examination of the books and records of Friendship Group, Inc., reveals that the holding company was used to divert approximately $3,000,000 from the savings and loan for the apparent benefit of Koones, Fry and other "insiders."

From March of 1982 through August of 1984, Friendship Savings and Loan Association purchased sixty-two HUD insured rental projects at discounts. For a number of the transactions, the association used either USGI, Inc. or Reilly Mortgage Group

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[5] See Division Order 607, Exhibit IIIF2.

[6] Md. Fin. Inst. Code Ann. §§ 9-501, 9-502 (1980).

as a broker. (USGI was formerly USGA and may be identified by its former name on some exhibits.) The broker would appear at a HUD auction authorized to bid on behalf of Friendship Savings and Loan Association on packages of HUD project loans. Following the auction, the association would issue a letter to the broker directing the disbursement of funds, often requiring that a portion of the funds be remitted by wire to Friendship Group, Inc.

For instance, by memorandum dated November 16, 1983, Koones proposed the purchase of eight HUD projects to the Friendship Board of Directors, through USGI, for a total amount of $10,824,511.[7] The Board of Directors, consisting of Fry, Koones, Joan Spermo and W. Robert Wolf, approved the purchase. USGI successfully bid on the properties at a HUD auction. By letter of December 20, 1983,[8] Fry directed USGI to disburse $10,982,135.38 for the purchase of the HUD project loan, as follows:

$10,299,664.83	to HUD
94,026.00	to USGI, Inc.
227,104.62	to USGI, Inc. for escrows
361,339.93	"balance" payable to Friendship Group, Inc. by wire

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[7] *See* November 16, 1983 memorandum, Exhibit IIIF3.

[8] *See* letter of December 20, 1983, Exhibit IIIF4.

The funds were disbursed as directed by Fry. Consequently, a substantial sum was remitted to Friendship Group, Inc., the holding company owned by Koones and Fry, apparently for no services whatsoever.

On July 27, 1983, an additional package of HUD mortgages was presented to the Board for authorization, again to be purchased through USGI, and Reilly Mortgage Group. The Board approved purchasing a package for $11,393,769.35 through USGI, and $1,728,918.65 through Reilly.[9] By letter of August 1, 1983, Fry directed USGI to distribute $11,249,217 for the HUD mortgages as follows:

$10,597,004.86 to HUD
58,279,000.00 to USGA (USGI)
593,933.14 to Friendship Group, Inc. by wire[10]

Again, on July 30, 1984, a memorandum was submitted to the Board of Directors seeking approval of the purchase of HUD mortgage packages through USGI and Reilly, this time totalling $14,947,310. The Board approved the request by Koones.[11] On August 24, 1984, Koones wrote to Reilly regarding the distribution of $6,156,452.94 due for the HUD package as follows:

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[9] See July 27, 1983 memorandum, Exhibit IIIF5.

[10] See August 1, 1983 letter from Fry to USGI, Exhibit IIIF6.

[11] See Koones memorandum to Friendship Board of Directors July 30, 1984, Exhibit IIIF7.

$5,823,186.65 to HUD

87,874.42 to Reilly for tax escrows

245,391.87 to Friendship Group, Inc. by wire[12]

Also on August 24, 1984, Koones wrote to USGI regarding the distribution of $9,057,017.63 for HUD mortgages purchased through them, as follows:

$8,601,872.08 to HUD

81,202.24 to USGI for escrow

81,768.00 to USGI for its fee

292,175.31 to Friendship Group, Inc. by wire[13]

These examples are representative of Friendship purchases of HUD mortgage packages through USGI and Reilly pursuant to which funds were diverted to Friendship Group. The "mortgage purchase agreement" entered into between USGI and Friendship contained a standard provision calculating the purchase price in accordance with an attached exhibit but also providing that "purchaser [Friendship] also agrees that it may pay as consideration...an Additional Purchase Price as may be determined by Purchaser to be disbursed as directed by purchaser..."[14] Thus, the savings and loan association entered into purchase agreements on the HUD loan package which permitted it, at its discretion, to pay out money in addition to the purchase price.

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[12] See August 24, 1984 letter from Koones to Reilly, Exhibit IIIF8.

[13] See August 24, 1984 letter from Koones to USGI, Exhibit IIIF9.

[14] See July 30, 1984 Mortgage Purchase Agreement between USGI, Inc. and Friendship Savings and Loan Association, Exhibit IIIF10.

Koones and Fry apparently have used the funds diverted to Friendship Group, Inc. for their own benefit in a variety of ways. The following chart demonstrates some of those uses. This chart is based on an examination by Sergeant R. Lee Caple of the Maryland State Police of money market account #08-710-699 maintained at Riggs National Bank of Washington, D.C. in the name of Friendship Group, Inc. This was the account into which money was remitted to Friendship Group from the HUD mortgage purchases.

Date	Check #	Payee	Amount	Explanation	Comments
8/19/83	None	American Group Inc.	$125,477.53	Transfer to AG, Inc.	(2)
8/29/83	103	Friendship Services	129,562.50	Purchase of HR (Hunting Ridge) Note	(1)
8/29/83	104	Friendship Services	250,000.00	Purchase of HR Note	(1)
9/30/83	105	Friendship S&L	87,978.47	Interest to 10/01	(3)
1/06/84	114	Housing Capital Corp.	175,000.00	Pay-out HR Notes	(1)
1/06/84	115	Nat'l Corp. for Housing	175,000.00	Pay-out HR Notes	(1)
3/13/84	129	American Group Inc.	114,281.86	Pettit Pymt- Princ. - $107,000.00 Int. - 7,281.86	(4)
3/23/84	134	Friendship S&L	87,978.47	Interest to 4/01	(3)
4/16/84	146	Anthony C. Koones	170,030.00	Taxes	(6)
4/24/84	147	Anthony C. Koones	318,000.00	Loan	(5),(6)
4/24/84	148	E. Mitchell Fry	318,000.00	Loan	(5),(6)
8/29/84	152	Anthony C. Koones	268,783.59	Loan	(5),(6)
8/29/84	153	E. Mitchell Fry	268,783.59	Loan	(5),(6)

(1) H. R. (Hunting Ridge) is a limited partnership of American Housing, Inc. (three percent), Friendship Services (forty-seven percent) and Friendship Group (fifty percent) . American Housing, Inc., is wholly-owned by Koones.

(2) American Group, Inc. is wholly-owned by Koones and Fry (Koones-ninety-five percent and Fry-five percent).

(3) These funds used to pay interest payment on outstanding loan which Friendship Group, Inc. has with Friendship Savings and Loan Association.

(4) These funds were utilized to pay-off an existing loan by a former partner of Friendship Group, Inc., John Pettit.

(5) These transactions were recorded in the check register as "loans." Barbara Currier, Secretary to Koones, revealed that the register was coded as such and that there is no supporting loan documentation for these transactions.

(6) No loan documentation could be located for these transactions.

In addition to the foregoing, Koones and Fry were paid "consulting fees" out of the Riggs account between October 1983 and August 1984 amounting to $141,500.

Other funds of Friendship Group, from sources other than the Riggs account, have been used for the apparent benefit of Koones and Fry. Hunting Ridge Limited Partnership (Hunting Ridge) (see Note 1 on the chart) is owned directly or indirectly either totally or in part by Koones and Fry. On April 30, 1983, it started a series of nine loan transactions with Friendship Group totalling $196,813.16. At the time of our examination, no payment had been received on this account.

American Housing, Inc. (see Note 1 on the chart) started a series of eleven loan transactions with Friendship Group resulting in a total loan of $189,557.79. At the time of our examination, no payments had been received on this account.

Other funds that Friendship Group had in other accounts at Riggs and other banks appear to have been used for the benefit of Koones and Fry. Investigation to date has not attempted to trace all of the funds received by Friendship Group.

Once money was channeled from Friendship Savings and Loan Association to Friendship Group, it was beyond the examination parameters of the Division. An examination of the books of Friendship Group was not included in the annual audits performed by Friendship Savings and Loan Association's accountants, Coopers & Lybrand, which were submitted on behalf of the association to the Division and MSSIC. Once money was placed on the accounts of Friendship Group it was used subject to the total discretion of Koones and Fry, who either paid it directly to themselves or "loaned" it to themselves without supporting documentation or collateral.

Insider Transactions at Friendship

Friendship also engaged in a number of insider transactions and other transactions which were designed to generate illusory income to the association. For instance, in March of 1982, Friendship entered into a "loan swap" with Old Court which was a mutual scheme to falsely inflate each association's income. Friendship purchased a pool of single family mortgages with below market rates and unpaid principal balances of $4,743,944 from Old Court for $2,707,843. They took three percent of the outstanding balance into income immediately and deferred the rest of the discount of $1,893,782 over the next seven years on a monthly straight line amortization. At the same time, they sold a pool of single family mortgages to Old Court with unpaid principal balances of $4,706,225 for $2,683,313. They deferred the loss of $2,019,912 over 23.5 years, amortizing on a monthly straight line basis. Thus, through the loan swap, Friendship and Old Court were both able to generate substantial paper income while deferring substantial losses, rendering a false picture of their financial condition.

Friendship also, on August 16, 1984, made a $208,000 commercial business loan to Julian Seidel, President and Chairman of the Board of First Maryland. Seidel had undergone bankruptcy proceedings in 1982. The proceeds of the loan were used to purchase 64,800 shares of First Maryland stock from Fry, First Maryland's former president and Friendship's current president, and William S. Steed. The loan was a bad credit risk and the proceeds went to directly benefit Fry.

In December of 1984, Friendship loaned $500,000 to Hunting Ridge Limited Partnership to refinance two existing loans at the association, provide funds for interest, engineering and preconstruction expenses. The security was five noncontiguous land parcels comprising ten acres. Hunting Ridge was controlled by Koones and Fry. This insider loan did not receive Division approval.

Friendship also falsely inflated its income by having Friendship Group purchase a block of loans with a face value of $8,800,000 from it at par. Friendship Group then sold the loans at a loss of $1,852,178. Friendship Savings and Loan Association was remitted cash and a $1,852,178 note from Friendship Group. The note was carried as an asset. In fact, no payments were made and, in March of 1985, at the request of their auditors, Friendship requested Division approval to write the note off.

Conclusion

The Division examination of Friendship was hindered by a statute which granted authority to conduct examinations of savings and loan associations and their subsidiaries but not their parents. The books and records of Friendship Group, which were kept at the same premises, were not made available to the Division examiners. Correspondence was contained in the association's files, however, which directed the mortgage brokers to remit funds from settlements to Friendship Group. These transactions should have been questioned. In fact, the purchase of deep discount HUD mortgages was used to divert money from the association to the holding company which was entirely owned by Koones and Fry. Koones and Fry then used the money for their own purposes, including one disbursement in the amount of $170,030 to Koones for "taxes."[15]

Friendship's accountants, Coopers & Lybrand, certified the financial statement for Friendship Savings and Loan Association without questioning the diversion of funds to Friendship Group, Inc. Note eleven in the financial statement describes transactions with related parties but completely omits the series of payments to Friendship Group.[16] Again, although they did not audit Friendship Group, the diversion should have

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[15] See Exhibit IIIF11.

[16] See Friendship Financial Statement, March 31, 1984, Exhibit IIIF12.

been apparent from the association's records. Additionally, Coopers & Lybrand filed a consolidated tax return for Friendship Group and Friendship Savings and Loan Association.

Finally, Friendship's operation diverged drastically from the traditional operation of a savings and loan association in Maryland. Out of its total assets in 1985 of $264,900,000, approximately 60.1% was invested in HUD originated loans secured by aged rental properties throughout the country. Its method of generating income through deceptive accounting practices created a false picture of financial health for the regulatory agencies.

Friendship exemplifies some of the worst problems faced by the State of Maryland. In order to qualify for federal insurance, it would have required a capital infusion of $35,478,145. Koones and Fry received excessive compensation through the holding company and were guilty of conflicts of interest. On advice of their attorneys, they have declined to testify concerning these matters, asserting their Fifth Amendment privileges. In short, Friendship like Old Court, Merritt and others, represented all that was bad about Maryland savings and loan associations.

Despite this, Maryland found itself having assumed liability for over $200,000,000 of deposits in this substandard institution. The state freed these deposits when Chase Manhattan Bank acquired Friendship along with Merritt and Chesapeake. As a result of the Chase acquisition, the Office of Special Counsel understands that Koones and Fry have received assets valued between $15,000,000 and $20,000,000 for their stock in

Friendship, without having to account for the vast sums of money they previously diverted. While the depositors of Friendship understandably applaud this transaction, others understandably fail to discern justice in the result.

G. RIDGEWAY SAVINGS AND LOAN ASSOCIATION

Ridgeway Savings and Loan Association (Ridgeway) was a mutual association which was founded on February 14, 1955. Walter F. Farnandis, an attorney, incorporated the association, contributed $250 in capital to it and became its first president and chairman of the board. The association's first office was in a storefront rented for twenty-five dollars per month in Catonsville in which Farnandis "put an old desk and a dining room chair...and painted the name on the window and started it."[1] Farnandis remained president and chairman of the board and ran the association from 1955 through 1984. Although it was originally opened only on Wednesday nights and Saturday mornings, it operated on a full-time basis starting in 1965.

Farnandis' law firm did all of the legal work for the association. He and one of the other directors approved all of the association's loans. He also formed Suburban Title Corporation, obtained an agency from a title insurer and did all of the title work, settlements and title insurance for the association's customers. Members of the board of directors did appraisals and were paid a fee, on a rotating basis. Borrowers of Ridgeway were told that Farnandis would handle the settlement. Farnandis also incorporated Total Real Estate Enterprises, a real

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[1] Farnandis transcript, page 4, 5.

estate brokerage firm which referred customers to Ridgeway and Farnandis' title company. Although Farnandis was president of the association, he never received a salary.[2]

Ridgeway spent a substantial portion of the period from 1980 through 1985 in violation of various MSSIC rules and regulations. In particular, MSSIC minutes reflect concern about Ridgeway's violation of their liquidity and net worth rules. At the MSSIC Board of Directors' meeting on March 23, 1983, members discussed requiring Ridgeway to enter into an insurance agreement with them.[3] At the meeting on May 25, 1983, Elsnic recommended an insurance agreement for Ridgeway because its net worth was less than three percent and Dolivka seconded the motion.[4] At later meetings of the Board of Directors, the difficulty in getting Ridgeway to enter into an insurance agreement with MSSIC was discussed. An insurance agreement was never obtained.

Division Examinations of Ridgeway

Ridgeway was examined by the Division on a regular basis. The examination as of February 28, 1983 was conducted by Charles F. Endres and Kenneth A. Henneberger. At the time, Ridgeway had approximately $6,900,000 in savings accounts. The net worth of the association was approximately 1.91% of its

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[2] Farnandis transcript, pages 9-16.

[3] MSSIC minutes, Exhibit IIIG1.

[4] MSSIC minutes, Exhibit IIIG2.

savings liability, in violation of Division regulations.[5] The association's lending was primarily in first mortgage loans on residential property. The examiners discovered various loan files which did not contain loan applications, appraisals, settlement memoranda, the original insurance policy or the original mortgage instrument, in violation of Division regulations.

Additionally, the examination contained an "informational comment" to the effect that, on May 21, 1975, the association granted a first mortgage loan to "Farnandis Farms, Inc." of which Farnandis was president, in the amount of $20,000 at a nine percent interest rate for ten years. On January 31, 1979, the mortgage was paid off but the pay-off letter stated "leave $100 balance on the mortgage but close escrow account. Do not close mortgage account." Subsequently, periodic advances were made on the mortgage in amounts ranging from $200 to $9000 in a total amount of $18,000. The balance at the time of examination was $11,000 and payments of interest only were being made. The nine percent rate, to an entity owned by the president of the association, was substantially below current market rates. It was not clear from the examination why this loan was written up as merely an "informational comment" since it was a clear violation of Section 9-307 of the Code, prohibiting insider loans without board of directors' and Division approval and adequate security.[6]

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5 Md. Admin. Code Tit. 9 § 05.01.40-1B (1985)

6 Division examination of Ridgeway as of February 28, 1983, Exhibit IIIG3.

The examination comments were communicated to Ridgeway by letter of Division Director Brown dated July 27, 1983.[7] The Board of Directors of Ridgeway discussed the comments at their meeting on August 24, 1983 and resolved to correct them. The "informational comment," however, was not discussed. The board of directors' minutes were sent to the Division on September 13, 1983.[8]

Ridgeway was reexamined by the Division as of February 29, 1984. The examination was performed by Stanley Goren and Robert Rucks. At the time, the mutual association had approximately $7,800,000 in savings accounts. Again, various deficiencies were noted in mortgage loan files. One commercial loan was made in an amount which exceeded 100% of the appraised value of the security. No comments were made regarding the Farnandis Farms, Inc. loan.[9] The examination was transmitted to Ridgeway's Board of Directors by June 4, 1984 and discussed at Ridgeway's board meeting on July 20, 1984. Again, the board resolved to correct the deficiencies and transmitted their board minutes to the Division by letter of July 30, 1984.[10]

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[7] See Brown letter to Ridgeway Board of Directors July 27, 1983, Exhibit IIIG4.

[8] See Board of Directors' minutes of August 24, 1983 and letter to Division of September 8, 1983, Exhibits IIIG5, IIIG6.

[9] Ridgeway examination of February 29, 1984, Exhibit IIIG7.

[10] See letter of Charles H. Brown to Ridgeway Board of June 4, 1984, Board minutes of June 20, 1984, transmittal letter of July 30, 1984, Exhibit IIIG8, IIIG9, IIIG10.

The Sale of Ridgeway

Robert B. Greenwalt, an attorney formerly associated with Farnandis' law office, also provided various legal services for Ridgeway in 1984. In his capacity as Ridgeway's attorney, he submitted to the Division on May 7, 1984, an Application for Approval of Conversion. The application sought approval of the Division for a conversion of Ridgeway from a mutual to a stock association.[11] It was accompanied by an appraisal of Ridgeway performed by Trident Appraisal Company dated May 16, 1984. The appraisal concluded that the fair market value of the association was $325,000. The appraiser used the "price earnings method" of appraisal because the value of the association as a going concern exceeded its liquidation value. The appraisal also contained a consolidated balance sheet as of January 31, 1984, which was unaudited, which demonstrated that the association had $309,000 in undivided profits, $130,000 of which was appropriated to general reserves, leaving retained earnings of $178,000.[12] The application for conversion was given preliminary approval by Charles Brown on September 25, 1984.[13]

Prior to conversion, however, the association was sold. Greenwalt, now the attorney for David L. Rouen, approached Farnandis in August, 1984 to inquire as to whether he would sell "his association." Farnandis regularly had offers from people to buy the association and Paul Trice, Vice President of

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[11] See Application for Approval of Conversion, Exhibit IIIG11.

[12] See Trident appraisal, Exhibit G12.

[13] See Brown letter of September 25, 1984, Exhibit IIIG13.

MSSIC, was putting pressure on him to merge into another association.[14] After negotiations, Farnandis consented to sell the association for $1,275,000.[15]

Ridgeway, as a "mutual association" did not have the authority to issue capital stock.[16] As such, the "owners" of the association were the holders of the various saving share accounts. Farnandis did not "own" the association but simply had an ownership interest based on his saving share accounts at Ridgeway. Additionally, Division Regulations[17] prohibited a director, officer or employee of an association acting as proxy from selling the proxy to anyone else. Farnandis testified that he was not aware of the Division Regulation. He was aware that Ridgeway was a mutual association but stated that "I had the business for twenty-nine years and never drew any money out of it....had built it up from nothing, $250 up to $9,000,000 dollars." Greenwalt, Rouen's attorney, also knew that Ridgeway was a mutual association. Farnandis believed that he was selling Rouen the right to take over the association and obtain its stock after conversion.[18]

A purchase agreement was drafted by Greenwalt.[19] Pursuant to the agreement, Rouen was required to pay $150,000

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[14] Farnandis transcript, page 38.

[15] Farnandis transcript, page 40.

[16] Md. Fin. Inst. Code Ann. §9-101(h) (1980).

[17] Md. Admin. Code Tit. 9 §05.01.43(B)6) (1985).

[18] Farnandis transcript page 42, 43.

[19] See Agreement of September 19, 1984, Exhibit IIIG14.

upon execution of the agreement, $125,000 on March 19, 1985, and "the association, at direction of purchaser," was required to pay $100,000 per year to Farnandis for ten years. One of the association's assets was a building in Ellicott City which housed one of their offices and which sat on three quarters of an acre of commercially zoned land. It had been purchased by the association in 1976. As part of the agreement of sale, the association was required to execute a mortgage to Farnandis in the amount of $300,000 secured by Ridgeway's Ellicott City property. The mortgage permitted Farnandis to foreclose upon any default in payment.[20] Ridgeway also executed a confessed judgment note dated September 19, 1984, under which it promised to pay Farnandis the ten consecutive annual installments of $100,000. Upon default, Farnandis was entitled to file a confessed judgment against Ridgeway and collect fifteen percent attorneys' fees.[21]

On September 19, 1984, the agreement of sale and accompanying documents were executed. Farnandis met with his board of directors, which included his son, W. Walter Farnandis, III, his daughter, Anita Wilcox, Joseph Fry and Grace Devitt. Additionally, an "annual shareholders" meeting was held at Ridgeway, at which "all shareholders of the association" approved the sale of the association to David Rouen.[22] The "shareholders" who appeared were the Farnandis board of directors. After

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[20] See Mortgage of September 19, 1984, Exhibit IIIG15.

[21] See Confessed Judgment Note of September 19, 1984, Exhibit IIIG16.

[22] See shareholders' meeting minutes of September 19, 1984, Exhibit IIIG17.

approving the sale, the board resigned.[23] The various documents were then executed and a new board of directors was elected by Rouen.[24] Farnandis paid his son and daughter $10,000 each, Fry and Devitt $5000 each and Rosemary Tyler, an employee of Ridgeway, $5000 at the time of resignation. He denied that the payment was in consideration for the Board's resignation and approval of the sale.[25]

To summarize, Farnandis sold an association he did not own for $1,275,000. He, Rouen and Greenwalt conspired to have the association itself pay the bulk of the purchase price and the promise to pay was secured by the association's real estate.

Rouen claimed that he did not know the difference between a mutual and stock association when he purchased Ridgeway. He believed that Farnandis was the owner by virtue of ownership of all of the proxy rights. He paid Farnandis $150,000 on September 19, 1984. He also believed that the $100,000 per year payments by Ridgeway to Farnandis, although part of the purchase price, were set forth as they were in the contract by Greenwalt so that Ridgeway could write the payments off as an association "expense." Rouen admitted that he did not plan for Farnandis to do any work for the annual payment.

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[23] See Board of Directors' resignation of September 19, 1984, Exhibit IIIG18.

[24] See September 19, 1984 Consent of New Directors, Exhibit IIIG19.

[25] Farnandis transcript, page 65, 66.

Approximately a month after the purchase, Rouen discovered that he had no stock in the association and that the conversion plan had not been finally approved and effected. Greenwalt proceeded to represent him and the association in obtaining final approval of the conversion plan and in the issuance of stock. Pursuant to the plan, no officer or director of the association was permitted to buy more than twenty-five percent of the stock of Ridgeway. Rouen planned to buy twenty-five percent and to have his wife buy twenty-five percent. In addition, he financed the purchase of twenty-five percent each for Greenwalt, his attorney, and Rosemary Tyler, a Ridgeway employee. He obtained financing from First Maryland for the purchase of his, his wife's, Greenwalt's and Tyler's stock. His financing agreements with Greenwalt and Tyler required that they pay Rouen within forty-five days and that, upon their default, their stock would go to Rouen. Neither Greenwalt nor Tyler paid for the stock and, consequently, by default, Rouen and his wife became the owners of all of the issued stock of Ridgeway forty-five days after the stock issuance. Rouen paid $313,950 for the stock.[26]

Ridgeway Insider Transactions

Subsequent to the last Division examination, Ridgeway proceeded to engage in a number of insider transactions which were prohibited by Maryland law. In July of 1984, Ridgeway agreed to issue a $200,000 line of credit to Frank's Auto Fair,

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26 Interview of David L. Rouen, September 24, 1985.

Inc., a used car dealer. Frank's Auto was fifty percent owned by Frank Fair and fifty percent owned by Farnandis.[27] Ridgeway's service corporation, Reico, extended credit to Frank's which was secured, purportedly, by the automobile inventory. The Ridgeway Board of Directors had understood that Reico, not Farnandis, would be Fair's partner.[28] Additionally, Reico authorized Frank's Auto to issue automobile loans to purchasers, financed by Ridgeway. Again, the security would be the individual automobiles. By January 3, 1985, all $200,000 of the line of credit had been extended to Frank's and an additional advance of $330,000 was authorized. Although a number of automobiles had been sold, none of the line of credit had been reduced by any sales price. By March 31, 1985, additionally, Frank's had extended thirty-three loans to automobile purchasers in the total amount of $52,831.28. Pursuant to the Frank's Auto Fair loans, Ridgeway extended credit to a corporation fifty percent owned by Ridgeway's president under circumstances where automobiles were security both for the line of credit extended to purchase inventory and the individual loans to automobile purchasers.

After the Rouen board of directors took over management of Ridgeway, Ridgeway commenced a number of commercial insider loans. On December 19, 1984, the Ridgeway board authorized a $1,800,000 first mortgage loan secured by a shopping center in Newark, Delaware. At the meeting, Director Oglebay resigned because he was a thirty percent partner in University Mall

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[27] Farnandis transcript, page 56.

[28] Tyler transcript, pages 37, 38.

Associates, the borrower. Rouen, also a director, was a ten percent owner of the borrower. The loan was granted on December 31, 1984, but the mortgage was not recorded until May 22, 1985, at which time there were $3,800,000 in prior liens. The total liens of $5,600,000 exceeded the estimated value of the property ($4,800,000) by $800,000, in violation of Division regulations. No approval of the Division Director was sought or obtained for this loan.

Additionally, the association loaned a total of $377,400 to Director Cary Thompson to purchase condominiums in Ocean City from Rouen. It also advanced $155,954.79 in four loans to director and attorney Greenwalt, one for a condominium purchased in Ocean City from Rouen. A total of $2,409,653.64 (including the University Mall Associates loan) was advanced to Rouen, his wife and partnerships in which he had a ten percent interest.[29]

Dispute Over Sale of Ridgeway

Rouen sought the advice of an attorney concerning the sale of Ridgeway and obtained an opinion from David L. Daneker of Semmes, Bowen & Semmes that the sale violated Maryland law and was invalid.[30] As a result of obtaining the opinion, Rouen refused to pay the March 19, 1985 installment of $125,000 to

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[29] Board of Savings and Loan Association Commissioners and Melville S. Brown v. Ridgeway Savings and Loan Association in the Circuit Court for Baltimore County, Complaint and Petition for Appointment of a Conservator.

[30] See Daneker opinion, Exhibit IIIG20.

Farnandis. Farnandis retained an attorney and threatened suit. Negotiations proceeded and the matter eventually was settled by permitting Rouen to keep the association and by permitting Farnandis to keep the $150,000 down payment and to obtain the transfer of two properties from Rouen to Farnandis estimated in value at $250,000.[31] Thus, although the depositors of Ridgeway and not Farnandis owned the association, Farnandis succeeded in selling it and obtaining approximately $400,000. Rouen proceeded to run the association by consummating various insider loans and, as of December 13, 1985, the association had been placed into receivership. Although the various depositors at Ridgeway, according to the Trident appraisal of May, 1984, had an equity interest in the association of at least $178,000, that interest was sold to Rouen without any payment to depositors, converted to stock which Rouen owned and then dissipated by mismanagement.

The Division and MSSIC had an opportunity to actively supervise the management of Ridgeway as early as 1983, based on various regulatory violations. Although MSSIC's regulation regarding substandard net worth required an insurance agreement with Ridgeway and the MSSIC board discussed such an agreement, the agreement was never consummated. A standard insurance agreement would have provided for monitoring which could have prevented the illegal sale of the association and abusive insider transactions. Once again, however, the regulators failed to take obvious regulatory steps, permitting mismanagement to lead to the association's demise.

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[31] See Rouen interview, September 24, 1985.

H. SHARON/SECURITY

Introduction

Sharon Savings and Loan Association (Sharon) began in 1930 and has been owned and operated by the Hurwitz family since its founding. Sharon acquired Security Savings and Loan Association (Security) in 1980 with MSSIC assistance and supervision. Security was suffering from the effects of several bad real estate loans and in December 1979, Security had advised MSSIC that its future was bleak.[1]

MSSIC arranged for Sharon to purchase the stock of Security, by providing financial support including MSSIC's purchasing up to $17,000,000 of outstanding low market rate mortgages owned by Security and by providing $2,532,000 in cash assistance.[2] As a result, Security became a wholly-owned subsidiary of Sharon. Sharon and Security were not merged into a single institution and consequently, the Division continued to conduct separate examinations of Security and Sharon.

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[1] MSSIC Membership Committee, December 14, 1979, Exhibit IIIH1.

[2] MSSIC Special Executive Committee meeting, March 5, 1980, Exhibit IIIH2 and MSSIC Board of Directors meeting, March 25, 1981, Exhibit IIIH3.

Management of Sharon and Security

Zell Hurwitz (Hurwitz) served as president, managing officer, director and chairman of the board of Sharon. Other family members on the board of directors included Hurwitz's son, Marc Hurwitz, Hurwitz's brother, Lee R. Hurwitz and Hurwitz's uncle, S. Rubin. The association's attorney, Theodore C. Denick, also served as a director. Hurwitz's sons, Marc and Steven, served as an executive vice president and as a vice president of Sharon, respectively.

Hurwitz also served as president, managing officer, and chairman of the board of Security. Steven Hurwitz, Theodore C. Denick, and two officers of Security, Roberta L. Wertz and Judith A. Frank, served as directors. Hurwitz's son, Marc, served as executive vice president of Security.

The Hurwitz family is the majority shareholder of Sharon. Zell Hurwitz individually owns fifty-one percent of the association's voting shares. Family members and related businesses own at least an additional twenty-five percent of the association's stock.

Sharon Division Examination as of February 28, 1983

On December 9, 1983, the Sharon Division examination as of February 28, 1983 was sent to the board of directors almost ten months after the as of date.[3] The examination lasted from March 15, 1983 to May 6, 1983 with six examiners spending a total

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[3] Division examination of Sharon as of February 28, 1983, Exhibit IIIH4.

of 114.5 examiner-days. The examiners were Diana F. Moore, Mary C. Smrcina, Rosemary S. Donnelly, Kenneth R. Henneburger, Charles Endres and Alexander Watt. During this examination period, the officers and directors of the association were Zell C. Hurwitz (President and Director), Theodore C. Denick (Secretary, Vice President, Counsel and Director), Lee R. Hurwitz (Director), Sydney Brown (Director), Samuel Rubin (Vice President and Director), Arnold Brown (Director), Roberta L. Wertz (Vice President - Operations), Leah Meledones (Vice President - Lending), Judith Frank (Vice President - Branch Operations), Marc Hurwitz (Vice President), Mishel S. Roseman (Vice President and Treasurer) and E. Jack Cavey (Comptroller).[4]

The examiners noted the following problems:

1. Mortgage files did not contain original mortgages, insurance policies, financial information on borrowers and certificates of title, all in violation of Division Regulations.

2. Sharon granted a commercial loan to Jeffrey Levitt and Allan Pearlstein on December 18, 1981 in the amount of $1,100,000. The security consisted of twenty units of the "Court Haven" Condominium. The eight percent interest rate extended to Levitt and Pearlstein was considered "well below market" at the time and also below the association's cost of funds.

3. Numerous accounting entries did not reconcile to the general ledger.

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[4] List of officers and directors, Exhibit IIIH5.

4. There were loans to related companies, including Maryland Institutional Corporation, Milpond, Franklin Street, MSD Associates, Sun Title, and 121 Associates for a total of $8,600,000. MSD Associates, Sun Title and 121 Associates were owned and controlled by members of the Hurwitz family and not Sharon. These loans were reinvested by the borrowing entities into jumbo certificates of deposits which were then assigned to Sharon. The income of these certificates was credited to the Sharon general ledger account; the loans to the related companies carried the same rate of interest as the jumbo certificates. This practice was in violation of Section 9-422 of the Code.

On February 20, 1984, the Board of Directors of Sharon reviewed the Division comments.[5] Responses to the comments included:

(1) Missing documentation was placed in files;

(2) With respect to the Levitt and Pearlstein loan, the association stated that this was a loan workout situation. Sharon also stated that in addition to the interest rate, there was a provision that Sharon would receive a percentage of the profits on the disposition of the sale of the condominium units;

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[5] Sharon Board of Directors' response, February 20, 1984, Exhibit IIIH6.

(3) The association reconciled its out of balance accounts.

(4) The loans to the related companies were paid off and the certificate of deposits closed out. In addition, there had been no loans made to related companies for over six months.

Sharon Examination as of May 31, 1984

On December 17, 1984, the Sharon Division examination as of May 31, 1984 was forwarded to Sharon's Board of Directors.[6] The examination lasted from June 8, 1984 to August 6, 1984 with eight examiners spending a total of 131.5 examiner-days. The examiners were Gregory Watkins, examiner in charge, Cynthia C. Barnickel, Donna Dickie, John Chua, Douglas Lauenstein, Richard Younger, Diana Moore and Mary Smrcina. During this examination period, the officers and directors of the association were Zell C. Hurwitz (President and Director), Theodore C. Denick (Vice President, Secretary, Counsel and Director), Samuel Rubin, M.D. (Vice President and Director), Arnold Brown (Director), Lee R. Hurwitz (Director), Mishel Roseman (Vice President and Treasurer) and Marc A. Hurwitz (Executive Vice President).[7]

Problems pointed out in the examination were as follows:

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[6] Division examination of Sharon as of May 31, 1984, Exhibit IIIH7.

[7] List of officers and directors, Exhibit IIIH8.

1. Missing documentation in mortgage and consumer loan files.

2. A 3.1% delinquency rate for its subsidiaries' outstanding mortgage loan balances.

3. A loan by Maryland Institutional Corporation, a Sharon service corporation, to Duncan Family Campgrounds was reviewed. This joint venture included Hurwitz, other association personnel, and Sharon's service corporation, Maryland Institutional Corporation. The delinquent status of this mortgage had been the subject of comments in several prior Division examination reports. As of this examination date, the delinquent unpaid interest was in excess of $99,200.

4. A loan to PLL Associates, a New York partnership, was criticized for lack of documentation. The partners in PLL Associates, Jeffrey Levitt, Allan Pearlstein, and Edwin Lax were granted a $1,160,000 loan on August 11, 1983. The review of the loan file documentation revealed that the following items were missing: (1) a loan application which is required by Division regulations; (2) a financial statement on PLL Associates required by Division regulations; and (3) the appraisal report did not contain a statement signed by the appraiser that met the requirements of Division regulations and the appraiser, Robert Hudson, was an employee of Old Court.

At a special meeting of the Board of Directors of Sharon on January 24, 1985, the Division examination was reviewed.[8] The responses of the board included:

1. With respect to the loan granted to PLL Associates, the Board noted that a letter had been sent to Jeffrey Levitt requesting additional insurance coverage, a financial statement and a loan application.

2. With respect to the Duncan Family Campgrounds' delinquent interest, Sharon stated that all interest had been brought current and a distribution made to the joint venture.

Security Examination as of May 31, 1983

On February 7, 1984, the Security examination as of May 31, 1983 was sent out almost eight months after the as of date.[9] The examination lasted from June 21, 1983 to August 15, 1983, with six examiners spending a total of sixty-five examiner-days. The examiners were John Michael, Rosemary Donnelly, Richard Younger, Alexander Watt, Abdul Kamal and Louis Foudos. During this examination period, the officers and directors of the association were Zell C. Hurwitz (President, Treasurer, and Director), Theodore C. Denick (Secretary, Vice President, Counsel, and Director), Roberta L. Wertz (First Vice President and Director), Marc A. Hurwitz (Vice President-Marketing and Director), Mishel S. Roseman (Vice President-Financial and

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[8] Sharon Board of Directors' response, January 24, 1985, Exhibit IIIH9.

[9] Division examination of Security as of May 31, 1983, Exhibit IIIH10.

Director), Leah H. Meledones (Vice President-Lending), Judith A. Frank (Vice President Branch Operations) and E. Jack Cavey (Controller).[10]

Problems pointed out in the examination were as follows:

1. Mortgage files did not contain mortgage instruments, appraisal reports, applications, title certificates and settlement memoranda, all in violation of Division regulations.

2. Security settled loans which were originally committed to by Sharon. While the loans were made by Security, the commitment fees were diverted into the income of Sharon. The commitment fees totalled approximately $24,000.

3. The association failed to provide complete responses to the Division's management questionnaire. The questionnaire failed to disclose that Security had made loans to companies or partnerships that had a direct or indirect interest held by MSD Associates (a partnership of Marc, Steven and David Hurwitz) or to Marc, Steven and David Hurwitz individually. Examples of these loans were loan number 208807 (MSD Associates), loan number 208791 (New Oak Grove Limited Partnership: MSD Associates, limited partner) and loan number 208828 (David T. Hurwitz and Arthur Wagner).

4. Directors and officers of Sharon were also directors of another savings and loan, Atlas Savings and Loan Association (Atlas). Mr. Roseman, a Security Vice President and Director, was the Managing Officer of Atlas. Atlas had accepted

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[10] List of officers and directors, Exhibit IIIH11.

jumbo certificates of deposit from Security in the amount of $1,400,000 as of May 31, 1983, representing more than fifty percent of the total assets of Atlas. By Division regulation, Atlas could not accept deposits from financial institutions that would exceed five percent of its assets.

5. The examination reviewed in detail three loans made to Marc, Steven and David Hurwitz.

a. On November 29, 1982, Security granted a mortgage loan to MSD Associates in the amount of $115,000 on a residential home at 609 Old Crossing Drive, Baltimore, Maryland 21208.[11] This loan was granted on November 29, 1982 based on an appraisal in the amount of $130,000 dated November 11, 1982 by Leon Amernick, a stockholder of Sharon. MSD Associates purchased the property in November 1982 for $102,500.[12]

b. Another loan in the amount of $2,750,000 was made on apartments purchased by New Oak Grove Limited Partnership. MSD Associates was thirty percent limited partner. The examiners noted that the loan violated Maryland law and Division Regulations. The loan file contained no financial statements or tax returns for any of the partners. Levitt and Pearlstein were general partners in New Oak Grove. The limited partners were Karol Levitt, Rosemary Pearlstein, Robert

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[11] MSD Associates, a partnership, consisted of Marc, Steven and David Hurwitz. MSD Associates' assets were eventually transferred to a management trust for estate purposes.

[12] MSD Associates borrowed $115,000 from Old Court on December 10, 1982 to purchase 608 Old Crossing Drive, Baltimore, Maryland 21218, Exhibit IIIH12; Sharon lent Jerome Cardin $82,000 to purchase 607 Old Crossing Drive in October 1982, Exhibit IIIH13.

Pearlstein, Jeffrey Levitt, Allan Pearlstein, Allan Feinberg, and MSD Associates. The examiner pointed out that the partnership made no down payment for the property. The association financed in excess of 100% of the purchase price. The purchasers had obtained an appraisal in the amount of $5,275,000 on August 11, 1982 from Leon Amernick. The examiner questioned the appraisal because it did not seem realistic that a property valued at $5,275,000 would be sold for a "paltry" forty-five percent of the appraised value.

c. Security granted a loan to David Hurwitz on a property at 714 South Hanover Street. Permission had been granted by the Division to make this loan, but the approval had expected a fair market rate of interest. The actual rate of ten percent was considerably below market at the time.

On May 3, 1984, a special meeting of the Board of Directors of Security reviewed and responded to the Division's examination.[13] The Board responded as follows:

1. Security indicated the missing documentation had been located.

2. The association acknowledged that if Sharon was scheduled to settle a loan which eventually was settled by Security, Sharon would take the points as income.

3. The Board acknowledged that Atlas had violated the Division Regulation concerning the percentage of deposits from another financial institution.

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[13] Security Board of Directors' response, May 3, 1984, Exhibit IIIH14.

4. With respect to the comment concerning loans to officers and directors, the Board stated that they had believed that on residential owned property, as opposed to commercial property, the association could make home loans to officers, directors and employees who are related parties without seeking the approval of the Division. In the future, the association indicated that it would be careful concerning granting of loans on residential or commercial property to officers and directors of the association. The association indicated that it was the association's practice to give employees a favorable mortgage rate. The loans were all on rental properties, including apartment houses and were clearly subject to the conflict of interest statute.

With respect to the New Oak Grove Limited Partnership, it was stated that MSD Associates did not join the partnership until after the loan commitment had been issued by Security. Because this was considered residential owned property, no approval was sought by the Division. With respect to lending of $300,000 in excess of the purchase price, the association responded that the amount seemed "inconsequential." The Board also stated that a lender must rely on its appraiser.

Security Examination as of June 30, 1984

On February 19, 1985, the Security examination as of June 30, 1984 was sent to its Board almost eight months after the as of date.[14] The examination lasted from August 7, 1984 to September 14, 1984 with four examiners spending a total of 100 examiner-days. The examiners were Gregory Watkins, Diana Moore, Mary Smrcina and Rich Younger. During this examination period, the officers and directors of the association were Zell C. Hurwitz (President and Director), Theodore C. Denick (Secretary, Vice President, and Director) Roberta L. Wertz (Vice President and Director), Marc A. Hurwitz (Executive Vice President and Director) Mishel Roseman, (Vice President, Treasurer and Director), Leah H. Meledones (Vice President), Judith A. Frank (Vice President), Allan J. Cavey (comptroller).[15]

The examiners noted the following problems:

1. Mortgage files did not contain the original mortgages, insurance policies, applications, appraisal reports, title insurance, and settlement sheets as required by Division regulations.

2. The association made six loans in excess of the loan to value ratios required by Division regulations.

3. Consumer loans were made in violation of Division regulations and apparently for commercial purposes. None of the consumer loan files examined contained completed loan application forms. For example, Jeffrey Levitt, Allan Pearlstein, and MSD Associates in a partnership called Hampton

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[14] Division examination of Security as of June 30, 1984, Exhibit IIIH15.

[15] List of officers and directors, Exhibit IIIH16.

Associates received a $1,300,000 "consumer loan."[16] Fenwick Development, a corporation owned by Gerald S. Klein, received four "consumer" loans which totalled $1,000,000. At the time of this Division examination, these five consumer loans had been paid off. Five loans including the Hampton Associates loan did not include documentation required by Division regulations, such as declaration of value of collateral, insurance on collateral and the original financing statement.

4. There was a variance between the loans-in-process account and the general ledger in the amount of $1,200,000. It was also noted that there was a delay in processing disbursements. Late posting had materially affected the monthly reports sent by Security to MSSIC and the Division.

5. The Hampton Associates partnership which included Levitt, Pearlstein, and MSD Associates, had received a loan from a Security subsidiary. The examiner noted that the loan to value ratio was 81.8%, in violation of Division regulations. In addition, the two loans granted by Security on this project exceeded the total purchase price of the property by $123,561.

On April 26, 1985, the Security Board of Directors reviewed and responded to the Division's examination.[17] Responses to the comments included:

1. Missing documentation was located or requested from the borrower.

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[16] MSD Associates had a 30% interest in the Hampton Associates.

[17] Security Board of Directors' response, Exhibit IIIH17.

2. Examiners had miscalculated the loan to value ratios. The Board said that in some instances, the property had either increased in value or additional collateral was posted.

3. With respect to consumer loans, the Board stated that the Loan Committee had been cautioned about the requirements of the regulations. The consumer loans had been substantially reduced and an effort was being made to bring them into compliance.

4. The time lag in posting disbursements had been corrected.

5. With respect to the Hampton Associates loan, the association stated that the insurance and title policy endorsements had been requested. The Board stated that it could lend eighty percent of the appraisal value and the loan was current when purchased.

Our investigation has confirmed Sharon and Security's loan underwriting problems and the association's transactions with officers and directors. We have noted five major areas of concern.

1. A review of major loans disclosed significant deficiencies in loan underwriting policies and procedures, including appraisal deficiencies, lack of borrower equity, inadequate financial information on borrowers, inconsistent documentation on construction loan disbursements, and inadequate documentation on the approval of major loans. As noted above, the Division examiners had previously commented on Sharon and Security's failures in these areas.

2. Seven real estate loans were made to entities in which members of the Hurwitz family owned at least fifteen percent totaling $12,577,136 as of April 30, 1985. The borrowers of the loans were 4401 Joint Venture, New Oak Grove Limited Partnership, Logan Village Limited Partnership, Mountain Green Associates, IPC Associates, Hampton Associates and Duncan Family Campgrounds. Six of these loans were reviewed by federal authorities. All exhibited underwriting deficiencies consistent with deficiencies noted in other major loans.

3. Sharon and Security was a major lender to business interests of Jeffrey Levitt, the former managing officer of Old Court. Security and Sharon loaned Levitt and his business interests approximately $14,000,000.

4. Besides loans, there were other conflicts of interest involving the business interests of officers and directors of Sharon and Security.

5. The levels of substandard assets were 16.4% of assets. This was excessively high and attributable in part to poor underwriting procedures.

Sun Title

Sun Title Company (Sun Title) acted as a real estate settlement agent and title insurance agent on association loans. It relied primarily on processing loans of Security and Sharon. Sun Title was owned by Marc, Steven, and David Hurwitz. Association director and attorney Dennick acted as title insurance agent for Sun Title. The officers, Mark and Steven

Hurwitz, and association director, Denick, approved loans for Sharon and Security. These loan decisions could have generated additional business for Sun Title, therefore, creating a conflict of interest.

In addition, it was noted that Sun Title directly benefited from its close relationship with Sharon. In 1984, Sharon supplied Sun Title employees, office space and supplies. Sharon estimated that the cost of such expenses exceeded $40,000.

With this subsidy and referred business from Sharon and Security, Sun Title posted substantial profits. Since Sun Title was a Chapter S corporation, its shareholders received Sun Title's profits. Sun Title's profits for the fiscal years ending March 31, 1979 through March 31, 1985 were: FY1979: $6400; FY1980: $56,000; FY1981: $107,000; FY1982: $79,000; FY1983: $315,000; FY1984: $409,000; FY1985: $153,000 (estimated).[18]

Maryland law permitted savings and loan associations to provide title and settlement series. Therefore, Sharon and Security should have received the profits of the settlement and title work instead of Sun Title's shareholders. In response to an inquiry by the Office of Special Counsel concerning the basis for this diversion of a corporate opportunity, an attorney for Sharon stated "everybody did it."[19]

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[18] Letter from Ethan L. Bauman, Exhibit IIIH18. This letter includes Sharon's explanation for Sun Title, the leasing transactions and officer loans discussed, infra.

[19] Zelig Robinson, an attorney assisting Sharon in its federal insurance application, stated this opinion to Wilbur D. Preston, Jr., Special Counsel.

Loan Underwriting

Significant underwriting weaknesses in a majority of major loans (loans over $500,000) were noted. The deficiencies included appraisal deficiencies, lack of borrower equity, inadequate financial information, undocumented inspections of major construction projects and unclear loan approval. In addition, it was noted that in several instances, particularly loans to Levitt, borrowers received loan proceeds with little or no equity at risk. With respect to the seven loans made to members of the Hurwitz family, three of those loans involved partnerships with Levitt. Underwriting deficiencies were noted in each of these insider loans.

Our investigation has disclosed that Sharon and Security made eight loans totalling $14,000,000 to interests of Jeffrey Levitt. In addition, MSD Associates had an ownership interest in three of these loans. All of Levitt's loans exhibited underwriting deficiencies.

It was also noted that Sharon and Security had made loans to Gerald S. Klein and Fenwick Development Corporation, totaling $7,250,000 as of April 30, 1985.

Our examination disclosed that the Board minutes of Sharon and Security were not in sufficient detail to determine what action was taken at the Board meetings.

Director and Officer Transactions

Officers and directors of Sharon have engaged in series of transactions with Sharon and Security which violate the laws and regulations of Maryland concerning conflicts of interest. While Maryland recognizes that certain transactions can be approved by the Division Director or an association's board of directors, the officers and directors of Sharon and Security did not comply with these requirements.

Leasing Transactions

Sharon and Security leased five offices, a parking lot and various equipment from seven entities in which the Hurwitz family had at least a ten percent ownership interest as shown in the following table:

Lessor	Hurwitz Ownership Interest	Type of Property Leased	Gross Monthly Rental Rate
Four East Associates	MSD Associates	association's administrative offices	$20,000*
105 Corporation	Z. C. Hurwitz - 25% L. R. Hurwitz - 75%	one branch office	2,000
Delight Associates	Z. C. Hurwitz - 10%	two branch offices	3,500
1417 Associates	Z. C. Hurwitz - 85%	one branch site	3,000
121 Associates	100% owned by Z. C. Hurwitz and sons	telephone equipment, trailers for branch office, EDP equipment, various office equipment	7,890

Zell Hurwitz	individual	copying machines, computer equipment	9,426
York Associates	100% owned by Mrs. Z. C. Hurwitz and sons	parking lot	900

*The association sublets space in this building for $6500 month.

The associations pay annual rentals of $560,592 to these seven Hurwitz business interests. Maryland law requires such transactions to be reviewed by the board of directors and approved in good faith by the recorded vote of disinterested directors. An examination of the Board minutes of both Sharon and Security did not include any such review or board approval. For example, there were no appraisals of the fair market value of the transactions obtained prior to the leasing. Furthermore, by this self-dealing the Hurwitz family was able to profit from the association to which it owed fiduciary duties.

Sharon states that all such leases were at or below fair market value and the Board was aware of the transactions and approved them informally.[20]

Sharon and Gibraltar

On March 19, 1982, MSD Associates obtained a $500,000 loan from Gibraltar Services Corporation, a service corporation of Gibraltar Savings and Loan Association (Gibraltar).[21] During the examination of Gibraltar, Division examiners received information that Gibraltar had reduced the interest rate to ten

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[20] See Exhibit IIIH18.

[21] Loan of March 19, 1982, Exhibit IIIH19.

percent in exchange for a committment by Sharon to lend Gibraltar $500,000 at ten percent. On November 18, 1983, LeCompte was notified in writing by Jeffrey Fine, an examiner, concerning this transaction including internal documents of Gibraltar to support the allegation.[22] This action would have benefited the Hurwitz partnership at the expense of Sharon and avoided the Division approval which would have been required if Sharon or Security had made the loan directly to MSD Associates. On December 7, 1983, LeCompte forwarded the facts to John C. Cooper, Assistant Attorney General. LeCompte and Cooper agreed that the matter would be informally reversed.[23] A cross lending arrangement at submarket rates was clearly a conspiracy to avoid insider lending limitations. LeCompte does not recall what action, if any, he took.[24]

A Division examiner requested additional time at the end of the Gibraltar examination to analyze the certificates of deposits and savings accounts of Sharon, Security and Atlas. The examiner was directed by the Division to conclude the examination.[25] She was told that if additional information was needed, the office would request the information.

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[22] Examiner workpapers, Exhibit IIIH20.

[23] Case index/sheet, Exhibit IIIH21.

[24] Interview with LeCompte.

[25] Examiner workpapers, Exhibit IIIH22.

The rate reduction on the MSD loan was commented upon in the Gibraltar examination as of September 30, 1983.[26] The association responded that the reduction was made because of a decline in interest rates and a shorter maturity on the note.[27]

Sharon denies that there was any agreement by it to commit funds to Gilbraltar in order to obtain a reduced rate from Gilbraltar on the loan to MSD Associates.[28]

Loans to Hurwitz Business Interests

As of April 30, 1985, Sharon and Security had outstanding seven loans to business entities in which members of the Hurwitz family had at least a fifteen percent interest. The current loan balances were $12,577,136. The associations have been able to produce documentation evidencing notification to the Division of only three loans: Candlewood Condominiums, 4401 Joint Venture, and Duncan Family Campgrounds.[29] Three loans were made to joint ventures in which Jeffrey Levitt was a partner. Loans made to New Oak Grove Limited Partnership, Logan Village Limited Partnership, and Hampton Associates had outstanding balances as

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[26] Division examination of Gibraltar, Comment 17, Exhibit IIIH23.

[27] Response to Division examination, Exhibit IIIH24.

[28] See Exhibit IIIH18.

[29] Pursuant to Office of Special Counsel subpoena duces tecum, no. 85-019, Sharon and Security were required to produce all documents granting approval by the Division Director to Sharon or Security to make a loan to any controlling person or insider. Sharon and Security produced documents which identified these loans.

of April 30, 1985 of $7,223,561. MSD Associates' interest varied in each venture: New Oak Grove (thirty percent), Logan Village (fifteen percent), and Hampton Associates (thirty percent).

Each of these Hurwitz family loans required the approval of the Division Director. Three loans to Levitt ventures and the 4401 Joint Venture have been criticized by federal, state and MSSIC examiners. For instance, a MSSIC analyst noted that in the loans to the 4401 Joint Venture, the New Oak Grove Limited Partnership and the Logan Village Limited Partnership, the borrower received a loan in excess of the purchase price.[30] As a result, the borrower received cash at the settlement. Although appraisals were obtained to support the loan amount, their accuracy was questioned. In two instances, the appraised value of the property was two to three million dollars higher than the purchase price.

The "Wilson Farm" Store Loans

In 1983, Niagara Frontier Services, Inc., sold thirty-five "Wilson Farm" stores located in New York to two partnerships. The first partnership was MSDL Associates, whose partners were Marc, Steven, and David Hurwitz and Edwin Lax. The second purchaser was PLL Associates, whose partners were Allan Pearlstein, Jeffrey Levitt and Edwin Lax. Maryland law required Old Court to obtain the approval of the Division Director to lend money to PLL Associates. Sharon and Security were required to obtain similar approval for loans to MSDL Associates. To avoid

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[30] MSSIC Sharon/Security Savings and Loan Review, Exhibit IIIH25.

this approval process, Old Court loaned money to MSDL Associates while Sharon and Security loaned money to PLL Associates. On three separate occasions, the associations made same day loans at submarket eleven percent interest rates to PLL Associates and MSDL Associates.[31]

The loans were made on the basis of appraisals prepared by Robert H. Hudson. Hudson worked for Bankers Appraisal Services, Inc., an Old Court subsidiary. The appraisals consisted of a one page summary with photographs.[32] Hudson prepared two different appraisals in May, 1983.[33] The second appraisals were substantially higher than the first appraisals. Based on these appraisals, Sharon, Security and Old Court made loans to MSDL Associates and PLL Associates.

In short, the "Wilson Farm Store" loans were a conspiracy by principals of Old Court, Sharon and Security to avoid conflict of interest laws and regulations. The conspiracy

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[31] On August 11, 1983, PLL purchased the properties for $971,514 and borrowed $1,160,000 from Sharon. On the same day, MSDL purchased properties for $1,056,657 and borrowed $1,135,000 from Old Court. On October 11, 1983, PLL purchased the properties for $971,514 and borrowed $1,024,000 from Security. On the same day, MSDL purchased the properties for $953,142 and borrowed $1,000,000 from Old Court. On November 18, 1983, PLL purchased the properties for $1,004,961 and borrowed $1,085,000 from Security. On the same day, MSDL purchased properties for $1,062,096 and borrowed $1,135,000 from Old Court.

[32] The appraisals were criticized by Division examiners. An example of the appraisals is included as Exhibit IIIH26.

[33] Division Examination Comment, MSDL Partnership, Exhibit IIH27.

generated insider loans at below market rates to the detriment of each association and for the benefit of the principals, in violation of their fiduciary duties.[34]

Conclusion

The Division had information concerning the loans by Sharon and Security to Hurwitz business entities. The Division failed to take affirmative steps to compel Sharon and Security to comply with Division regulations and the laws of Maryland. Sharon and Security were not viewed by MSSIC as "problem associations." Despite the Division examinations, Sharon and Security were not discussed at either MSSIC Board of Directors' or Membership Committee meetings in 1984 and 1985.

Sharon and Security serve as examples of associations whose officers and directors diverted corporate opportunities and used the associations' assets in their personal business deals.

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[34] Sharon and Security contend that these were fair transactions and that neither Sharon or its depositors were prejudiced by them in the slightest degree. See Exhibit IIIH18.

I. OVERVIEW OF PROBLEM INSTITUTIONS

In addition to those discussed above, some other associations engaged in unsafe and unsound practices.

Commercial real estate "investments," as opposed to loans, comprised the bulk of the portfolios of several associations. Commercial "investments" are distinguished from loans by combinations of the following characteristics.

1) The lender agrees to provide all or substantially all of the funds to acquire and complete a project. The borrower retains title, but has little or no equity.

2) The lender funds all loan fees (i.e., commitment, origination) and interest by including them in the loan.

3) The transaction is secured by the project on a nonrecourse basis without a personal guarantee by the borrower.

4) If the borrower does personally guarantee the debt, he or she does not have the financial capacity to support the loan, or inadequate or no financial information is available to confirm the worth of the guarantee.

5) The deal is set up to avoid foreclosure because the borrower is not required to make payments until the project is complete.

6) The lender participates in the profits, if any, from the sale of the project.

Loans with these characteristics were prevalent among certain fast-growing associations.

Diversions of corporate opportunities were also prevalent among certain associations.

Our investigation has disclosed, for instance, that Fairfax Savings Association directors, Malcolm Berman and Jack Stollof, were on the Fairfax loan committee and also owned Maryland Title Company (Maryland Title). According to federal authorities, Fairfax required all local commercial real estate borrowers to use Maryland Title for settlement services. Stollof and Berman received approximately $900,000 in management fees from Maryland Title in fiscal year 1984. Berman also owned 77.47% of Fairfax Financial Corporation, the holding company that owned Fairfax Savings Association. Stollof and his wife owned the other 22.53%.

The management fees from Maryland Title were both a conflict of interest and a corporate opportunity diverted from the association. Berman claimed to have disclosed this arrangement to the Division. Charles H. Brown, Jr., Division Director, has no recollection of this disclosure. Beyond these fees, Berman received an additional $100,000 salary from the association, plus close to $20,000 in appraisal and trustee fees. Stollof's annual salary was $60,000 and he received the same amount of appraisal and trustee fees as Berman.

Gibraltar Building and Loan Association, Inc., (Gibraltar), an Annapolis based institution, presented similar problems. Gibraltar's net worth was negative $8,300,000 as of April 30, 1985. Excessive asset growth was a major contributor to the association's net worth deficit. An additional factor revealed by our investigation was that Gibraltar had no discernible underwriting standards or policy guidelines for commercial loans. Association President and 55.8% owner, Laurence Goldstein, also owned Arundel Title Corporation (Arundel Title). Borrowers paid $49,315 in title insurance fees to Arundel Title from June 1984 to June 1985. This was a diversion of a corporate opportunity from Gibraltar.

Additionally, a Division examiner reported Gibraltar to LeCompte in November, 1983 concerning cross lending with Sharon, described in Section IIIH, supra.

John Hanson Savings and Loan, Inc. (John Hanson) was also plagued by a conflict of interest. Gerald Holcomb was a director of the association as well as Chairman of the Board and President of John Hanson Financial Services, Inc. (John Hanson Financial), a wholly-owned subsidiary of John Hanson. At the same time Holcomb was serving in this capacity, he was making privately financed loans at rates over 100%. These activities were conducted out of John Hanson's offices and some of Holcomb's private loans involved John Hanson customers.

During the same period of time Holcomb was Chairman of the Election Committee for Larry Hogan, former United States Congressman from Maryland's 5th District. Hogan was president and a director of First Founders Financial Corporation, an entity which was sixty-eight percent owned by John Hanson Financial. Hogan received a $65,000 dollar yearly salary. This salary was excessive because John Hanson Financial had never brokered a loan or generated any income since its creation in 1984.

After a John Hanson April 23, 1985 board meeting to discuss Holcomb's activities, Holcomb was allowed to continue as a John Hanson director. In June 1985, as a result of federal pressure, Holcomb resigned as a director of the association and as an officer and director of the service corporation. He still remained as a loan originator for the service corporation until July 16, 1985.

Problems at Liberty Savings and Loan Association, Inc. (Liberty) and Custom Savings Association (Custom) stand out because they were resolved by the regulators taking forceful stands against the association involved in one case, and by the guilty plea of the responsible individual in the other. Neither enforcement action caused a "run" or "crisis in confidence." Both demonstrated the illusory nature of the regulators' fears that the entire industry would collapse if corrective action were taken against other associations.[1]

Frank T. Peach, Jr. was the managing officer of Liberty until he was discovered to have misappropriated over $800,000 from the association. In 1985, Peach entered a nolo contendere plea in Baltimore County Circuit Court to a charge of fraudulent misappropriation of funds by a fiduciary.[2] Peach was running a

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[1] Brown October 29, 1985 transcript at 103-105, 111-115; Brown October 30, 1985 transcript at 44-45, 66-67; Hogg October 21, 1985 transcript at 113-119; Trice November 25, 1985 transcript at 35-38; Trice December 13, 1985 transcript at 34-35; Hall November 20, 1985 transcript at 69, 222-224 and Cooper transcript at 90-91.

[2] Exhibit III(I)1, Memorandum of Plea Negotiations and Statement of Facts, State of Maryland v. Francis T. Peach, Jr., Case No. 83 CR 3200.

real estate brokerage and development business, Peach and Company, at the same time he was managing Liberty. He developed a scheme where he gained control of Liberty's disbursements for construction loan accounts. At the same time, he arranged for Liberty to fund construction projects set up or owned by Peach and Company. Peach then arranged to release Liberty funded disbursements for construction funds to entities in which he had an interest. The rates of disbursement, however, greatly exceeded the actual work performed on the projects. These "overdisbursements" were diverted to "purposes not in the due and lawful execution" of Peach's trust.[3]

Peach received a two year jail sentence with all but ninety days suspended and was ordered to pay $75,630 in restitution. These actions were reported in the Baltimore media without adverse effect on the rest of the industry.

Similarly, Custom's practice of engaging in deceptive and misleading advertising was stopped by a combined MSSIC and Division effort. Custom regularly advertised "high guaranteed yields" on a daily basis. A six month MSSIC investigation, however, revealed Custom's consistent practice of lowering the advertised rate by up to 3.6% on weekends and holidays. For example, account holders who placed funds in a Custom account on a Friday based on an advertised 10.3% rate, only received an undisclosed 6.9% rate on Saturday and Sunday. When MSSIC brought this matter to Division Director Brown's attention he promptly required Custom to terminate the practice and asked the Assistant

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[3] Id.

Attorney General assigned to the Division, John C. Cooper, if restitution could be obtained. Cooper concluded that "it would be stretching matters to conclude that the Division Director's general supervisory power over associations, combined with the liberal construction directed by §§ 8-103 and 9-906 of the Financial Institutions Article, allow the Director to order restitution in this situation."[4]

The statutory provisions relied on by Cooper provided that the savings and loan statutory framework "shall be liberally construed to promote the purposes of savings and loan associations."[5] Cooper did not mention the immediately proceeding legislative policy statement of Section 8-102 of the Code that "[t]he savings and loan business...is so important as a method of promoting home ownership and thrift that it is in the public interest that: (i) Savings and loan associations be supervised as a business affecting the economic security and general welfare of the people of this State...."[6] Nor did Cooper recommend a criminal investigation into Custom's activities.

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4 Letter John C. Cooper to Charles Brown, April 10, 1984, Exhibit III(I)2.

5 Md. Fin. Inst. Code Ann. §§ 8-103 and 9-906 (1980).

6 Id. § 8-102(1)(i).

Brown, with Cooper's advice, called Custom's management into his office and simply ordered them to cease their deceptive practice. Custom followed his order. Despite his strong action and press reports concerning Custom, there was no adverse impact on the MSSIC industry.[7]

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[7] Brown transcript, October 29, 1985 at 24-27.

J. OVERVIEW OF TRADITIONAL ASSOCIATIONS

Not every MSSIC member association shared the problems of the institutions described above. Most of the smaller mutual neighborhood oriented associations had conservative portfolios, consisting primarily, if not exclusively, of mortgages on residential owner-occupied property. They continued to fulfill the original role of savings and loan associations by providing individuals the opportunity to pool their funds to finance home ownership. They did not evolve into real estate finance companies focusing on commercial properties and joint ventures. Self-dealing was virtually nonexistent, and loans to any insiders were invariably secured by the borrowers' primary residence.

Fairmount Savings and Loan (Fairmount) is a representative institution. Fairmount is a mutual association founded in 1915 and located at 8201 Philadelphia Road in Baltimore. In April of 1985, it had assets slightly exceeding $13,000,000. Fairmount has no subsidiaries, affiliates or a holding company. Our investigation did not disclose any loans to insiders. Fairmount's net worth as of April 30, 1985 was $824,334, or 6.6% of liabilities. This calculation excluded an indicated loss of $313,700 resulting from a MSSIC capital deposit of $239,800 and a central reserve investment of $73,900. Fairmount's lending activities primarily consisted of single family residential mortgages. Although savings account loans were offered, no other commercial loans were available.

Another smaller, also conservative, mutual association is Kopernik Building and Loan Association, Inc. (Kopernik). Kopernik, founded in 1924, is located at 2101 Eastern Avenue in Baltimore. Its total assets in April 1985 were $6,716,000. As of May 1985, the association's entire portfolio was in loans on single family dwellings located in the Baltimore area. Its net worth as of April 30, 1985 was $1,000,000 or 17.52% of liabilities. Subtracting a MSSIC capital deposit of $110,000, net worth was still 15.6% of liabilities. Three of the association's 294 loans were to directors or employees, but they were all secured by the individual's primary residence. Although mortgage applicants were informed that they could obtain hazard insurance from association President, Edward M. Blazucki, they were not required to do so.

Weekly Savings and Loan Association, Inc. (Weekly), a mutual association founded in 1920 and located on Fait Avenue in Baltimore City was also typical of a small, conservatively run association. Again, most loans were secured by owner occupied single family dwellings. The association's net worth was 15.16% of liabilities and if the association's MSSIC capital deposit and central reserve contributions were subtracted, net worth remained at 12.60% of liabilities. Our investigation did not disclose any practices engaged in by Weekly's management that comprised a conflict of interest.

We have described only a sample of well run institutions to demonstrate that despite the adverse economic environment of the 1980's some associations continued to engage in the traditional savings and loan business. Management of these associations chose to run them for the benefit of their customers and for the most part succeeded in maintaining the financial soundness of their operations.

K. CONCLUSIONS CONCERNING THE QUALITY OF STATE REGULATION

The Office of Special Counsel believes that the description of the practices of MSSIC associations and the reaction of the regulators to those practices leads to the inescapable conclusion that regulation in Maryland from both the Division and MSSIC was woefully inadequate. Although some regulatory tools were lacking which could have made the regulators' jobs easier, the basic tools were there. For the most part, field examiners were able to detect problems in associations early enough so that swift and sure regulatory action could have dealt successfully with them. When regulatory and prosucutorial action was taken with respect to Custom and Liberty, it was successful and without adverse repercussions. With the major problem associations, however, the management of the Division and MSSIC, who were responsible to industry-dominated boards, chose to sit back and watch the outrageous patterns of insider abuses and mismanagement grow into the 1985 crisis.

Although the lack of regulation was a major cause of the crisis, it was no excuse for the gross breaches of fiduciary duties and violations of law regularly engaged in by those who were entrusted with depositors' funds.

IV. GOVERNMENT OVERSITE

Although we believe that the major regulatory failures occurred at the management levels of the Division and MSSIC, we have also analyzed the question of whether other government entities knew or should have known about the impending savings and loan crisis. That analysis follows.

A. ACCESS TO THE GOVERNOR'S OFFICE

Governor Hughes' Executive Office is organized with a senior and junior staff. Since 1979, Ejner J. Johnson has been the Staff Director and Chief Assistant to the Governor. Other staff members include, at present, Benjamin M. Bialek, Chief Legislative Officer, Constance Beimes, Appointments Officer and Louis G. Panos, News Secretary. The junior staff consists of program aides who are assigned to provide liaison with each of the major state departments. Governor Hughes' general policy is to permit access to his office by administrative officials upon request.

1981 Savings and Loan Crisis

In 1980 or 1981, the prime interest rate fluctuated from fifteen to 21.5%, creating substantial earnings problems and losses in a number of state-chartered savings and loan associations. These associations, which traditionally "borrowed short and loaned long" developed severe loss trends throughout

1981. In the estimate of Charles Hogg, many large associations were in danger of needing substantial infusions of money from MSSIC before the year's end.

As a result of the 1981 crisis, a number of memoranda were prepared by interested persons who sought access to the Governor's office in order to deal with the situation. A memorandum from David Wells, deputy director of the Division to John J. Corbley, Secretary of the Department of Licensing and Regulation, dated May 4, 1981, described in detail the savings and loan problems.[1] An _Ad Hoc_ Committee consisting of Jerome S. Cardin, former Chairman of the Board of MSSIC, Charles H. Brown, Thomas Gisriel, Charles Hogg, Charles Kresslein, President of the Maryland Savings and Loan League, and Jerry Whitlock, President of MSSIC, was formed to attempt to resolve the situation. The Committee met on several occasions and, through Secretary Corbley, arranged a meeting with the Governor on July 7, 1981. Brown presented a memorandum to the Governor dated July 6, 1981, in which he presented his analysis of the problem.[2] Secretary Corbley, by letter of June 1, 1981, apprised the Governor of the situation[3] as did Hogg, by a report entitled State of MSSIC Industry.[4]

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[1] _See_ Wells memorandum, May 4, 1981, Exhibit IVA1.

[2] _See_ Brown memorandum of July 6, 1981, Exhibit IVA2.

[3] _See_ Corbley letter of June 1, 1981, Exhibit IVA3.

[4] _See_ State of MSSIC Industry, Exhibit IVA4.

Governor Hughes met with the Ad Hoc Committee, listened to their presentation and committed to have Secretary Corbley continue to meet with them, along with any other necessary state officials, to work out a resolution of the problem.[5]

Subsequent to the meeting with the Governor, various meetings took place among the Ad Hoc Committee and state officials. The meetings were summarized by a letter from Jerome Cardin to Governor Hughes dated January 27, 1982, in which he proposed various remedies to the savings and loan problem, including future legislation when their situation was less delicate. Cardin suggested that, in the future, legislation could be introduced pursuant to which the state would support the savings and loan industry in the same manner that the federal government supports the FSLIC industry.[6] Governor Hughes responded to Cardin that he was receptive to reviewing any legislation proposed by the group.[7]

The 1981 savings and loan crisis is demonstrative of three points. First, it was relatively easy for the group to obtain access to Governor Hughes directly and to make a presentation of the problem which they viewed needed a remedy. Secondly, the Governor reacted by delegating to cabinet level government officials the responsibility to work out a resolution

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[5] See July 21, 1981 letter of John J. Corbley to William S. James, Exhibit IVA5.

[6] Jerome Cardin letter to Governor Hughes, January 27, 1982, Exhibit IVA6.

[7] Governor Hughes letter to Jerome Cardin, February 2, 1982, Exhibit IVA7.

to the problem. Thirdly, in dealing with the crisis, it was the practice of the Division to send detailed and specific memoranda describing the crisis to Secretary Corbley.[8]

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[8] See, for instance, on December 14, 1981 memorandum from Charles Brown to John H. Corbley, Exhibit IVA8.

B. STAFFING OF THE DIVISION OF SAVINGS AND LOAN ASSOCIATIONS

The staff of the Division has consisted of between thirty and thirty-five authorized positions from 1980 through 1985. Of these authorized positions, between twenty and twenty-five have been positions which are directly involved in the examination of savings and loan associations. The staff has decreased over the past five years, both in authorized positions and because of vacancies, while the size and complexity of the industry they regulated substantially increased.

The Maryland State Budgets for the fiscal years ending June 30, 1981 through June 30, 1985 show that, in examiner personnel, the authorized positions in the Division decreased from twenty-five in 1981 to twenty-two in 1985.[9] In addition to the decrease in authorized personnel, the Division traditionally has suffered from a high turnover rate in examiners. This problem was pointed out in the Department of Fiscal Services evaluation report for the Division prepared pursuant to the Regulation Programs Evaluation Act of 1978.[10] The report pointed out that a poll of savings and loan executives indicated that state examiners do a good job, overall. The state examination program was hampered, however, by excessive turnover. Between 1975 and 1980, when the report was completed, with an authorized

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[9] See excerpts from Maryland State Budgets, Exhibit IVB1-5.

[10] See Evaluation Report, Exhibit IVB6.

twenty-five examiner positions, twenty-one had left, three to retire and eighteen to take other jobs. The Division Director attributed the turnover rate to the poor state salary scale, especially in comparison to the salary scale for federal examiners.

The report also reviewed the function and status of MSSIC. A survey of savings and loan executives demonstrated that over one-half felt that MSSIC's funds were adequate to secure deposits, while sixteen percent felt that they were inadequate and thirty percent did not know. The ratio of the fund to deposits insured was comparable to the ratios for other states with private insurance. Approximately seventy percent of the executives surveyed favored a change in state law to put the credit of the state behind MSSIC. Additionally, sixty percent of the savings and loan executives indicated that the average depositor did not understand that the credit of the state did not already exist behind MSSIC. The report concluded, however, that recent changes in federal law reduced the likelihood that state intervention would be necessary because the Depository Institutions Deregulation and Monetary Control Act of 1980 permitted state-chartered associations to borrow from the Federal Reserve.

The report concluded that Maryland should consider consolidation of its financial regulatory agencies. It pointed out that Maryland was one of thirteen states with three or more financial regulatory agencies. It also pointed out that the Bank

Commissioner and Consumer Credit Commissioner lack sufficient personnel in occasional circumstances. Notably, it did not conclude that the Division was inadequately staffed.[11]

Between 1980 and 1985, the authorized number of examiners for the Division decreased from twenty-five to twenty-two because of mandated calls for budget reductions by the Governor. Brown objected to budget reductions in his memorandum to Corbley dated September 23, 1980.[12] In his memorandum, Brown stated that the only way the Division could achieve cost reductions was in the salary area by holding the line on employee reclassifications. He referred to the turnover problem among examiners, however, and stated that he opposed such an action. In further memoranda in 1984, Brown formally requested three new examiner positions.[13]

In his memoranda, Brown pointed out that the overall growth in the industry regulated by the Division was from $2,750,000,000 in 1977 to $9,200,000,000 in 1984. He stated that the growth, coupled with additional investment powers authorized by the legislature in 1982 and 1983 led to considerably more

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[11] Ironically, workpapers for the Report included one comment which was not included in the final report but which succinctly focused on the problem of industry control of the regulators which has been discussed previously. The comment pointed out that in Board of Commissioner meetings from 1975 through 1979, the public interest and welfare of the state was discussed four times, while the welfare of the industry was mentioned 308 times. See Exhibit IVB7.

[12] See Brown memorandum to Corbley September 23, 1980, Exhibit IVB8.

[13] See Brown memorandum to Carville J. Brian of August 13, 1984 and of August 27, 1984 to Gordon N. Wilcox, Exhibits IVB9, 10.

complex examinations. He also stated that, although the state law mandated an examination every two years he felt that that was not frequent enough and endeavored to examine the associations every fifteen months. Brown also stated that the franchise tax on associations, which was intended to offset the cost of regulation, resulted in a $900,000 profit to the state. He concluded that it was "imperative" that he be authorized three new positions "to assure the funds of the public are protected." He also sought salary raises for his existing positions. Despite Brown's entreaties, the Division staff continued to dwindle.

Brown approached Frederick Dewberry, Secretary of the Department of Licensing and Regulation, shortly after Dewberry became Secretary in July, 1984 to obtain the salary increases and new positions. At the time, the Division was offering "examiner trainees," their lowest examiner position, to persons with a college degree in finance, business education, or accounting at a salary of $12,600 per year. With Dewberry's endorsement, the request was forwarded to the Department of Personnel for action. A meeting was held with Secretary John O'Brien of the Department of Personnel in early 1985. Secretary O'Brien stated that the changes could not be made at that time but that a salary review would be considered for the next year. He also offered assistance in bringing in experienced individuals at a higher level than trainee.[14]

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[14] Statement of Charles H. Brown, Jr., Exhibit IVB11.

Although the workload of the Division staff increased substantially over the last five years while the staff itself decreased, the examinations reviewed by the Office of Special Counsel and discussed in Section III revealed that, for the most part, examiners were capable of identifying numerous and substantial regulatory violations in even the more complex associations. Undoubtedly, additional examiners and better pay would have helped considerably and would have encouraged many good examiners to stay on the staff. Examiners interviewed by the Office of Special Counsel have also stated that regular access to professional assistance in the form of appraisers, accountants, and attorneys would have assisted them and improved their examinations considerably. We believe that the lack of response to Brown's requests was a mistake but not a major factor in contributing to the savings and loan crisis. Additionally, we believe that lack of response should be viewed in the context of the general pressure to control the state budget and Brown's failure to provide specific information about savings and loan problems.

C. REPORTING FROM THE DIVISION TO THE DEPARTMENT OF LICENSING AND REGULATION

The Department of Licensing and Regulation has thirty-four agencies, boards and commissions that report to the Secretary.[15] At this time, there is no set reporting system from the various boards or agencies to the Office of the Secretary. Coordination among the different boards and the Secretary's office generally occurs with respect to the annual budget submission, the preparation of departmental legislation for the next session of the General Assembly and the handling of consumer complaints which are directed to the office of the Secretary and forwarded to various boards and commissions.

The Division and Board of Commissioners, like the other boards, are not required to regularly report to the Secretary concerning matters within their regulatory jurisdiction. As a matter of course, the Secretary receives copies of the minutes of the meetings of the various boards within the department, including the Board of Commissioners. When Dewberry became Secretary of the Department in July of 1984, he was informed by his predecessor, John J. Corbley, that the Board of Commissioners seldom turned over the Board minutes as meetings occurred but would turn over a package of three or four months at once. Corbley's impression, communicated to Dewberry, was that the Board viewed itself as "its own little fiefdom and did not want

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[15] With the creation of the Maryland Deposit Insurance Fund by the General Assembly in 1985, there are now thirty-five agencies which report to the Secretary.

any interference from the Secretary." Dewberry's impression was that there was a very poor working relationship between the Secretary's office, the Board and the Division.

After taking over as Secretary, Dewberry met with each Division head for general discussion. When he met with Brown, Brown complained about the inadequate staffing, large turnovers and inadequate pay of Division examiners. He stated that he was "scared to death" because the industry had grown so large and pointed out that it had tripled in three years in total assets. Brown did not mention any particular regulatory problems. Dewberry agreed with Brown's position concerning the salaries and staffing and supported Brown's position in the Departmental annual salary review package presented to the Department of Personnel. When the salary raise for examiners was declined by Secretary O'Brien of the Department of Personnel, Dewberry went to Ejner Johnson, Chief of the Governor's staff, to complain. The salary increases were still denied.

During the initial interview with Brown, Dewberry was not apprised of any particular regulatory problems in the industry. Brown gave him the general impression that the regulators were in control of the situation.

In the past, it had been the practice of the Division Director and deputy director to report on specific regulatory problems to the Secretary of the Department of Licensing and Regulation. For instance, a series of memoranda concerning interest rates precipitated the Ad Hoc Committee meetings which resulted in a meeting with the Governor in 1981. On April 29, 1982, Director Brown sent a "highly confidential" memorandum to Secretary Corbley concerning problems with Yorkridge Calvert Savings and Loan Association.[16] In his memorandum, Brown explained in considerable detail that errors in accounting had been discovered at Yorkridge Calvert which "wiped out" the associations reported $8,000,000 in net worth. In his opinion, this created an unsafe and unsound condition at the association. He also discussed in some detail the possible remedies being considered by the Division and the Federal Home Loan Bank Board, including merger, conservatorship and receivership. Brown pointed out that appointing a receiver could start a run on the industry.

Despite these examples of specific reporting to the Secretary of problems identified by the Division, no such reports have been discovered by the Office of Special Counsel with regard to associations discovered in 1985 to be in unsafe and unsound conditions. Although the examinations of Old Court, First Progressive, Merritt, First Maryland, Community and others revealed serious regulatory concerns, no special memoranda were written to apprise the Office of the Secretary about those concerns or about the Division and MSSIC's proposed action to remedy them. As a result, although the informal method of reporting problems in the past had been effective in keeping the Secretary informed, that method ceased in 1982 or 1983 and,

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[16] See Brown memorandum, April 29, 1982, Exhibit IVC1.

consequently, the Office of the Secretary and Governor's office were kept in the dark regarding Division regulatory problems until the 1985 crisis.

The disparate nature of the Department of Licensing and Regulation, which includes regulatory agencies ranging from the Insurance Division to the State Board of Cosmetologists, makes it a difficult department for its Secretary to monitor. The Office of Special Counsel believes that good management required some type of regular reporting within the Department which would have assisted in earlier detection of mismanagement of associations, providing the reporting was accurate. Additionally, an efficiently run Executive Branch should include a system of reporting which ensures that significant problems are brought to the attention of the Governor, whose ultimate responsibility it is to deal with such matters. Finally, because of the importance of the regulation of financial institutions, we believe that the General Assembly should consider removing that function from the Department of Licensing and Regulation to its own department with direct linkage to the Governor's office.

D. THE LIEBMANN MEMORANDUM

On one occasion, the Governor's office did not have to rely entirely on reporting through regulatory agencies to discover facts relevant to the impending savings and loan crisis. George W. Liebmann, a Baltimore lawyer who formerly worked on Governor Hughes' staff, reported such facts in two memoranda in 1984.

In 1978, Liebmann worked on the Governor's transition team and he became an executive assistant on the Governor's staff in January of 1979. He dealt with various issues, including environmental and energy problems under a "floating mandate" from the Governor. On May 31, 1980 he resigned to rejoin private practice.

After returning to private practice, Liebmann was hired as a consultant for the state to provide research and advice on a variety of topics. He worked on projects ranging from drafting environmental laws, reapportionment laws, advising on local government antitrust liability, drafting parts of the Chesapeake Bay bill, medical malpractice reform and State Department of Personnel hearings. He also wrote periodic memoranda for the Governor, both solicited and unsolicited, providing a wide variety of advice on state government issues.

In April of 1984, Liebmann wrote a memorandum to the Governor concerning savings and loan associations. Neither he nor the Executive Department has been able to locate a copy of the memorandum. The memorandum was delivered shortly prior to the adjournment of the 1984 Session of the General Assembly. On the last night of the session, Liebmann was in Annapolis to promote a medical malpractice reform bill. He saw Governor Hughes and mentioned that he had sent the memorandum concerning savings and loan associations which expressed that they were engaging in some practices which should be investigated. The Governor acknowledged the memorandum. Afterwards, at a reception in the Governor's conference room, Liebmann talked to Ejner Johnson about the memorandum. Johnson indicated that he was aware of the memorandum and that a special legislative group would be meeting in the summer to deal with savings and loan regulations. He stated that Liebmann would be part of that group. Several months later, Liebmann asked Johnson about the savings and loan associations in a phone conversation. Johnson responded that they were "looking into it." Liebmann was not advised of the existence of the hearings of the Joint Subcommittee on the Savings and Loan Industry co-chaired by Senator Dennis and Delegate Kirchenbauer, nor was he invited to participate in them.

Liebmann's personal experiences had led him to believe that savings and loan associations were engaging in unsafe practices which should be investigated. During 1984, he represented clients who were dealing with Gerald Klein of Merritt in an Ocean City project. Liebmann's clients had purchased property from a Klein partnership, on which Klein had taken back a mortgage. Litigation ensued from a default on the mortgage resulting from the client's inability to develop the property because of restrictive covenants in the deed. The litigation was settled by negotiations between Liebmann and Klein. The settlement agreement was typed in an office of one of Klein's businesses at a lumber yard in Selbyville, Delaware (the Delmarva Lumber Company). Liebmann had previously known Klein from a tour of duty in the Maryland National Guard and, while waiting for the typing, they proceeded to chat about Klein's various business successes since their former acquaintance. Klein had plans on an easel in the office for developments in Ocean City and described his real estate acquisitions and ventures. His business philosophy was to "grow or die" and he was advertising vigorously. While describing his success in real estate deals, he stated that "the best thing I ever did was to buy a savings and loan because now whenever I need money, I can just write myself a check." He also explained that, with a state association, he could do many things that a federal association could not.

When Liebmann returned to Baltimore, he reviewed the state statute on savings and loan associations because he was concerned about Klein's activities. Subsequently, Liebmann's clients obtained financing, on their own, from Old Court. At closing, there were five points to be paid on the settlement sheet: two for Old Court, one for a mortgage broker and two for Levitt personally. In addition, there were $2000 in attorneys' fees for Levitt, who did not attend the closing.

In the spring of 1984, Liebmann also had general knowledge regarding the instability of certain associations. His law office was in the Keyser Building, which had been bought by

Levitt. Posters with the fourteen percent interest rate were in the front hall and "street talk" portrayed Old Court as an unstable institution. In the fall of 1984, Liebmann had lunch with a banker who stated that the savings and loan practices "could not go on" and that "first to go" would be Old Court.

In October of 1984, Liebmann wrote his second savings and loan memorandum to Governor Hughes.[17] The memorandum discussed both the savings and loan industry and perceived problems with regional banking. Liebmann stated that he believed that the recommendations of the legislative committee with respect to savings and loan associations would be inadequate and would fail to touch on important issues, such as the unlimited insurance coverage provided by MSSIC and serious problems with self-dealing by officers of "high flying associations." He pointed out the contrast between the inadequate Maryland law regarding insider dealing and the federal prohibitions. He also stated that there had been an "extraordinary amount of self-dealing" in some of the "best known associations" and that in many associations it took the form of "points" for legal services assessed by controlling persons. Liebmann also discussed the fact that the industry's majority on MSSIC's board made it "little more than an industry promotion fund." He concluded that the state should move to tighten conflict of interest provisions and restrict the insurance of multiple accounts and brokered deposits. His final paragraph was as follows:

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[17] See October 5, 1984 Memorandum from George W. Liebmann, Exhibit VD1.

> A state should not be converted into a backwater so far as control over its banking system is concerned, nor should it issue blank checks to its savings and loan industry in general or the least ethical elements in it in particular. If you doubt what I say about the latter, I suggest you make appropriate inquiries among those knowledgeable in such matters with respect to the amount of self-dealing which now prevails.

Liebmann had no idea of what became of his memorandum. He never met with anyone in state government about it, nor did he receive any contact about it in any way.

The date on which the Governor's office received the memorandum is unknown. Ejner Johnson forwarded it to Frederick Dewberry, Secretary of the Department of Licensing and Regulation and Benjamin Bialek, Chief Legislative Officer for the Governor, by memorandum of October 30, 1984.[18] The Johnson memorandum echoed Liebmann's concerns about self-dealing in associations and the capability of MSSIC to respond to insolvencies. Johnson also stated that he shared Liebmann's opinion that the recent legislative recommendations were inadequate. His memorandum, accompanying the Liebmann memorandum, was forwarded to the Bank Commissioner and Division Director by memorandum of Frederick L. Dewberry on November 1, 1984[19]

Marjorie H. Muller, the Bank Commissioner, responded to Dewberry by memorandum of November 5, 1984[20] and Brown responded

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[18] See October 30, 1984 Johnson Memorandum, Exhibit IVD2.

[19] See November 1, 1984 Memorandum of Frederick L. Dewberry, Exhibit IVD3.

[20] See November 5, 1984 Memorandum by Majorie H. Muller, Exhibit IVD4.

by memorandum of November 21.[21] Brown's memorandum stated that he also had "some reservations about insider loans and have often felt this should be more restrictive." He further stated that he "would not be upset if legislation was introduced restricting loans to affiliated parties, i.e., officers, directors, and controlling persons." He acknowledged that some "of our associations do make such loans." Brown continued to defend the MSSIC directors in the memorandum, stating that they were "most interested in the safety and soundness of the industry, and they watch very closely the activities of each association in the state-chartered system." He also pointed out that there was an industry majority on the Board of Commissioners. Brown concluded that: "I will agree George Liebmann raises some interesting, and important issues which we can discuss further at your convenience if you feel it necessary to do so."

The Brown and Muller memoranda were forwarded to Johnson by Dewberry's memorandum of November 27, 1984.[22] The memorandum concluded with a statement that "we will be pleased to arrange a meeting with George Liebmann and Benjamin Bialek as you may see fit." Copies of the memorandum were sent to Mr. Bialek and Francis X. Pugh, Assistant Attorney General and counsel to the Department of Licensing and Regulation.

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21 See November 21, 1984 Memorandum of Charles H. Brown, Jr., Exhibit IVD5.

22 See November 27, 1984 Dewberry Memorandum, Exhibit IVD6.

The Liebmann memorandum and responses were not discussed in connection with the 1985 session of the General Assembly or in connection with any legislation. The period of November and December, 1984 were extremely busy periods for the Executive Department, which was dealing with a volatile situation in the Maryland prisons, the killing of Officer Tolson and prison guard strike. The administration was also dealing with the capital budget and the various administration legislative packages. Although Johnson acknowledges that he considers Liebmann to be "brilliant" and a "one man think tank," he has no recollection of passing the responses to Liebmann's memorandum on to the Governor. The Governor apparently did not receive the response until approximately May 17, 1985, when he met Liebmann in the State House and Liebmann referred to his October, 1984 memorandum. Governor Hughes talked to Johnson who brought him the memorandum and response, which the Governor saw for the first time.[23]

Liebmann had several occasions to speak to Governor Hughes between the writing of his memorandum and the savings and loan crisis. He was involved as an attorney in the Fairchild Industries matter and, during the course of that representation, talked to Governor Hughes on the phone "several times" and was in the Governor's office on December 27, 1984 and May 2, 1985. Savings and loan matters were not discussed and the topic of conversation, on each occasion, was totally unrelated.

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[23] See Interview of Governor Hughes, December 6, 1985; Johnson transcript at 23-32.

Considering the information available to Brown when he responded to the Liebmann memorandum on November 21, 1984, the response with respect to insider loans was, at least, understated. Brown had available to him, in the Division examinations of several associations, evidence of excessive insider dealing which jeopardized the safety and soundness of the institutions. Based on his prior experience in 1981, he could have taken the opportunity to bring to the attention of Dewberry and the Governor's office concerns about specific associations which were in danger of jeopardizing the entire MSSIC system. Instead, he stated that he "would not be upset" if legislation restricting insider dealing were introduced. Brown further did not respond to Liebmann's concern about the extent of MSSIC insurance, a circumstance which is critical to the State today and which greatly increases the State's liability. Brown also defended the industry-controlled structure of savings and loan regulation. Finally, Brown expressed his willingness to "discuss further these matters...if you feel it necessary." No sense of urgency whatsoever was conveyed, in contrast to the desperate state of affairs in Brown's Division at the time, when the 1984 Old Court examination was about to be forwarded to the Board of Directors and just a few weeks after the joint MSSIC and Division meeting with First Progressive and Old Court management concerning the March 31, 1983 First Progressive examination.

The Liebmann memorandum sounded alarms which ring true through today. His perception that the state's interests were being jeopardized by the "essentially unlimited MSSIC insurance coverage" and by the self-dealing of officers of the "more high flying associations" were both accurate. A minimal inquiry to Liebmann himself would have identified the associations and illuminated pertinent facts. The failure of the Governor's staff to respond directly to Liebmann, a former senior staff member, was, in hindsight, a mistake. We believe that the administration's handling of the Liebmann memorandum is an example of the fact that the Hughes administration has had insufficient staffing to deal with significant problems as they arrive. On the other hand, when problems have arisen from other areas during the Hughes administration and in the savings and loan industry itself in 1981, concerned persons have been able to obtain quick access to the Governor's office and present those problems. Had Brown taken the Liebmann memorandum as an opportunity to discuss with the Governor the serious problems confronting the regulators of the savings and loan industry in 1984, we believe that he would have been afforded a quick audience.

The Office of Special Counsel doubts, however, that a pointed inquiry, armed with the specifics which Liebmann could have provided, directed through channels to the regulators or to MSSIC, would have uncovered the facts because of Brown and Hogg's long standing practice of concealing pertinent facts based on the belief that any dissemination of the knowledge of mismanaged or unstable associations would jeopardize the entire savings and loan industry. Brown and Hogg maintained, until lines of angry depositors were forming in May, that there were no problems in the industry which they did not have under control.

The Office of Special Counsel was provided a copy of the Liebmann memorandum and the replies in the first month of our investigation by Francis X. Pugh, Assistant Attorney General, in response to a request for his files. The memorandum was not provided at the initial interview of Ejner Johnson. No formal request for documents had been made and Johnson provided various documents relating to the crisis meetings in April and May of 1985. He stated that he assumed earlier documents were not pertinent. After press reports of the Liebmann memorandum, subpoenas were issued to the Governor, Johnson and Dewberry and all pertinent documents were obtained. We have interviewed all recipients of the memorandum at considerable length.

E. TESTIMONY BEFORE LEGISLATIVE COMMITTEE HEARINGS

Summer Task Force Study, Joint Subcommittee on Savings and Loan Industry

During the Summer of 1984, a Joint Subcommittee on the Savings and Loan Industry, chaired by Senator Howard Dennis and Delegate Diane Kirchenbauer, reviewed the savings and loan industry and MSSIC.[24] As part of the task force, Charles Brown, William LeCompte, and Charles Hogg attended the Subcommittee's sessions.[25] Despite the numerous opportunities given to the Division and MSSIC to raise their problems with particular savings and loan associations, both chose to remain silent.[26]

On June 26, 1984, Brown told the legislators that he had no problems with savings and loan associations making commercial loans because commercial loans were more profitable than mortgage loans.[27] In addition, Brown stated that there was no problem with an association being involved in land development because it facilitated the availability to make development loans

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[24] The Subcommittee's findings are discussed, in Section IIE, *infra*.

[25] The Subcommittee held the following meetings: June 12, 1984 (see Exhibit IVE1); June 26, 1984 (see Exhibit IVE2); July 10, 1984 (see Exhibit IVE3); July 17, 1984 (see Exhibit IVE4); July 31, 1984 (see Exhibit IVE5); and, August 8, 1984 (see Exhibit IVE6).

[26] By June 1984, both the Division and MSSIC knew about the serious problems at First Progressive and Old Court, see Section IIIB, *infra*.

[27] Exhibit IVE2, page 2.

to builders.[28] Concerning enforcement actions, Hogg stated that MSSIC had never voted on a cease and desist order during his tenure.[29]

Both Brown and Hogg failed to disclose the problems in MSSIC-insured associations to the Subcommittee. Brown stated that while he was concerned about loans to officers and directors in the summer of 1984, he did not raise the issue with the Subcommittee.[30] His rationale was that you "take what you can get and don't ask for too much or you're going to lose it all."[31] Hogg testified that he recalled being asked by the members of the Subcommittee whether there were any problems among savings and loan associations insured by MSSIC.[32] He responded that while "there are always problems at one point or the other, MSSIC had the situation under control."[33] Given that the Subcommittee's purpose was to explore regulatory problems and propose legislative solutions, Brown and Hogg's approach to the hearings was inexplicable. They had knowledge of the most wanton regulatory abuses, but they failed to disclose them.

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28 Id.

29 Exhibit IVE4, page 1.

30 Charles H. Brown Testimony, Volume II, page 141, line 12 to page 142, line 8.

31 Id.

32 Charles Hogg Testimony, Volume II, page 177, lines 3 to 19.

33 Charles Hogg Testimony, Volume II, page 178 to page 179, line 11.

Testimony Before the General Assembly

During the regular session of the 1985 General Assembly, Hogg and Brown attended hearings held by the Senate Finance Committee. Hogg testified that he was more careful than Brown when he testified.[34] Brown would say that there were no problems, while Hogg would say that any problems were manageable.[35] In the opinion of the Office of Special Counsel, both representations were inaccurate. By this time, Brown and Hogg knew the extent and severity of the Old Court, First Maryland and Merritt problems. Such information was never disclosed to the Legislature. In response to a question about the Ohio situation from Delegate Rummage for instance, Brown testified that there were no problems in savings and loan associations in Maryland.[36]

Congressional Testimony

On April 3, 1985, Hogg testified before a subcommittee of the House of Representatives Committee on Government Operations.[37] The hearings intended to examine the Ohio deposit insurance situation and other state/private deposit insurance systems. Hogg testified that MSSIC's "exacting procedures for membership... and the careful ongoing scrutiny that we make of our state's savings and loan industry, are a depositor's best

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[34] Id.

[35] Id.

[36] Id.

[37] Testimony of Charles C. Hogg, II, Exhibit IVE7.

protection against loss." In addition, Hogg stated that Maryland's early-warning and regulatory system should "preclude the failure of one or more large insured thrifts from occurring suddenly or as a surprise to regulators and insurers."

Charles Brown was requested to provide information to the committee.[38] The information requested included the number of "problem" Maryland associations. Despite his knowledge of Old Court's problems, Brown responded on March 29, 1985 that:

> Presently we do not have any associations that we feel have severe operating problems. There are always some associations which we feel we need to monitor more closely than others and at this time we have three associations in this category.[39]

Brown and Hogg's rationale for their testimony was that any revelation in a public forum regarding problem associations would damage depositor confidence and create the possibility of a run.

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[38] Letter of Congressman Doug Barnard, Jr., Exhibit IVE8.

[39] Letter from Charles H. Brown, Jr., Exhibit IVE9.

F. THE ROLE OF THE ATTORNEY GENERAL'S OFFICE

Maryland Attorney General Stephen Sachs' approach to his office has created a hybrid institution. Under Maryland law he and his assistants must represent, as advocates, the various state agencies that are their clients.[40] Attorney General Sachs has added to his office the responsibility of ensuring that those same agencies adequately protect the public who comprise the Attorney General's constituency. His assistants were instructed to practice aggressive, preventative law.[41]

John C. Cooper was the Assistant Attorney General assigned to the Division. Attorney General Sachs has admitted that "out of the 225 lawyers I have, 175 probably would have been more aggressive than Cooper."[42]

Besides the Division, with which Cooper spent approximately fifteen to twenty percent of his time, Cooper was also counsel for the Racing Commission, and at one contemporaneous point or another, the Barber Examiners Board, the Architectural Registration Board, the Cosmetologist Board, the Foresters Registration Board and the Hearing Aid Dealers Board. Forty to fifty percent of Cooper's work was devoted to the Racing Commission.[43]

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40 Md. Const. Art. V § 3.

41 Interview with Attorney General Stephen Sachs.

42 Id.

43 Cooper transcript at 5-6.

Cooper's philosophy of representation differed from the Attorney General's. He believed that his role as Assistant Attorney General assigned to the Division was generally limited to reviewing documents for legal form and sufficiency and giving advice when requested.[44] For example, when an application for a new branch, merger, or conversion was submitted, Cooper reviewed the legal papers but never investigated the regulatory status of the associations involved. Cooper left the determination of whether the public interest was served by a new branch, merger or conversion, up to Director Brown and the Board of Commissioners.[45] Cooper's approach to his job was exemplified by his response to Custom's false advertising - he believed that savings and loan regulations should be interpreted liberally in favor of furthering the purposes of savings and loan associations.[46] Although he agreed with the decision to stop Custom's deceptive advertising he did not believe that restitution could be obtained[47] and he never recommended criminal sanctions. Cooper testified that this matter and similar practices at Fairfax were disclosed to his superiors in the Attorney General's office, Francis X. Pugh and Robert deV. Frierson.[48] They agreed that it was not Cooper's job to "seek out" information concerning savings and loan associations. Cooper was never told to probe

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[44] Id. at 30-37.

[45] Id.

[46] Exhibit IVF1, Cooper Letter to Brown, April 10, 1984.

[47] Cooper transcript at 202.

[48] Id.

for information or go through files to find problems because "usually more than enough problems surface through the normal process and can be dealt with in an orderly fashion."[49]

Cooper stated that he could not recall ever reviewing a Division examination of an association, either prior to a merger, conversion or new branch, or at any other time. He stated that although it was possible that on a specific occasion he might have been consulted about a Division examination, he never asked to see an examination. During contested Division hearings, when allegations of financial abuse were made, Cooper did not review the accused association's examination reports to verify or discredit the allegations.[50]

Cooper regularly attended Board of Commissioners and Executive Session meetings and he testified that "from time to time" troubled associations, including Old Court and Merritt, were discussed. He stated that both "the board and I were aware that a number of these associations" had problems. This was true even though the Board did not regularly receive copies of Division exams. Cooper testified that he did not have any recollection of specific comments regarding an association ever coming before the Board.[51]

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[49] Interview with Pugh and deV. Frierson.

[50] Id. at 35-39.

[51] Id. at 41-43, 52, 66-68.

Cooper approved Old Court's request to merge with First Progressive without taking any steps to determine whether Old Court was in regulatory compliance. He testified that "it's a fair statement to say that a merger went ahead with the knowledge that Old Court was still in somewhat shaky condition." Cooper approved the merger for legal sufficiency after requiring a few minor changes in wording in the Articles of Merger.[52] He left to the regulator's discretion the question of whether Old Court was financially sound and able to absorb First Progressive, without adversely "affecting the economic security and general welfare" of Maryland citizens.

Similarly, Cooper testified that he never looked at the current Division examination of Merritt prior to the Division's approval of a new branch application on July 25, 1983. When asked whether he would have approved the branch had he known of the detailed findings presented in the examination of Merritt, Cooper replied, "I think I still would have approved it as a proper exercise of the Director's authority." He further testified that there was no discussion between him and Brown or LeCompte concerning using denial of the branch as a lever to force Merritt to comply with Division regulations.[53]

Cooper explained:

> [M]y personal view of my position representing state agencies is that the agencies are appointed by the governor to make this particular type of decision. I'm appointed or hired by the attorney general to advise them as to whether its

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[52] Id. at 47; Cooper Memorandum to Brown, May 28, 1984, Exhibit IVF2.

[53] Id. at 72-75.

legitimate or not, legitimate under the law. I don't make those decisions. I think it's properly made by the agency.[54]

Cooper believed in avoiding public Division hearings against rule violators for fear of causing a run.[55]

Cooper took handwritten notes of an April 4, 1984 hearing concerning whether or not a new Old Court branch should be approved. His notes reflect the testimony of witnesses opposed to the branch. These witnesses testified that Old Court was in violation of the required percentage of homeowner mortgage loans and that Baltimore County land records demonstrated that Old Courts average loan in 1983 was for $317,000.[56] A memorandum from Division examiner Alexander Watts attached to Cooper's handwritten notes contains the examiners opinion that the branch should be denied.

Watts' opinion was based on the following factors:

1. excessive rent;
2. inferior location; and
3. the barely adequate net worth of the association.

Additionally, Watts recommended that approval be withheld until "a favorable examination and certified audit" are received.[57]

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[54] Id. at 75.

[55] Id. at 90-91.

[56] Cooper's handwritten notes, and Watts' memorandum to Brown, April 23, 1984, Exhibit IVF3.

[57] Id.

Cooper testified that he did not know if a favorable examination or certified audit were ever received. He never made any effort to investigate or report the witnesses' allegations about Old Court lending practices, considering them complaints of competitors.[58] In fact the branch application was withdrawn on May 7, 1984.[59]

Cooper testified that he could not recall ever reporting to Attorney General Sachs concerning any savings and loan issue, but he did recall that a few matters other than the Custom and Fairfax advertising practices, might have been discussed with Pugh and Frierson.[60] He could not recall reviewing any matter that he considered required a criminal referral. He noted that the conversion of Hopkins from a mutual to a stock association raised some securities fraud questions but he did not consider it a criminal matter.[61] As discussed previously, neither Custom's misleading advertising nor Gibraltar's interest rate reduction deal with Sharon were referred by Cooper for further action.[62]

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58 Cooper transcript at 100, 103.

59 Exhibit IVF4.

60 Id. at 7-11, 202.

61 Id. at 10-13.

62 See Section IIIH, supra.

Restrictions on Proposed Board Regulations

Other members of the Attorney General's office provided antitrust advice to the Board of Commissioners on various proposed regulations. During the past five years, the advice has covered a number of regulatory issues.

In 1980, the Board of Commissioners wanted to adopt a uniform schedule of rate ceilings specifying the maximum dividend or interest rates that state-chartered savings and loan associations would be able to pay on savings accounts. The Board of Commissioners thought that such a regulation would enable them to maintain control on the growth of the savings and loan associations.

During 1981 and 1982, the Board of Commissioners addressed the need to amend the regulations governing variable rate mortgages. The Board of Commissioners believed that it was necessary to regulate the savings and loan associations to prevent consumers from being victimized by widely fluctuating payments or interest based on manipulated indexes.

In September 1984, the Board of Commissioners had proposed an amendment to their regulations which would have limited the amount of brokered savings deposits that associations could accept. The Board viewed such regulation as important to control the influx of short term deposits placed by money brokers. This so-called "hot money" was attracted by the high interest rates offered by MSSIC-insured institutions. The regulatory concern was that the "hot money" could eventually lead to liquidity problems and encourage excessive growth by the associations.

In analyzing the above regulatory issues, the Office of the Attorney General concluded that the proposed regulations would have a substantial risk of violating the federal antitrust laws. Such a violation could impose significant personal liability for the members of the Board of Commissioners because the Board was industry-dominated. On November 8, 1980, the Attorney General issued his opinion that the Board of Commissioners did not have the requisite statutory authority to impose interest rate ceilings.[63] After considering the issue of regulating variable rate mortgages on January 23, 1981[64] and February 10, 1981,[65] the Office of the Attorney General notified the Board of Commissioners and the Division that the Board of Commissioners lacked affirmative authority to regulate the rates on variable rate mortgages.[66] In addition, the legal advice recommended that the Board of Commissioners repeal all such regulations. On September 24, 1984, the Board of Commissioners was notified that its proposed regulation on brokered deposits would be subject to scrutiny under the antitrust laws.[67]

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[63] 65 Op. Att'y. Gen. 13 (1980) Exhibit IVF5.

[64] Memorandum from Naomi F. Samet, January 23, 1981, Exhibit IVF6.

[65] Memorandum from Charles O. Monk, II, February 10, 1981, Exhibit IVF7.

[66] Memorandum from Charles O. Monk, II and Naomi F. Samet, May 10, 1982, Exhibit IVF8.

[67] Letter from Alan M. Barr, September 24, 1984, Exhibit IVF9.

In each of these instances, the Office of the Attorney General concluded that the proposed regulations would not be exempt under the state action doctrine, which grants immunity from the antitrust laws for certain acts of government. The Office of the Attorney General consistently concluded that the state action doctrine did not apply to the actions of the Board of Commissioners.[68]

In order to correct this perceived limitation on the Board of Commissioners power to regulate, the Office of the Attorney General suggested that the General Assembly amend the powers of the Board of Commissioners.[69] It was believed that an amendment clarifying the Board of Commissioners authority would alleviate the concern about antitrust liability. As a result of the Office of the Attorney General's advice, Senate Bill 363 was introduced in the 1982 session of the General Assembly to clarify the Board of Commissioners powers. Despite substantial support from the Division and Board of Commissioners, it failed to pass.[70] The General Assembly's failure to enact the suggested language was interpreted by the Office of the Attorney General as a clear indication that they did not intend the Board of Commissioners to have the needed authority.[71] In 1985, the Office of the Attorney General again suggested language

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[68] Minutes of the Joint Subcommittee on Savings and Loan Industry, Exhibit IVF10.

[69] See Exhibit IVF7.

[70] See discussion in Section IIE.

[71] See Exhibit IVF8.

addressing the antitrust question.[72] The legislation was adopted.[73]

Although the antitrust state action doctrine is a complex legal issue about which competent attorneys can differ, the Office of the Special Counsel has concluded that the Office of the Attorney General erred in its legal advice concerning the state action doctrine. In our opinion, the Board of Commissioners was protected by the state action doctrine.[74]

The legal opinion of the Office of the Attorney General concerning possible Board of Commissioners' antitrust liability affected the implementation of certain regulations. In the opinion of many members of the Board of Commissioners, regulations controlling brokered deposits and interest rates would have restrained to some degree the rapid growth in Maryland savings and loan associations which contributed to the crisis.

In August, 1984, the Board of Commissioners requested advice regarding the federal tie-in amendment, Section 9-419(c) of the Code. The issue was whether that amendment precluded the exercise of the regulatory authority over investments granted the Board of Commissioners. The Board of Commissioners was concerned that Section 9-419(c) of the Code may have deregulated invest-

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[72] Letter from Alan M. Barr, Exhibit IVF11.

[73] See discussion in Section IIE.

[74] Opinion to the Office of Special Counsel, October 30, 1985, Exhibit IVF12.

ments by the Maryland savings and loan industry, permitting them to invest in anything federal associations were permitted to invest in without regulation by the Board of Commissioners.

In order to permit continued regulation, the Office of the Attorney General crafted a legal opinion which retained the power of the Board of Commissioners to regulate investments. The opinion noted the antitrust risks but still concluded that regulation of investments by the Board of Commissioners was lawful. In rendering this advice, the Office of Attorney General was particularly sensitive to the need to preserve the Board of Commissioners authority in the face of legislation passed by the General Assembly which, potentially, greatly diluted that authority.[75]

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[75] See letter of advice from Michael F. Brockmeyer and Robert deV. Frierson, August 3, 1984, Exhibit IVF13. Also see discussion in Section IIE.

G. THE ISSUE OF GENERAL KNOWLEDGE

The Office of Special Counsel has interviewed numerous witnesses concerning the question of whether general knowledge existed among reasonably informed people that certain savings and loan associations were mismanaged and required regulatory scrutiny. Almost without exception, those who were interviewed within the savings and loan industry, such as Division and MSSIC staff, Board of Commissioners, and the MSSIC Board, had strong suspicions that Old Court and Merritt were running high risk, poorly managed operations. The suspicions were based on the high interest rates being offered, aggressive advertising, rapid growth and investments primarily focused on real estate acquisition and development projects which were considered risky and beyond the expertise of the thinly staffed associations. Additionally, when the Merritt Tower construction began, concerns were heightened that Merritt was "getting in over its head." At MSSIC Board meetings, questions were raised about how high interest paying institutions could be reporting "profits." It was intimated that, in order to have a positive "spread," such institutions would have to engage in risky investment practices.

David Wells, deputy director of the Division from 1975 through 1981, and currently President of Key Federal Savings and Loan Association, maintained a relationship with the Division and occasionally reported rumors he heard concerning the industry. On one occasion in 1984, he heard a rumor that Paul Freeman at First Progressive was speculating in the futures market and had lost $2,000,000 in one day. He reported the rumor to William LeCompte of the Division. On another occasion, he reported to LeCompte concerns about Old Court's booking "phony" profits on a property in Carroll County which they sold to themselves through a subsidiary at foreclosure. He also reported other general concerns about Old Court in 1984. LeCompte responded that Old Court was "making a lot of money" and, on one occasion, he referred to the "tubs of lobster and shrimp" at the Old Court Christmas party.

In the savings and loan industry itself, there was concern in 1984 about the operations of certain associations including Old Court and Merritt. Certain industry members referred to a group of MSSIC associations as the "Baltimore crazies" and believed that they were running unsafe and unsound operations. Levitt, for instance, had the reputation of being willing to "buy anything" in a handshake deal and pay greater than a market price for it. Federally insured associations in Maryland perceived a danger in these rapidly growing institutions because it was known that managing a growth pattern of doubling in assets each year is an "insurmountable task." They discussed their concerns at the Maryland Savings and Loan League, a trade association for FSLIC and MSSIC insured institutions in Maryland, but because they were viewed as competitors, their concerns were written off as "sour grapes." It was also generally known among industry members that, because of the use of regulatory accounting practices rather than generally accepted accounting practices, a number of institutions which were considered profitable may well have been unprofitable. Smaller MSSIC institutions were also concerned that MSSIC was not intended to insure major associations, exceeding $500,000,000 in assets, because problems at one major institution could wipe out MSSIC's insurance fund and bring the industry down. Some smaller institutions proposed to MSSIC that, at a certain size, associations should be forced into FSLIC.

The banking community also had general knowledge about the rapid growth and risky investment practices of certain Maryland associations. Some banks refused to establish lines of credit for certain associations. The banking community did not report their concerns, as a group, to any part of the state government. One banker stated, however, that during the 1982 legislative session, he attended a meeting at Attorney General Sachs' office regarding decontrol of interest rates. At the meeting, Sachs objected on behalf of consumers to the bank's legislative efforts to decontrol interest rates. After the meeting, the chief executive officer of a bank stated that he said to the Attorney General words to the effect of "if you are interested in protecting consumers, you should look at the savings and loans." Sachs responded with words to the effect that the situation was under control and "we are looking at them." No specific association or specific practices or reasons were stated as to why the associations deserved scrutiny. The Attorney General has no recollection of such a conversation and states that it did not take place.

Government officials interviewed by the Office of Special Counsel generally denied any knowledge of the "street talk" prevalent among financial institutions regarding the practices of certain associations. Governor Hughes received no such impressions from the private sector and relied on his ready accessibility and his administrators to keep him informed of any problems. Because no problems were brought to his attention, he assumed there were none. Over the past five years, Governor Hughes has had numerous meetings with bankers on other matters, as has his Secretary of the Department of Community and Economic Development, Thomas Maddux. Bankers never expressed their concerns regarding the savings and loan associations to either Governor Hughes or Maddux. Attorney General Sachs stated that he "didn't walk on the street" where the "street talk" abounded. He was generally aware of the deregulatory climate and aggressive practices of some portion of the industry but heard nothing to raise his concerns until the spring of 1985, which will be discussed, infra.

Holden Gibbs, currently a bank vice president and formerly Bank Commissioner (1978 - 1980), during the 1980 session of the General Assembly talked to Ejner Johnson, Governor Hughes' Chief of Staff, regarding legislation deregulating the interest rates. During the course of the conversation, the discussion turned to MSSIC insured institutions. Gibbs told Johnson that the Governor eventually would have to decide to give state backing to MSSIC institutions or to "cut the depositors off." He made the point that some MSSIC institutions would be destroyed by the high interest rates in effect at the time and the state would have to make a decision to pledge its full faith and credit or see some depositors go unpaid. Gibbs was not alluding to mismanagement in any savings and loan.

During the critical year of 1984, members of the general public also had premonitions of "something rotten" in the state of Maryland savings and loan associations. On January 8, 1984, for instance, Mrs. Seena King of Bethesda, Maryland, wrote a letter to Governor Hughes expressing concern about discovering that MSSIC institutions were not backed by the State and concerns that "financial experts" had stated that they would not put money in MSSIC institutions.[76] She also expressed concern that MSSIC's inclusion of the word "Maryland" in its name was deceiving depositors into believing that MSSIC institutions were backed by the state government. She was specifically considering depositing money in Friendship Savings and Loan Association. The response generated is indicative both of the attention given to consumer inquiries by the Hughes administration and the general posture of the regulators when confronted with such inquiries.

The letter was channeled through Secretary Corbley to Director Brown who drafted a response.[77] Secretary Corbley reviewed the response but requested a redraft from Brown because it "skirted the issues."[78] Brown's redraft was forwarded to Corbley with a memorandum noting that "Mrs. King asked many

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[76] See Seena King letter, Exhibit IVG1.

[77] See Exhibit IVG2.

[78] See Exhibit IVG3.

questions which I found rather difficult to answer."[79] Corbley had him revise the draft again. The second revised draft was forward to Ejner Johnson for signature of the Governor, whose letter was sent to Mrs. King on March 5, 1984.[80] The response described the relationship between MSSIC and the state through the Governor's appointment of public members to the MSSIC Board and through the regulatory cooperation with the Division. It also described the various steps open to regulators to deal with ailing institutions, including advancing funds, mergers, conservatorship and receivership. The response reported that "MSSIC associations are very liquid and their assets can be converted to cash promptly, which would result in a prompt liquidation of an association." The general tone of the letter was upbeat and reassuring, designed to encourage Mrs. King to deposit her money in Friendship.

Inquiries concerning MSSIC institutions came from as far away as the Peoples Republic of China.[81] Many consumer inquiries raised the simple question of how certain MSSIC institutions could afford to offer the highest interest rates offered in the country, suggesting that in order to cover such rates their investments would have to be highly speculative. In all cases, reassuring answers were given, either by MSSIC or the Division. On occasion, MSSIC even enclosed lists of certain

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[79] See Exhibit IVG4.

[80] See Exhibit IVG5.

[81] See Exhibit IVG6.

MSSIC insured institutions which offered specific depositor services, regardless of the regulatory quality of the institution.[82]

In one instance, Kenneth A. Richer of Harford County made telephone inquiries to MSSIC and the Division on December 20, 1984, which were prompted by an article of the same date in the Harford County Aegis. The article concerned a lawsuit threatened by Steven R. Hankins against the Harford County government because of the denial of building and occupancy permits for Emmorton Business Park.[83] Hankins was described as:

> The thirty year old developer who has lived in the county for twenty-five years burst on the commercial development scene here this year with heavy financial backing from Old Court Savings & Loan, a Baltimore financial institution which has become heavily involved in highly speculative commercial and residential development ventures here and elsewhere in the state.[84]

Richer had a certificate of deposit (CD) at Old Court and became concerned enough about Old Court's status to consider withdrawing the certificate, taking early withdrawal penalties. He first called MSSIC, which said it could not give out any information on a specific savings and loan. He then called the Division and was referred to a man to whom he posed his concerns based on the Aegis article. He was told that Old Court was "in fine financial shape," that their reports were received monthly and they were prohibited from investing more than eighty percent of the value

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82 See MSSIC and Division responses, Exhibit IVG7.

83 For a description of Emmorton, see Section IIIB.

84 See Exhibit IVG8.

of the property. Richer specifically asked how Old Court could afford to pay one percent to 1.5% higher interest than anyone else and was told that they could because they had "eliminated the middle man" in their real estate deals by having their own real estate division. He was also told that, because their investments were diversified throughout this state and others, they were less vulnerable to changes in local housing markets. Finally, he was told that the article might have been inspired by the jealousy of an Old Court competitor operating in the same area. The Division representative made these statements at a time when the results of the Old Court 1984 examination were generally known throughout the Division and MSSIC. As a result of the assurances, Richer left his CD in Old Court.[85]

In addition to the Aegis, the Washington Times also wrote several articles in 1984 questioning the stability of certain Maryland associations and the efficacy of their regulation. On January 30, the Times published an article entitled "First Maryland Warned by Agency," describing the fact that First Maryland was in violation of various lending limit regulations despite a warning by MSSIC eleven months earlier.[86] The following day, the Times published an article describing that First Maryland was in violation of three regulations and had excessive commercial and construction loans. The article also stated that First Maryland increasingly relied on brokered deposits, had a low net worth and that numerous employees were

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[85] See interview of Kenneth A. Richer.

[86] See Exhibit IVG9.

leaving.[87] On February 3, the Times published an article and an editorial concerning MSSIC associations. The editorial, entitled "protecting Maryland's savers" stated that the MSSIC staff was small and had not grown enough to keep up with the "astonishing growth" in the industry. It also described the Division as understaffed and as not showing "the aggressive inquisitiveness that lets depositors sleep at night." The editorial concluded with the following: "The present system has worked for two decades but it would be stretched to the breaking point if the state's savings and loan associations' growth continues unchecked and undersupervised."[88]

An article of the same date specifically named Gibraltar, First Progressive, Old Court and Fairfax as institutions that were growing rapidly while they had low net worths.

The Washington Times articles were the subject of some concern by Director Brown, who discussed them in two memoranda to Secretary John J. Corbley of the Department of Licensing and Regulation. In the first memorandum, dated February 3, 1984, Brown pointed out that the Times reporter did not calculate net worth in the manner that the Division did and, consequently, his identification of those in violation of the net worth requirement was incorrect. He also pointed out that "the worst thing" in the article was the statement that a Maryland agency was lax in regulating savings and loan associations. Brown pointed out that

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[87] See Exhibit IVG10.

[88] See Exhibit IVG11.

you had to read the first two paragraphs to find out that the reporter was not talking about the Division but was referring to MSSIC.[89]

Brown updated Corbley on the Washington Times articles by memorandum of March 19, 1984. There, Brown responded to an article entitled "Safeguards for Maryland Savings and Loan Depositors not Working." Brown answered specific points made in the article, including a comment regarding associations making loans all over the country. Brown concluded that he would be in favor of a restriction of out-of-state lending, to be discussed at the summer task force.[90]

The Times articles were noted by Attorney General Sachs, who made an inquiry to MSSIC and received a response by letter of Charles Hogg dated March 12, 1984. Hogg stated that the Times articles "are a mixture of accurate statements, often offset by inaccuracies, wrong interpretations of data and unfounded innuendoes and irrelevant facts." He went on to assure Sachs that the situation was well in hand:

> I assure you that both MSSIC and the Division bear the responsibilities placed on us seriously and that we are doing a good job of insuring the deposits placed by consumers in our member savings and loans. If there were not some problems, we would not need regulators, insurers, or for that matter, attorneys general. We are, however, fully aware of and dealing with the problem areas.[91]

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89 See Brown memorandum to Corbley, February 3, 1984, Exhibit IVG12.

90 See Brown memorandum to Corbley, March 19, 1984, Exhibit VG13.

91 See Exhibit IVG14.

Although there was some "street talk" during critical periods prior to the 1985 crisis, that street talk mainly served to inform the regulators - MSSIC and the Division - that a crisis was brewing. Upon specific inquiry by Attorney General Sachs, no pertinent facts were forthcoming from the regulators. The operation of the Governor's office through the years has focused its attention on one crisis after another. Many of these crises were brought to the Governor's attention by administrators who reported problems in their area of state government. After so reporting, the Governor's staff mustered resources to deal with the crisis. Here, this mechanism for dealing with impending crises failed by virtue of the simple fact that the regulators in charge did not report to their superiors regarding the facts that were clearly before them.

H. THE 1985 SAVINGS AND LOAN CRISIS

Despite the concerted effort to keep higher government officials in the dark regarding the deplorable state of certain Maryland savings and loan associations, external forces in 1985 gradually brought the crisis to light. The "60 Minutes" broadcast about Commonwealth Bank's failure and the Ohio crisis sharpened official and public concern regarding Maryland associations. Even then, however, it took a major run on Maryland associations before the highest officials of the state were fully informed.

Nebraska and Ohio

On January 20, 1985, the CBS news show, "60 Minutes", ran a segment regarding the failure of Commonwealth Bank, an industrial bank in Nebraska. The bank had been uninsured and many depositors lost their savings. Following the show, MSSIC and the Division were inundated with telephone calls and letters regarding the MSSIC insurance system. In the opinion of economists, the savings and loan industry and regulators, the widely viewed show heightened public wariness regarding financial institutions in general and contributed to the likelihood of a panic.

On March 8, 1985 Homes State Savings Bank in Cincinnati, Ohio closed its doors. Home State had borrowed heavily from ESM Government Securities, Inc., a government securities broker in Fort Lauderdale, Florida, which was closed called both Brown and Hogg on March 15, 1985 to tell them to have MSSIC associations get borrowing resolutions in place with the Federal Reserve.[94]

Charles Hogg took steps to insure that MSSIC's funds were as liquid as possible in the event of a run in Maryland and sent a memorandum to the membership regarding MSSIC's reaction to the Ohio crisis.[95] At approximately the time of the Ohio crisis, a meeting had been arranged by Frederick Dewberry for Brown and Hogg to consult with Ejner Johnson. The purpose of the meeting was to give Hogg and Brown an audience concerning House Bill 1609 which had been introduced in the 1985 Session of the General Assembly. The bill, introduced by Delegate Terry Connolly, sought to require MSSIC and MSSIC institutions to state in their advertisements that they were not state insured and were not backed by the full faith and credit of the state. MSSIC was concerned that a public hearing on the bill could damage depositor confidence and sought, through Brown and Dewberry, a meeting with Ejner Johnson. The meeting was arranged, by chance, for March 16, 1985, the day after the Ohio run. It was attended by Johnson, Brown, Hogg, Dewberry and MSSIC Chairman of the Board, George Pierson.

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[94] Pursuant to the Depository Institution Deregulation and Monetary Control Act of 1980, the Federal Reserve was authorized to provide services to any depository institution including state savings and loan associations. Immediately after the act was passed, Federal Reserve personnel had meetings with MSSIC and Division representatives in an attempt to get borrowing mechanisms in place for the future. Very few MSSIC institutions had such mechanisms in place as of March 15, 1985.

[95] See Hogg memorandum of March 25, 1985, Exhibit IVH3.

by the SEC because of insolvency. Home State had borrowed through reverse repurchase agreements, using Government Securities as collateral, many of which ESM sold to other parties. Depositors hastily withdrew $20,000,000 from Home State, forcing it to close. Although many federally insured banks and savings and loans had failed in the preceding five years, Home State was the first large failure for a private insurance fund. Its deposits were insured by the Ohio Deposit Guaranty Fund (ODGF) which, like MSSIC, was not a state agency and was not backed by the faith nor credit of the state government. ODGF insured the deposits of seventy Ohio savings and loan associations and had assets of $139,000,000. The Home State loss was estimated at $150,000,000.[92] Within a few days, depositors, who realized the insurance fund could be exhausted by the Home State loss, started a run on the other seventy privately insured institutions. To stop the run, all of the associations were closed by Governor Richard F. Celeste of Ohio on March 15, 1985, pending their qualification for federal insurance.[93]

As with the "60 Minutes" show, depositors reacted quickly to the Ohio crisis, barraging the Division and MSSIC with telephone calls and letters. The phone systems at the two agencies went into "grid lock" and hot lines had to be installed in both to maintain communications with the public. Welford Farmer, senior counsel for the Federal Reserve in Richmond,

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92 See March 15, 1985 Baltimore Sun, Exhibit IVH1.

93 See FIAC Important Notice, Exhibit IVH2.

At the meeting, Hogg expressed concern about the bill's potential impact on depositor confidence, stating that a public hearing on it could start a run in Maryland. Johnson agreed to see that the bill was withdrawn. He also stated that, in light of Ohio, they had "more to discuss than the MSSIC seal" and asked for a situation report on Maryland institutions so that he could pass it on to the Governor. The regulators responded that "everything was fine with our associations" and described the MSSIC reporting system as providing adequate information for them to closely monitor the industry. Relieved, Johnson told Dewberry to take Brown and Hogg to see Speaker of the House of Delegates Benjamin Cardin and President of the Senate Melvin Steinberg to report on the state of the industry. The same report was given to Cardin and Steinberg - all was well with the MSSIC associations.

At approximately the same time the Attorney General's office made its own inquiry to ascertain the status of the industry. Robert deV. Frierson, Assistant Attorney General and Assistant General Counsel to the Department of Licensing and Regulation, asked William LeCompte whether the Ohio situation could happen in Maryland in order to determine whether any contingency planning needed to be done. When he made his inquiry on the phone, he met immediate resistance, with LeCompte alluding to the fact that Frierson's "boss" Attorney General Sachs was running for governor, that the regulators had the situation in hand and that he should "mind his own business." A heated exchange took place which surprised Frierson because they had a good relationship before. When the conversation ended, Frierson expected no response from LeCompte regarding his inquiry.

On March 21, 1985, however, LeCompte provided Frierson with a handwritten response.[96] The memorandum analyzed the Home State failure and the Ohio run and stated that no MSSIC institutions were involved with ESM and that MSSIC had a guideline limiting borrowings to fifteen percent of liabilities. He also enclosed data which purported to show that MSSIC and the MSSIC industry were stable. LeCompte pointed out the Maryland rules and regulations which would "protect against some of the problems encountered in Ohio" such as the conflict of interest statute and regulations, loan to value regulations and loans to one borrower regulations. He also described the examination, audit and reporting regulations, concluding as follows: "Bottom line, we don't feel we have any surprises out there, and our problems are manageable.... MSSIC and the industry are liquid and sound...." The memorandum closed with LeCompte's concerns about the necessity to maintain public confidence and the impact of exterior forces on public confidence.

In early April of 1985, another out-of-state event caused ripples of concern in the Maryland savings and loan community. Brevill, Bressler and Schulman (BBS), a New Jersey based government securities dealer, was closed on April 8. Merritt was reported to have invested approximately $2,200,000 with BBS and Old Court an unspecified amount. Again, there was

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[96] See March 21, 1985 memorandum, Exhibit IVH4.

publicity in local papers regarding the failure and the MSSIC associations' investments. Regulators and the industry viewed this event as another factor which undermined public confidence in the MSSIC system.

The administration attempted to keep abreast of developments by getting information from the Division and MSSIC regarding the status of the industry. On April 1, 1985, Secretary Dewberry forwarded Congressional testimony by Hogg and Brown to Ejner Johnson.[97] Brown's testimony, which was prepared for Representative Douglas Barnard, Jr., Chairman of the Commerce, Consumer and Monetary Affairs Subcommittee of the House of Representatives and which is discussed in Section IVE of this Report gave assurances that no MSSIC associations had severe problems.

Attorney General Sachs also had conversations with two friends in the business community in early April of 1985 in which he was advised of their concerns about the stability of certain savings and loan associations and the "high flying" practices of their owners. He discussed the matter with Frierson and Pugh who agreed with Sachs that they had no confidence in Brown or Hogg to handle the situation. Frierson and Pugh responded by memorandum of April 11, 1985, alluding to the difficulty in getting accurate information from the regulators and recommending that the Governor find out in a "face to face" meeting whether any MSSIC

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[97] See 4/1/85 memorandum from Dewberry to Johnson, with attachments, Exhibit IVH7.

institutions were in trouble.[98] The memorandum was sent to Ejner Johnson on April 15, 1985. At Johnson's request, Pugh and Frierson then began to draft an emergency legislative package and began planning for the institution of conservatorships. The draft legislative package, forwarded to Johnson on April 23, 1985, became the basis for legislation passed in the first Special Session of the General Assembly in May.[99]

On April 11, Attorney General Sachs had a meeting scheduled with Governor Hughes concerning state police matters. He specifically arranged to have Ejner Johnson present because he also wanted to talk to the Governor concerning another matter - the savings and loan associations. He expressed his concerns about the street talk he had heard and the inadequacy of the regulators. He also suggested that the state amplify its "regulatory fire power" by getting federal examiners to assist.

Two days later, while on a post-legislative session vacation in Florida, Governor Hughes received a call from the Federal Reserve advising him that several Maryland associations were borrowing heavily to meet heavy withdrawals. Governor Hughes appointed Johnson to look into the matter. Johnson discovered, in a meeting with federal representatives on April 16, 1985, that a "silent run" was taking place, with a $375,000,000 loss in deposits from MSSIC institutions in the preceding two months. At the meeting, attended by Brown and

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98 See Pugh and Frierson memorandum of April 11, 1985, Exhibit IVH5.

99 See April 23, 1985 letter to Johnson, with attachments, Exhibit IVH6.

Hogg, the regulators again gave assurances that there were no significant problems among the MSSIC institutions and that they had the situation under control.

Because the Maryland associations were borrowing from the Federal Reserve, federal examiners were sent to the Division and MSSIC to review their status. They had access to examinations and concluded that some institutions were real estate development companies, not savings and loan associations. They were concerned about the Division and MSSIC reports because, unlike the federal examinations, they were primarily descriptive rather than conclusory. The federal examinations classify loans in categories of "satisfactory," "special attention," "substandard," "doubtful" and "loss," requiring a percentage or the whole loan to be written off in certain cases. Federal examiners also reached conclusions about the overall management of institutions, which the Division examinations lacked.

The Federal Reserve and MSSIC began receiving daily reports from large associations regarding deposits and withdrawals in April. The figures were also forwarded to Ejner Johnson, who consulted with Thomas Maddux, Secretary of the Department of Economic and Community Development and who had formerly served on the Board of the Federal Reserve branch in Maryland. The Division at this time was performing update examinations on Old Court and Merritt and asked for Federal Reserve assistance. Ten federal examiners were brought in to assist with the two institutions. The head of the team examining Old Court had never encountered anything like the transactions at

Old Court in years of examining banks. After two weeks, the federal examiners reached the conclusion that, although Old Court had reported $12,000,000 in profits in the nine months ending March 31, 1985, they were "under water." When the runs started at Old Court and Merritt, the federal examiners pulled out with their examinations incomplete.

The administration met directly with regulators and federal representatives. On April 16, 1985, Johnson, Maddux and Robert McTeer of the Federal Reserve met with Charles Brown, a meeting which was summarized for the Governor in Johnson's memorandum of the same date.[100] At the meeting, a strategy for dealing with the silent run was discussed, as were specific concerns regarding certain associations. Johnson summarized his impressions as follows:

> The impression I have is that the consternation among the financial community, especially among bankers, is caused by just a few associations - Old Court, Merritt and Fairfax. Charlie Brown told me confidentially that MSSIC and Old Court have entered into a management agreement and I presume this results because MSSIC and Charles Hogg were dissatisfied with the association's operation. Jeff Levitt has a reputation for being flamboyant. If this management agreement becomes public, obviously it could create problems for Old Court insofar as confidence and that lack of confidence could spread quickly.

On April 18, Johnson met with Hogg, Maddux, Dewberry, Brown and federal representatives and on April 19 with Maddux and the federal representatives, both of which meetings were

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[100] See 4/16/85 memorandum from Johnson to Governor Hughes, Exhibit IVH8.

summarized in a memorandum to the Governor of April 19.[101] Hogg had expressed assurances at the April 18 meeting that everything was under control but the federal representatives were concerned about whether his optimism was realistic. At this point, Old Court had borrowed $75,000,000 from the Federal Reserve and federal examiners had a preliminary view of its loan portfolio, which gave them great concern.

On April 29, 1985, the first of the major crisis meetings took place in the Governor's office with representatives from the Federal Reserve, Federal Home Loan Bank Board, Governor Hughes, Ejner Johnson, Frederick Dewberry, Charles Brown, William LeCompte, Charles Hogg, Paul Trice, Attorney General Sachs, Robert Frierson, Lowell Bowen, Esquire, as special counsel to the state, Terry Hall, John Faulkner and others present. Federal representatives predicted a major run because of the extensive borrowing without the ability to pay and described some associations as being "at the end of their ropes." They also expressed their concerns with Old Court because of its bad collateral and transactions as revealed by their preliminary examination. Hogg and Brown responded that they had a management contract in effect with Old Court and that Faulkner would be the new chief executive officer and that "this would take care of it." They described Levitt as "inexperienced" and "in over his head," not dishonest, emphasizing the need to remove him quietly. Sachs strongly disagreed with the MSSIC and Division plans to

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101 See Johnson memorandum to Governor Hughes, April 19, 1985, Exhibit IVH9.

handle the situation, maintaining that if there were problems at Old Court because of its management, the public had a right to know. He also scoffed at the idea of removing Levitt quietly, since Levitt was an effective self-promotor and had maintained a prominent position in the public eye.[102]

On May 1, Assistant Attorney General Pugh, sought and obtained a copy of the insurance agreement between MSSIC and Old Court. The March 22, 1985 letter from MSSIC to Old Court, enumerating the various charges subject to cease and desist proceedings, was attached as an exhibit. It was the first time Pugh had seen the document and, upon reading it, he realized that the situation was far worse than it previously had been portrayed. He gave a copy of the letter to Attorney General Sachs and immediately drove to Annapolis to give a copy to Governor Hughes and Johnson.

A second "crisis meeting" was held at the Department of Economic and Community Development on May 2, including basically the same cast that attended the meeting on the April 29. At the meeting, Attorney General Sachs asked the federal representatives if they had seen the March 22 MSSIC letter. They had not, and Sachs presented it to them. He stated that, in his opinion, it clearly indicated criminal activity and that he was going to request authority from the Governor to investigate. The federal representatives, who had provided examiners to assist the

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[102] For instance, Levitt had been named one of the 85 people to watch in 1985 by Baltimore Magazine and was described in the March 1985 issue of the Jewish Times as a philanthropist, real estate genius and child prodigy who had played the violin in Carnegie Hall at the age of 5.

Division and MSSIC at Old Court and Merritt, were aghast at not having been provided the letter previously. They indicated that they would have to reconsider their position and that they had some questions as to whether they could continue to cooperate with the State. At the meeting, Hogg presented the letter to the Board of Directors of Merritt from MSSIC, also. Hogg, Brown and Faulkner continued to "chirp happily" about the situation, maintaining that it was under control. Sachs responded that conservatorship should be considered based on the contents of the MSSIC letters to Old Court and Merritt. Bowen pointed out that plaintiff had to be the Board of Savings & Loan Commissioners, who were at this point unwilling, and that, because affidavits would have to be composed, the conservatorship lawsuits could not be filed quickly. The Governor at this point had planned to travel to Israel on May 4 and a discussion took place as to whether the trip should be postponed. Although there was disagreement, the consensus was that the Governor should make his trip as planned, as any change in plans would focus public attention on the savings and loan industry.

That night, Attorney General Sachs heard an Old Court advertisement on the radio. The advertisement was Old Court's standard one at the time, emphasizing the "Old Court advantage" of high interest rates. Infuriated that Old Court was advertising for more deposits in its condition, Sachs called Hogg the next morning. Hogg was on a speaker phone, with others present, including his counsel. Sachs told Hogg to have Old Court "get its ads off the air." Hogg objected, stating that withdrawing the advertisements would affect public confidence. Sachs stated that "not one of you would put a dime in Old Court" and that the advertisements violated the State's Consumer Protection Act. No one disputed his contention. He followed the phone conversation with a letter of May 3, 1985 to Hogg stating his position that the advertising should cease immediately.[103]

The Governor proceeded to Israel on May 4 as planned. On May 8, 1985, another "crisis meeting" took place in the Governor's conference room at the State Office Building in Baltimore. The same cast of characters attended, minus the Governor and Maddux, and with certain additions. One of the additions was Dr. Huell E. Connor, Jr., the psychiatrist hired by Old Court to advise Levitt. Many at the meeting understood that Dr. Connor was an advisor to MSSIC. Connor and Hogg contend that he was introduced as a consultant to Old Court.

By the time of the May 8 meeting, Old Court was still advertising on the radio for additional deposits.[104] Sachs complained again about the advertising and delivered his letter of May 8 to John Faulkner directing that it cease.[105] He stated that if the advertisements did not cease immediately, the

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[103] See Attorney General Sachs letter of May 3, 1985 to C. Hogg, Exhibit IVH10.

[104] Old Court's advertisements took full advantage of MSSIC's existence. A circular mailed to customers in April 1985 included a full description of "stringent MSSIC and state regulations geared to protect the depositor" and quoted Paul Trice saying, among other things, "[W]e tend to catch things very early". Trice testified that he did not give Old Court permission to quote him and had no knowledge of the advertisement. See Exhibit IVH12.

[105] See May 8, 1985 letter from Sachs to Faulkner, Exhibit IVH11.

Attorney General's office would sue.

Hogg and Faulkner presented "game plan" charts at the meeting for the management of Old Court. Faulkner and Dr. Connor had previously devised a "short term strategy and action plan" for Old Court which they had presented to Old Court stockholders.[106] Even at that point, with Faulkner as the managing officer, the stockholders of Old Court, Levitt, Pearlstein and Cardin, were to be involved in management through regular senior management meetings. The plan was supported by MSSIC and the Division acquiesced.

The announcement of Old Court's management change was also discussed. The Old Court and MSSIC representatives appeared at the meeting with a draft press release dated May 8, 1985 composed by Levitt's public relations director.[107] The press release stated that "Jeffrey A. Levitt, President of Old Court Savings and Loan, has named John D. Faulkner, Jr. operating manager of the institution." It represented that the new position was created to accommodate Old Court's "rapid growth and increasing complexity." The release also described Faulkner as a "pioneer in the savings and loan industry" who had been cited for the development of the variable rate NOW account in various business magazines and who, as president and chief executive officer of Community Savings and Loan, had been responsible for its growth from $3,000,000 to $600,000,000 in assets in ten

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[106] See Old Court Savings and Loan, Inc. short term strategy and action plan, April 30, 1985, Exhibit IVH13.

[107] See Old Court press release, Exhibit IVH14.

years. Sachs and Johnson were incensed at the proposed announcement, considering it a deception on the public. Both pressed for a disclosure which was factual and which stated that Old Court had management problems. Old Court and MSSIC representatives disagreed but the Johnson and Sachs view prevailed and the press release was redrafted.[108]

On May 9, 1985, the Baltimore Sun published an article regarding the management change entitled "Old Court Reveals Problems".[109] Lines began forming at Old Court offices and other newspapers quickly picked up on the story. The Evening Sun headline was "Depositors Jam Old Court S&L" with a subtitle of "Management Troubles Make Customers Jittery".[110] On May 9, state and federal officials met at the Holiday Inn in Parole, Maryland in order to monitor the situation. The runs at the Old Court branches were being televised in the afternoon. Attorney General Sachs had requested and received authority from the Governor to conduct a criminal investigation into Old Court's management upon learning about MSSIC's March 22, 1985 cease and desist letter.[111] Sachs and Johnson discussed whether to announce the criminal investigation. Sachs contended that, although such investigations are usually not announced by the Attorney

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[108] See May 8, 1985 press release, Exhibit IVH15.

[109] See Exhibit IVH16.

[110] See Exhibit IVH17.

[111] See request of Attorney General Sachs to Governor Hughes for authority for criminal investigation and letter of authority from Governor Hughes to Attorney General Sachs, Exhibits IVH18 and 19.

General's office, the public should be made aware that state government was acting to control the situation. Johnson agreed with him and the announcement was made.

On the morning of May 10, 1985, articles appeared regarding Sachs' criminal investigation of Old Court's management. The lines continued to form at various Old Court offices and the Attorney General convened a team of assistants to draft a conservatorship lawsuit. On May 10, the story of MSSIC's management letter to Merritt was run on Baltimore television stations. Merritt's offices were faced with a run on Saturday morning which resulted in a loss of $3,000,000 in deposits.

MSSIC and the Board of Commissioners spent Saturday and Sunday, May 11 and 12, attempting to find a buyer for Old Court. The Board of Commissioners authorized their chairman, Thomas Gisriel, to make the decision as to whether conservatorship proceedings should be instituted, but only as a last resort. Meetings took place at the offices of VB&H, MSSIC's counsel, with representatives of MSSIC, the Division, Old Court, and various administration and federal officials. Frank Evans, a consultant who recently had been retained by MSSIC and who was a former FSLIC employee, reported an estimate of approximately $200,000,000 in losses in Old Court's loan portfolio. Various proposals were presented by other savings and loan associations to purchase Old Court, but all of the proposals required MSSIC indemnification for losses. MSSIC refused the various proposals because the loss estimate exceeded its insurance fund of $175,000,000. By Sunday evening, May 12, all of the potential purchasers had been rejected. The conservatorship lawsuit had been prepared by the Attorney General's office with supporting affidavits. Attorney General Sachs and his assistants, Ejner Johnson, MSSIC officials and their lawyers, and attorneys for Old Court's stockholders went to the home of Judge Martin B. Greenfeld of the Circuit Court for Baltimore City, where the conservatorship papers were presented and oral argument was heard. The Board of Commissioners consented to the filing of the conservatorship proceeding. The stockholders for Old Court resisted it. After hearing oral argument and reviewing the papers, Judge Greenfeld signed the conservatorship order.

A major article had also appeared in the Baltimore Sunday Sun concerning Merritt's investment in the Merritt Towers. On Monday, May 13, runs continued at Merritt and its board of directors voluntarily sought conservatorship, which was immediately instituted.

Governor Hughes was advised of the runs while he was in Israel and, along with Thomas Maddux, immediately flew home. He arrived in Baltimore on May 13 and proceeded to meet with state and federal officials on May 13 and 14. On May 14, other state associations reported heavier than normal withdrawals. The enormity of the problem was becoming apparent. From the outset, Johnson was haunted by the fact that deposits in MSSIC institutions exceeded the entire State budget. On May 14 at 4:47 p.m., Governor Hughes issued a Proclamation of a state of public crisis and emergency and imposed a $1000 per month limit on depositor withdrawals at MSSIC institutions.

By May 14 there was a consensus, assisted by advice from Chairman Volcker of the Federal Reserve, that the State should not declare a bank holiday as was done in Ohio but should hold harmless all depositors in MSSIC associations. Legislation accomplishing this followed at the Special Session of the General Assembly commencing on May 17. Attorney General Sachs has pointed out the irony of this: Maryland, through MSSIC, did not regulate the savings and loan industry as it had promised; but it did guarantee the deposits as it had <u>not</u> promised.

During the crisis month leading up to the Governor's emergency order, numerous decisions were made by government officials under extreme pressure and often with less than optimum knowledge. There were disagreements among government officials on particular strategies to follow at any given time. MSSIC officials, Division officials, and the Board of Commissioners have contended that the "crisis" could have been avoided if the management change at Old Court had not been announced in the press and if the Attorney General had not announced his criminal investigation. Some of these officials have also blamed the runs on the press itself, which, in their view caused public panic by its accounts of the developments of the crisis. Finally, these officials contend that the situation was well in hand with the management change at Old Court.

Various federal officials, on the other hand, have stated that by April of 1985 a run on the Maryland savings and loan industry was inevitable. Certain associations had been so mismanaged and the regulators had failed to regulate for such a long period of time that public awareness and public loss of confidence was unavoidable. In their view, the only questions that existed were when the run would occur and how it would be dealt with by state officials.

The Office of Special Counsel strongly believes that by April of 1985 a run on MSSIC associations was inevitable and that, given the growth in those associations over preceding years, the sooner it occurred the less the State's loss would be. The MSSIC and Division claim that the situation was "in hand" was fatuous. For example, despite the Agreement which was intended to correct the situation and which had been negotiated over a period of a month between MSSIC and Old Court, and executed on April 23, 1985, federal investigators found a $1,200,000 check drawn from Old Court to Levitt and Cardin for "Two J Airlines" on May 1, 1985. Federal officials believed that an Old Court employee who wanted to cooperate intentionally left the check in an area where they would see it. After the Governor's Proclamation, a check in the amount of $500,000 was paid on Levitt's behalf. Levitt had deposited money by check into the institution and wired the funds out. Levitt's check was subsequently returned for insufficient funds. In short, he was continuing to play the same game he started playing at First Progressive at least seven years earlier; the only difference was that the numbers had grown bigger. Therefore, in our view, the situation was far from "in hand"; the only sensible remedy was to wrest legal control of the institution from the hands of its stockholders. Furthermore, as of the date of the Governor's

Proclamation, the regulatory authorities had little sense of the true financial and management pictures of other associations which we have described in this Report, some of which have subsequently required conservatorship proceedings.

Although this report contains criticism of state officials at various levels, we believe that it is appropriate here to reiterate comments by various federal authorities who dealt with Maryland officials during the "crisis" period from April through the Special Session of General Assembly. One federal official, when advised that he would be working with Maryland elected officials through the crisis, stated that he expected the worst, given Maryland's recent history of political corruption. He proceeded to state that, without exception, he found the Maryland officials, including the Governor, the President of the Senate, Speaker of the House, and the Attorney General, "outstanding" in their handling of the crisis. Federal representatives in general stated that Maryland officials at all times worked solely with a view toward protecting the public interest and without inclination for political aggrandizement. They believed that the Governor's Proclamation was critical in stopping major runs which could have infected other financial institutions and that the First Special Session of the General Assembly passed critical and responsible legislation, which was necessary to prevent the runs from spreading and to prevent loss of confidence in other sectors of the financial community.

V. CONCLUSION

Our Report focuses on the history of savings and loan practices and their regulation in Maryland. This conclusion looks to the future.

At the Governor's request, we have drafted a complete recodification of Titles VIII and IX of the Financial Institutions Article. One of the basic themes of the draft legislation is to extricate regulation of the savings and loan associations from industry control by making the Board of Commissioners advisory and by having it controlled by a majority of public members. The powers of the Division Director have been expanded to include certain emergency powers, such as the authority to issue immediately effective cease and desist orders and to remove officers and directors. We also have strengthened the statutory prohibitions against conflicts of interest, tightened provisions regarding authorized investments and provided for civil and criminal penalties for certain statutory violations. We acknowledge that some of the provisions we have drafted are controversial. We believe, however, that it is extremely important for the State to consider and enact statutes which embody the substance of our recommendations. Of course, a regulatory program, no matter how strong, will be effective only if competent regulators choose to enforce it.

In the course of our investigation, we have made confidential recommendations for criminal investigations. We will continue to make such referrals, if warranted. We also will continue to investigate potential civil actions for the State of Maryland and for MDIF to recover any losses sustained as a result of wrongful acts previously discussed in this Report and we will recommend appropriate civil actions.

Finally, we recommend that the Administration and the General Assembly consider what has happened in the savings and loan industry in reviewing other State regulatory schemes, particularly where the industry has a substantial control over the regulatory machinery. Although industry input may be important, we believe that industry control is entirely inappropriate.