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An earlier version of portions of this Article—in particular the background discussion of the savings and loan industry in Part II and the description of the liability decisions in Part III—was published in the Public Contract Law Journal and is reprinted with permission of the American Bar Association. *See* Rodger D. Citron, *Lessons from the Damages Decisions Following* United States v. Winstar Corp., 32 PUB. CONT. L.J. 1 (2002).

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I. INTRODUCTION

Often it is said that there is a divide between the practice of law and the concerns of legal academics.[1] This sentiment may apply with equal force to the business of banking and the pursuits of scholars of financial institutions.[2] Such views arise because, in part, the realms of theory and practice do not intersect often. When they do, as they have in a set of cases following the Supreme Court's decision in *United States v. Winstar Corp.*,[3] the intersection is worth considering.[4]

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1. *See, e.g.*, Harry T. Edwards, *The Growing Disjunction Between Legal Education and the Legal Profession*, 91 MICH. L. REV. 34, 57 (1992) ("Legal practice is not only increasingly disjoined from legal scholarship, but from legal pedagogy as well."); *see also* Deborah Rhode, *Legal Scholarship*, 115 HARV. L. REV. 1327 (2002) (evaluating the state of contemporary American legal scholarship).

2. *See, e.g.*, Merton H. Miller, *Do the M&M Propositions Apply to Banks?*, 19 J. BANKING & FIN. 483, 483-84 (1995) (describing author's hostile reception at banking conference).

3. 518 U.S. 839 (1996).

4. There is a growing literature on the Supreme Court's decision in *Winstar*. *See* Jonathan R. Macey, *Winstar, Bureaucracy and Public Choice*, 6 SUP. CT. ECON. REV. 173 (1998) (arguing that the Supreme Court's decision in *Winstar* was contrary to the public interest); David Dana & Susan P. Koniak, *Bargaining in the Shadow of Democracy*, 148 U. PA. L. REV. 473, 476 (1999) (noting that "[r]egulatory contracts, especially the regulation-for-performance variety, are suddenly in vogue" after the "Supreme Court recently placed its imprimatur on approval of such contracts in *United States v. Winstar Corp.*"); Daniel R. Fischel & Alan O. Sykes, *Governmental Liability for Breach of Contract*, 1 AM. L. & ECON. REV. 313, 320 (1999) (describing *Winstar* as "probably the most important government contracts case ever decided"); Gillian Hadfield, *Of Sovereignty and Contract: Damages for Breach of Contract by Government*, 8 S. CAL. INTERDISC. L.J. 467, 482-88 (1999) (discussing *Winstar*); Abraham L. Wickelgren, *Damages for Breach of Contract: Should the Government Get Special Treatment?*, 17 J.L. ECON. & ORG. 121, 126 (2000) (examining the Court's holding in *Winstar* that the government is liable for damages for breach of contract); Richard E. Speidel, *Contract Excuse Doctrine and Retrospective Legislation: The* Winstar *Case*, 2001 WIS. L. REV. 795, 796 (2001) (analyzing the *Winstar* Court's use of "general principles of private contract law to decide public law questions of risk allocation and remedy in the face of retrospective legislation"); *see also* Joshua Schwartz, *Liability for Sovereign Acts: Congruence and Exceptionalism in Government Contracts Law*, 64 GEO. WASH. L. REV. 633, 637-38 (1996) [hereinafter Schwartz, *Liability for Sovereign Acts*] (describing the tension raised by *Winstar* between "exceptionalism" and "congruence" in government contracts law); Joshua Schwartz, *Assembling* Winstar*: Triumph of the Ideal of Congruence in Government Contracts Law?*, 26 PUB. CONT. L.J. 481, 482 (1997) [hereinafter

Winstar established the United States' liability for breach of regulatory contract in three cases in which acquirers of troubled savings and loan institutions sought favorable regulatory accounting treatment in exchange for doing the acquisitions.[5] The Supreme Court remanded the *Winstar* cases to the United States Court of Federal Claims for damages proceedings.[6] Although only three cases were involved in the appeal to the Supreme Court, there still are nearly 100 similar cases raising claims for compensation by acquirers of thrifts pending in the lower courts.[7]

In turn, the Court of Federal Claims has become a forum for evaluating the relevance of the basic principles of corporate finance—specifically, the Miller & Modigliani ("M&M") Propositions concerning capital structure and debt-equity ratios—to claims by savings and loan institutions for lost profits damages. In their 1958 article, Professors Merton Miller and Franco Modigliani set out a number of foundational principles of corporate finance, including the principle that the value of a private firm is independent of the mix of debt and equity used to fund its assets.[8] The results thus far are mixed. The courts have not embraced the M&M Propositions, as evidenced by their decisions to allow plaintiffs to present claims for lost profits damages and, in a smaller number of

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Schwartz, *Triumph of the Ideal*] (noting that in *Winstar*, the "Supreme Court addressed important issues concerning the liability of the United States for enactment of legislation or for other 'sovereign acts' that interfere with the performance of a government contract" and attempting to synthesize the "severely fragmented" decision). However, the more recent damages decisions have received scant attention in the academic literature. *But see* Rodger D. Citron, *Lessons from the Damages Decisions Following* United States v. Winstar Corp., 32 PUB. CONT. L.J. 1 (2002) [hereinafter Citron, *Lessons*]; *see also* Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 TEX. L. REV. 2021 (2001) (discussing approach to restitution in several *Winstar* cases).

5. Dana & Koniak, *supra* note 4, at 480 (defining regulatory contracts as "contracts between government entities and private actors subject to, or potentially subject to, regulation in which the government promises to maintain . . . a specified regulatory regime in exchange for either money or performance by the private party").

6. *Winstar*, 518 U.S. at 910.

7. Marcia Coyle, *Broken Promises May Bust Budget*, NAT'L L.J., April 27, 1998, at A1; Margaret Cronin Fisk, *S&L Cases Moving, but U.S. Draws Flak: A 'Scorched Earth' Defense Policy*, NAT'L L.J., Sept. 9, 2002, at A1 ("Of the 122 cases originally filed, only six have been settled; 19 others were voluntarily dismissed by the plaintiffs.").

8. Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

cases, their discussion of the M&M Propositions. Nevertheless, courts generally have arrived at the results dictated by the M&M Propositions in awarding damages to claimants.[9]

The focus in the damages decisions is on whether an acquiring thrift with supervisory goodwill was damaged by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)[10] phase-out and, if so, how it was damaged. Supervisory goodwill, as Justice Souter observed in his plurality opinion in *Winstar*, allowed an acquiring thrift to make more investments than it otherwise would have been able to, because it could include an intangible accounting entry in its regulatory capital requirements.[11] Such an acquiring thrift could then operate with more debt and less equity than a comparable thrift that had not engaged in such an acquisition.

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9. Dr. Merton Miller testified at trial in five cases involving claims by acquirers. In four of the cases the claimant sought lost profits based upon a claim that the government's breach of a goodwill promise caused the claimant to forego profitable business opportunities. *See* Glendale Fed. Bank v. United States, 43 Fed. Cl. 390, 400 & n.3, 409 (1999), *aff'd in part, vacated in part*, 239 F.3d 1374 (Fed. Cir. 2001), *after remand*, 54 Fed. Cl. 8 (2002); Cal. Fed. Bank v. United States, 43 Fed. Cl. 445, 449, 457-59, 460-62 (1999), *aff'd in part, rev'd in part*, 245 F.3d 1342 (Fed. Cir. 2001), *dismissed on remand*, 54 Fed. Cl. 704 (2002); LaSalle Talman Bank v. United States, 45 Fed. Cl. 64, 68-69, 87-112 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003); Bank United of Tex. v. United States, 50 Fed. Cl. 645, 646 (2001), *appeal pending*. The fifth case, *Bluebonnet Savings Bank v. United States*, involved a claim that the government breached a "capital plan and subordinated debt forbearances" previously promised by the government. Bluebonnet Sav. Bank v. United States, 47 Fed. Cl. 156, 162 (2000), *rev'd*, 266 F.3d 1348 (Fed. Cir. 2001), *after remand*, 52 Fed. Cl. 75 (2002).

As this Article was in page proofs, the Federal Circuit issued its decision in *LaSalle*. LaSalle Talman Bank v. United States, Nos. 00-2005, 00-2057, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003). The court of appeals affirmed the trial court's decision on liability and restitution and its award of slightly more than $5 million in mitigation costs. *Id.* at *12. It also remanded the case to the trial court for further proceedings on the cost of replacement and lost profits claims. *Id.* at *9-10, 12. Although the Federal Circuit made reference to principles of corporate finance insofar as it discussed the "cost of capital," it did not specifically discuss the value of leverage or comment on the testimony of Dr. Miller. *Id.* at *9-10. Due to the publication schedule, a more extended discussion of this recent decision is not possible in this Article.

10. The Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

11. United States v. Winstar Corp., 518 U.S. 839, 850-51 (1996).

The United States, citing the M&M Propositions, has insisted that the only recoverable damages by a claimant are its mitigation costs—that is, the costs associated with obtaining replacement capital.[12] The thrift claimants have responded that they were unable to mitigate and, therefore, should be entitled to present claims for lost profits damages.[13] Furthermore, they have argued that the M&M Propositions are not relevant to the evaluation of their claims given the availability of deposit insurance, which they insist is a subsidy of that particular form of debt.[14]

In 1999, the Court of Federal Claims entered a $909 million judgment, one of the largest ever entered against the United States, in the first supervisory goodwill damages decision, *Glendale Federal Bank v. United States*.[15] In allowing the thrift claimant to present a claim for lost profits, the trial court did not agree with the United States' arguments based upon the M&M Propositions and expressly rejected the testimony of Dr. Miller as "theoretical."[16] The trial court did not, however, award lost profits. Subsequently, in 2001, an appeals court vacated the judgment in *Glendale* and remanded the case to the trial court for further proceedings.[17]

In the journey from the Supreme Court's decision in *Winstar* to the current damages decisions, the lower courts developed a more

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12. *See, e.g.*, *LaSalle*, 45 Fed. Cl. at 102-03 ("[D]efendant contends that plaintiff is entitled to only transaction costs . . . that would have been necessary to raise the replacement capital.").

13. *See, e.g.*, *id.* at 103 (describing the thrift's inability to mitigate by issuing preferred stock in 1989, after enactment of FIRREA).

14. *LaSalle*, 45 Fed. Cl. at 79; Glendale Fed. Bank v. United States, 43 Fed. Cl. 390, 401 n.4 (1999), *aff'd in part, vacated in part*, 239 F.3d 1378 (2001), *after remand*, 54 Fed. Cl. 8 (2002).

15. 43 Fed. Cl. 390, 410 (1999). The size of the judgment prompted concerns that the Supreme Court had opened the floodgates to litigation that could bankrupt the Treasury. *See, e.g.*, Stephen Labaton, *West Coast S. & L. Wins $909 Million from Government*, N.Y. TIMES, Apr. 10, 1999, at A1 ("If the reasoning of [*Glendale*] is upheld on appeal, experts say it could, in effect, reopen the huge bailout of the savings and loan industry, adding $30 billion to $50 billion to the costs of the most expensive financial debacle in American history."); *see also* Coyle, *supra* note 7, at A1 ("[A]s with the eye-popping verdicts the thrifts have demanded, these new claimants, if victorious, could further threaten the government's projected multibillion dollar budget surpluses.").

16. *Glendale*, 43 Fed. Cl. at 402.

17. *Glendale*, 239 F.3d at 1384. On remand, the trial court awarded the thrift $381 million in reliance damages. *Glendale*, 54 Fed. Cl. at 14. That decision currently is subject to a petition for reconsideration and is likely to be subject to appeal.

complete understanding of the economics of the savings and loan industry, and of the accounting techniques used by regulators during the 1980s. As a result, the courts generally have awarded judgments that amount to the reimbursement of reliance expenditures.[18] At the same time, the courts generally have not been persuaded to apply the M&M Propositions in resolving the thrifts' claims for damages.[19] Indeed, the only trial court decision to embrace the M&M Propositions—a summary judgment in favor of the United States and against California Federal Bank on the thrift's claim for lost profits—was reversed by the Federal Circuit, which concluded that the thrift was entitled to a trial on that particular claim.[20]

This Article is an attempt to bridge the gap between practice and theory by describing and discussing the debate over the M&M Propositions in the goodwill damages decisions. Part II presents a brief history of the savings and loan industry. Part III provides an overview of the litigation of the United States' liability for breach of

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18. In the five cases in which Dr. Miller testified at trial, no thrift claimant was awarded lost profits for a reduced ability to leverage. *See Glendale*, 43 Fed. Cl. 390, 400 & n.3, 409 (1999) (rejecting lost profits claim and awarding $909 million in restitution and nonoverlapping reliance damages), *aff'd in part, vacated in part*, 239 F.3d 1374 (Fed. Cir. 2001) (vacating judgment), *after remand*, 54 Fed. Cl. 8, 14 (2002) (reinstating $381 million in "wounded bank" and other incidental reliance damages); Cal. Fed. Bank v. United States, 43 Fed. Cl. 445, 449, 457-59, 460-62 (1999) (awarding $23 million in replacement costs, rejecting claims for lost profits), *aff'd in part, rev'd in part*, 245 F.3d 1342, 1348-50 (Fed. Cir. 2001) (affirming cost of replacement award, remanding case for trial on lost profits damages), *dismissed on remand*, 54 Fed. Cl. 704 (2002); LaSalle Talman Bank v. United States, 45 Fed. Cl. 64, 68-69, 87-112, 120 (1999) (rejecting claim for lost profits, and awarding $5 million for mitigation costs), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250, at *9, 10-12 (Fed. Cir. Jan. 14, 2003) (vacating judgment in part and remanding case for further proceedings on lost profits and cost of replacement capital); Bluebonnet Sav. Bank v. United States, 47 Fed. Cl. 156, 186 (2000) (rejecting plaintiffs' claims for damages), *rev'd*, 266 F.3d 1348 (Fed. Cir. 2001), *after remand*, 52 Fed. Cl. 75, 77-78 (2002) (awarding $132 million pursuant to remand order); Bank United of Tex. v. United States, 50 Fed. Cl. 645, 646 (2001) (awarding $8.8 million in mitigation costs, rejecting lost profits claims), *appeal pending*.

19. *See, e.g., LaSalle*, 45 Fed. Cl. at 79 ("Although Professor Miller may be a brilliant academic, his generalized theories bear little relation to the specific context of the savings and loan industry."); *see also id.* at 79-80 & nn.14-16; *see also Glendale*, 43 Fed. Cl. at 401 n.4 (recognizing that Dr. Miller was "a brilliant scholar" but concluding that his testimony "regarding the value of leverage [was] of little utility in this case").

20. *See Cal. Fed. Bank*, 245 F.3d at 1350 (concluding that trial court "erred by not permitting Cal Fed to present its evidence [of lost profits] at a trial").

contract, quickly summarizing the opinions in *Winstar*. Part IV explores how the M&M Propositions have fared in the goodwill damages decisions. That Part first explains why the damages decisions—involving claims for breach of contract—implicate the M&M Propositions, and then it describes the courts' views with respect to the application of the M&M Propositions. The mixed results, in which the courts have generally rejected the relevance of the M&M Propositions but nevertheless arrived at the results dictated by the propositions, suggest a clash between the cultures of corporate finance and the Court of Federal Claims. Part IV concludes with some tentative thoughts on why this intersection between theory and practice has prompted this clash.

II. THE SAVINGS AND LOAN INDUSTRY IN THE 1980S

A. *The First and Second Thrift Crises of the 1980s*

Since the Great Depression of the 1930s, the savings and loan industry has been extensively regulated by the federal government. Three acts of Congress established the structure of the savings and loan industry that lasted through the enactment of FIRREA in 1989.[21] First, in 1932, the Federal Home Loan Bank Act created the Federal Home Loan Bank Board (FHLBB).[22] Second, the Home Owners' Loan Act of 1933 authorized the Bank Board to regulate federal savings and loan institutions.[23] Finally, in 1934, the National Housing Act created the Federal Savings and Loan Insurance Corporation (FSLIC), which was responsible for insuring thrift deposits.[24] Under this structure, the federal government had a dual role in the savings and loan industry. On one hand, it wanted the industry to grow and prosper, and could make funds available to thrifts for that purpose.[25] At the same time, the federal government

21. *See* United States v. Winstar Corp., 518 U.S. 839, 844 (1996).

22. Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449 (2000)).

23. Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 128 (1933) (codified as amended at 12 U.S.C. §§ 1461-68 (2000)).

24. National Housing Act, ch. 847, 48 Stat. 1246 (1934) (codified as amended at 12 U.S.C. §§ 1701-1750g (2000)).

25. *See* LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 54 (1991).

was responsible for regulating thrifts to ensure their safety and soundness and for insuring deposits in savings and loan institutions.

From the 1930s through the early 1980s, a typical thrift's business consisted of taking in short-term deposits in order to make long-term fixed-rate mortgage loans.[26] This arrangement worked for most savings and loan institutions, especially in the era of prosperity that followed World War II. As an insurer, the federal government only rarely had to intervene and take over or liquidate a savings and loan institution.[27]

In the late 1970s, the stable environment in which savings and loan institutions operated was shattered by soaring interest rates. In particular, "short-term interest rates rose above long-term interest rates," causing the market value of a thrift's long-term fixed-rate mortgages to fall.[28] At the same time, a thrift's short-term deposit liabilities increased as they repriced constantly.[29] As Justice Souter summarized: "Many thrifts found themselves holding long-term, fixed-rate mortgages created when interest rates were low; when market rates rose, those institutions had to raise the rates they paid to depositors in order to attract funds."[30]

Due to the mismatch in interest rates, the typical thrift became insolvent on an economic basis, meaning that the market value of its liabilities was greater than the market value of its assets.[31] Over time, the economic condition of many thrifts was reflected on their books, so that they became insolvent on a book (or accounting) basis. In the early 1980s, the savings and loan industry had a massive negative market value, and nearly all thrifts were insolvent on an economic basis.[32]

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26. *See, e.g.*, James R. Barth, *The S&L Crisis, 10 Years Later: Government Errors Caused the Problems and They Still Do*, NAT'L POST, Sept. 20, 1999, at C7 ("Since the 1930s, S&Ls had been required by law to make long-term, fixed-rate home mortgages funded by short-term deposits.").

27. *See* WHITE, *supra* note 25, at 59-60.

28. Barth, *supra* note 26.

29. Barth, *supra* note 26.

30. United States v. Winstar Corp., 518 U.S. 839, 845 (1996).

31. Barth, *supra* note 26.

32. *See* Sridhar Sundaram et al., *The Market Valuation Effects of the Financial Institutions Reform, Recovery and Enforcement Act of 1989*, 16 J. BANKING & FIN. 1097, 1097-98 (1992) ("The financial condition of the thrift industry had significantly deteriorated in the years 1979-82 during which the industry's net income fell from \$2.05 billion to a net loss of \$3.2 billion."); *see also* WHITE, *supra* note 25, at 70-72; JAMES R. BARTH, THE GREAT SAVINGS AND

As thrifts became insolvent on a book basis, the FSLIC was obligated to respond. The agency was overwhelmed by the situation and lacked the funds to immediately pay off depositors at book-insolvent institutions.[33] FSLIC did not, however, have to make a massive, immediate payment to the depositors at troubled institutions. As long as a thrift did not have to pay off all of its depositors at one time, it could continue to operate and hope that interest rates would fall. Lacking the funds to resolve all of the troubled institutions, federal regulators sought to promote the appearance of health in the savings and loan industry while waiting for interest rates to decline.[34] Thrifts shared this goal for a number of reasons, including concern over the loss of depositors to other investment opportunities, such as mutual funds.

Savings and loan regulators employed a number of strategies to allow even the most financially distressed thrifts to continue to operate. Capital requirements were lowered from five percent to three percent, and even thrifts that could not satisfy these requirements were allowed to continue to operate, frequently through the use of accounting "gimmicks" intended to give the appearance of solvency and regulatory compliance.[35]

The accounting gimmick giving rise to *Winstar* resulted from the regulators' actions with respect to mergers. Sometimes they approved proposed mergers; other times they played a more active role in encouraging the acquisition of a troubled savings and loan institution.[36] Perhaps the most common form of consideration

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LOAN DEBACLE 38 (1991) ("On a market-value basis, the entire industry was deeply insolvent in 1981 and even in 1980 before any of the accounting measures of capital revealed the seriousness of the problem.")

33. *Winstar*, 518 U.S. at 846-47.

34. *See, e.g.*, Cal. Fed. Bank v. United States, 43 Fed. Cl. 445, 461-62 (1999) (stating that the government and bank "essentially contracted to call liabilities 'assets' and used them to improve the bank's apparent health") *aff'd in part, rev'd in part*, 245 F.3d 1342 (Fed. Cir. 2001), *dismissed on remand*, 54 Fed. Cl. 704 (2002).

35. *Winstar*, 518 U.S. at 846 n.2; *see also* Robert A. Eisenbeis & Paul M. Horvitz, *The Role of Forbearance and Its Costs in Handling Troubled and Failed Depository Institutions*, *in* REFORMING FINANCIAL INSTITUTIONS AND MARKETS IN THE UNITED STATES 59 (George Kaufman ed., 1993) ("[T]he FSLIC, both because of financial constraints and political considerations, engaged in a series of accounting and related gimmicks to give the illusion that . . . GAAP insolvent institutions were in fact solvent.").

36. The United States has insisted that, in many of the savings and loan transactions, the federal government was acting as a regulator in reviewing and approving mergers or acquisitions proposed by various thrifts, and that these

provided by the regulators was permission to use the purchase method of accounting.[37] This, in turn, gave rise to an accounting entry known as supervisory goodwill, which "enabled an acquiring thrift to acquire an insolvent thrift, [and] mark the assets and liabilities of the acquired insolvent thrift to market as required by the applicable accounting rules," but nevertheless continue to comply with regulatory capital requirements they otherwise would not have been able to meet.[38]

Along with net worth certificates, income capital certificates, and other regulatory accounting devices, supervisory goodwill became a favored tool of the regulators.[39] As Robert A. Eisenbeis and Paul M. Horvitz summarized:

> On an industry wide basis, the situation of the thrift industry in the high-rate period of 1981-1982 is an example of widespread agency-sanctioned forbearance. The systematic policy of the Federal Home Loan Bank Board was to avoid closing institutions that were market-value insolvent during this period.[40]

Congress responded to the thrift crisis by enacting the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)[41] and the Depository Institution Act of 1982 (DIA

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regulatory actions should not be held to bind the government to a contract. *See, e.g.*, *Cal. Fed. Bank*, 245 F.3d at 1346-48 (rejecting the government's argument that it did not enter into a contract for recognition and "long-term amortization of goodwill" based upon contemporaneous documents and surrounding circumstances); *see also* Joshua Schwartz, *The Status of the Sovereign Acts and Unmistakability Doctrines in the Wake of* Winstar*: An Interim Report*, 51 ALA. L. REV. 1177, 1223-24 (2000) (noting that, with respect to liability issues, "[i]n the savings and loan context, the United States Court of Federal Claims has been reluctant to distinguish any of the other claims from those in *Winstar* itself").

37. *See, e.g.*, Charter Fed. Sav. Bank v. Office of Thrift Supervision, 976 F.2d 203, 204-05 (4th Cir. 1992) (describing the FHLBB use of supervisory goodwill to encourage acquisition of financially troubled thrifts).

38. Fischel & Sykes, *supra* note 4, at 361. For a detailed discussion of the accounting techniques and regulatory practices giving rise to supervisory goodwill, see Richard C. Breeden, *Thumbs on the Scale: The Role that Accounting Practices Played in the Savings and Loan Crisis*, 59 FORDHAM L. REV. S71 (1991).

39. *Winstar*, 518 U.S. at 846 n.2.

40. Eisenbeis & Horvitz, *supra* note 35, at 59.

41. Pub. L. No. 96-221, 94 Stat. 132.

or Garn-St Germain Act).[42] Together these Acts "phased out interest rate ceilings," attempted to address the interest rate mismatch between short-term deposits and long-term mortgage loans by allowing thrifts to diversify their investments, and, as a means of attracting or retaining depositors, increased the deposit insurance guarantee.[43] The combination of diversified investment opportunities and the increased deposit insurance guarantee made more insured funds available for more risky lending projects.[44]

The combination of the government's forbearance policy and its allowance of diversification by thrifts in their investments encouraged even "greater leverage in real estate investments."[45] As the decade progressed, it turned out that many thrifts lacked the ability or experience to compete effectively in the real estate business, especially when the market experienced a downturn in the Southwest following the fall in oil prices in the mid-1980s. In addition, there was a "general decline in commercial real estate prices following passage of the Tax Reform Act of 1986."[46] Yet as losses continued to grow at many thrifts, the government maintained a "policy of capital forbearance [that] delayed the closing of insolvent thrifts and overstated the institutions' net worth positions."[47]

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42. Pub. L. No. 97-320, 96 Stat. 1469.

43. Sundaram et al., *supra* note 32, at 1098.

44. *See* Sundaram et al., *supra* note 32, at 1098 (describing combination of policies that "exacerbated the financial deterioration of many thrifts and fostered the growing crisis in the industry").

45. *See* Barth, *supra* note 26, at C7.

46. Sundaram et al., *supra* note 32, at 1098. For further reference, see also Stanley I. Langbein, *The Thrift Crisis and the Constitution*, 53 WASH. & LEE L. REV. 159, 196 (1996):

> [I]n this second phase of the crisis, it was not interest-spread difficulties that were at the heart of the crisis, but asset quality problems. The problems were particularly acute in Texas, where the collapse of oil prices in 1985 and 1986 led to a collapse in real estate prices, which led, in turn, to the souring of real estate loans held by the thrifts; similar problems occurred in other 'oil patch' states, in Florida, and also in California.

47. Sundaram et al., *supra* note 32, at 1098.

These economic and regulatory developments culminated in the second thrift crisis of the late 1980s.[48] FSLIC was even more overwhelmed than it had been by the crisis caused by the interest rate spike of the early 1980s and lacked adequate funds to meet the deposit guarantees of hundreds of failing savings and loan institutions.[49] The politics of the crisis—not just the magnitude of the investment losses, but the fact that some thrifts' losses resulted from widely publicized fraudulent conduct by owners and managers—prompted escalating calls to overhaul the industry.[50] In 1989, as the decade came to a close and the costs of the thrift crisis mounted, Congress enacted a comprehensive statute to reform the savings and loan industry.[51] Among other things, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) accelerated the phase-out of supervisory goodwill as an asset in regulatory capital calculations.[52]

B. FIRREA

FIRREA addressed the thrift crisis in a number of ways. It provided funds to close and merge insolvent savings and loan institutions.[53] FIRREA restructured the agencies responsible for regulating thrifts, abolishing the FHLBB and assigning its regulatory responsibilities to the Office of Thrift Supervision (OTS), a new agency under the Department of Treasury.[54] It also eliminated the FSLIC, transferring its insurance responsibilities to the Federal Deposit Insurance Corporation (FDIC), and created the Resolution Trust Corporation (RTC), which was responsible for liquidating or arranging the sale of troubled thrifts from 1989 through 1995.[55]

FIRREA adopted tighter capital requirements. Although the statute did not require the immediate deduction of supervisory

48. Sundaram et al., *supra* note 32, at 1098. For further discussion of the events leading to the second thrift crisis, see generally WHITE, *supra* note 25, and BARTH, *supra* note 32.

49. Sundaram et al., *supra* note 32, at 1098.

50. *See* Langbein, *supra* note 46, at 201-03 (chronicling the actions of the political parties and their response to the crisis).

51. Pub. L. No. 101-73, 103 Stat. 183.

52. The regulatory capital provisions, including the "transition rule" for the phase-out of "qualifying supervisory goodwill," are located at 12 U.S.C. § 1464(t).

53. *Winstar*, 518 U.S. at 856-57.

54. *Id.*

55. *Id.*

goodwill from regulatory capital, it initially limited the amount of supervisory goodwill that could be counted towards capital to 1.5 percent of a thrift's assets.[56] Moreover, this "qualifying supervisory goodwill" had to be phased out as regulatory capital over a shorter time interval, a period of about five years.[57] FIRREA's capital requirements required a thrift, for the first time, to maintain a minimum amount of tangible capital.[58]

The government, as insurer, would pay off the thrift's depositors in the event of failure.[59] Therefore, as Professor Macey has explained, "[t]he requirement that a federally insured depository institution retain adequate capital is one of the few and perhaps 'the most powerful source of (market) discipline for financial institutions.'"[60] With their emphasis on tangible or "real" capital, instead of capital created by regulatory accounting techniques, FIRREA's capital requirements imposed market discipline by requiring a firm's owners to bear the firm's risk of failure as well as the benefits of its success. Before FIRREA, the owners enjoyed the latter without necessarily having to put their own money at risk.[61] Not surprisingly, the Supreme Court noted that FIRREA's capital

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56. 12 U.S.C. § 1464(t)(3)(A).

57. 12 U.S.C. § 1464(t)(3). The Supreme Court summarized:

> FIRREA . . . obligated OTS to "prescribe and maintain uniformly applicable capital standards for savings associations" in accord with strict statutory requirements. In particular, the statute required thrifts to "maintain core capital in an amount not less than 3 percent of the savings association's total assets," and defined core capital to exclude "unidentifiable intangible assets," such as goodwill. Although the reform provided a "transition rule" permitting thrifts to count "qualifying supervisory goodwill" toward half the core capital requirement, this allowance was phased out by 1995.

United States v. Winstar Corp., 518 U.S. 839, 856-57 (1996) (citations omitted). Then, "[o]n November 8, 1989, OTS published interim final rules, effective December 7, 1989, implementing FIRREA's capital requirements." Ariadne Fin. Serv. Party Ltd. v. United States, 133 F.3d 874, 877 (Fed. Cir. 1998) (citation omitted), *cert. denied*, 525 U.S. 823 (1998).

58. 12 U.S.C. § 1464(t)(3)(A).

59. *See, e.g.*, Macey, *supra* note 4, at 185 (stating that FIRREA created a new insurance fund).

60. Macey, *supra* note 4, at 185 (quoting Richard C. Breeden, *Thumbs on the Scale: The Role that Accounting Practices Played in the Savings and Loan Crisis*, 59 FORDHAM L. REV. S71, S75 (1991)).

61. Macey, *supra* note 4, at 185.

requirements were described as "the 'heart' of the legislative reform."[62]

FIRREA also restricted the diversification in a thrift's portfolio of assets. For example, thrifts were no longer allowed to invest in noninvestment grade (or "junk") bonds, were restricted in their ability to invest in real estate, and were required to hold more housing-related assets (which were less risky than investments permitted by earlier laws, such as commercial real estate).[63] In addition, FIRREA required banks and S&Ls to pay higher deposit insurance premiums.[64] Subsequent legislation, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),[65] included a provision requiring the FDIC to base deposit insurance premiums on the relative riskiness of a thrift.[66]

III. THE SUPREME COURT'S LIABILITY DECISION IN *UNITED STATES V. WINSTAR CORP.*

A. *The Savings and Loan Litigation in the Lower Courts*

After the enactment of FIRREA, many savings and loan institutions sued over the statute's more stringent capital requirements. Some thrifts sued for damages, alleging breach of contract and takings claims in the Court of Federal Claims.[67] The three cases that were consolidated for appellate review and ultimately decided by the Supreme Court in *Winstar* involved acquisitions by different entities at different times: Glendale, a large California savings and loan institution, acquired Broward, a Florida institution, in 1981; Winstar Corp., an investment holding company,

62. United States v. Winstar Corp., 518 U.S. 839, 857 n.11 (quoting remarks of Sen. Riegle, 135 CONG. REC. 18,863 (1989)).

63. Sundaram et al., *supra* note 32, at 1101.

64. Sundaram et al., *supra* note 32, at 1101.

65. Pub. L. No. 102-242, 105 Stat. 2236 (1991) (to be codified in scattered sections of 12 U.S.C.).

66. *Id.* at 12 U.S.C. § 1815.

67. Others sued in United States District Court, seeking injunctive relief to prevent application of the new capital rules. These suits were unsuccessful, as the courts essentially concluded that even assuming there were enforceable contracts between the thrifts and the federal government, such contracts could not be construed to prevent the application of the new law. *See generally* Langbein, *supra* note 46, at 218-27 (summarizing district court litigation).

was formed to acquire a troubled institution in 1984; and Statesman Savings Holding Corp. invested $21 million and received $60 million to acquire four troubled institutions in 1988.[68]

In these three cases, the acquirers moved for summary judgment.[69] Despite the factual differences in the underlying acquisitions, the story told by the acquiring entities was essentially the same: the acquiring entity was healthy, and it was relieving the United States of an obligation to most likely liquidate troubled savings and loan institutions.[70] The acquiring entities further maintained that the acquisition would have been detrimental for the acquiring entity absent a promise from government regulators guaranteeing the treatment of supervisory goodwill as regulatory capital.[71] The acquirers asserted that the enactment of FIRREA and its stringent capital requirements, including the phase-out of supervisory goodwill as regulatory capital, caused the thrift to either go out of business (as was the case with Winstar and Statesman) or experience severe disruption of its business operations (as was the case with Glendale).[72]

In response, the United States asserted a number of global defenses, based upon its status as the sovereign;[73] these defenses are discussed in more detail below. The Court of Federal Claims rejected the government's "special" defenses and held that FIRREA's capital requirements breached agreements to allow the institutions to include supervisory goodwill as an asset for regulatory capital calculations and to amortize that supervisory goodwill over long periods of time.[74] The court entered summary judgment on the contract claims of the acquirers of three savings and loan

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68. United States v. Winstar Corp., 518 U.S. 839, 858-67 (1996).

69. *Id.* at 858-59 (citing Winstar Corp. v. United States, 21 Cl. Ct. 112, 114 (1990); Winstar Corp. v. United States, 25 Cl. Ct. 541, 544 (1992); Statesman Sav. Holding Corp. v. United States, 26 Cl. Ct. 904, 907 (1992)).

70. *Winstar*, 518 U.S. at 860-68; *Winstar*, 21 Cl. Ct. at 113; *Winstar*, 25 Cl. Ct. at 543; *Statesman*, 26 Cl. Ct. at 907-11.

71. *Winstar*, 518 U.S. at 850; *Winstar*, 21 Cl. Ct. at 113-14; *Winstar*, 25 Cl. Ct. at 543; *Statesman*, 26 Cl. Ct. at 907-11.

72. *Winstar*, 518 U.S. at 858.

73. *See, e.g.*, *Winstar*, 518 U.S. at 871, 891 (addressing the government's claim that contracts limiting future governmental regulatory powers are rarely recognized and then only when restrictions are stated "in unmistakable terms," and that FIRREA's change in the capital requirement was excused under the "sovereign acts doctrine").

74. *See id.* at 858-59.

institutions.[75] The Federal Circuit initially agreed with the United States' arguments on appeal, then vacated its opinion and ultimately affirmed, en banc, the decisions below.[76]

The United States appealed to the Supreme Court.[77] When the United States petitioned the Supreme Court, no discovery had occurred in the lower court proceedings, and the United States had not developed a counter-story about the parties' costs of and incentives for entering into the acquisitions or the consequences of the breach of the alleged agreements through the enactment of FIRREA.[78] In its papers before the Supreme Court, the United States asserted that there were literally billions of dollars at stake in the goodwill cases.[79] If the government prevailed on one of its global defenses, it would avoid liability not only in the three cases before the Supreme Court but also in more than 100 goodwill cases pending in the courts below. The Supreme Court nevertheless rejected the government's arguments and affirmed the Federal Circuit by a 7-2 vote.[80] The decision produced four opinions, none of which commanded a majority.[81]

B. The Supreme Court Opinions in Winstar

Justice Souter wrote a lengthy plurality opinion—joined by Justices Stevens and Breyer (who wrote a short concurring opinion),[82] and joined in part by Justice O'Connor—emphasizing that, in the goodwill cases, the United States had acted like a private party and therefore should be subject to ordinary contract law

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75. *See Winstar*, 21 Cl. Ct. at 117 (holding that the government was a party to the implied-in-fact contract); *Winstar*, 25 Cl. Ct. at 553 (entering summary judgment on liability); *Statesman*, 26 Cl. Ct. at 924 (entering summary judgment on liability to Statesman and Glendale).

76. Winstar Corp. v. United States, 64 F.3d 1531, 1534, 1551 (1995).

77. *Winstar*, 518 U.S. at 859-60.

78. *Id.* at 859 (describing the two central defenses of the United States, neither of which dealt with damages).

79. Schwartz, *Triumph of the Ideal*, *supra* note 4, at 486-87 (citing the United States' Petition for a Writ of Certiorari at 24).

80. *Winstar*, 518 U.S. at 839, 910.

81. For a detailed summary of the procedural history of the case as well as each opinion in the Supreme Court's decision, see Joshua Schwartz, *Liability for Sovereign Acts*, *supra* note 4, at 640-50, and Schwartz, *Triumph of the Ideal*, *supra* note 4.

82. *Winstar*, 518 U.S. at 910-18 (Breyer, J., concurring).

principles.[83] Justice Scalia wrote a concurring opinion—joined by Justices Thomas and Kennedy—that was less sweeping in its reconsideration of the government's defenses based upon its sovereign status but nevertheless concluded that the defenses did not apply in these cases.[84] Chief Justice Rehnquist—joined in part by Justice Ginsburg—dissented.[85]

In its primary special defense, the government argued that the goodwill agreements were not "unmistakably clear" restrictions on future regulatory authority.[86] This defense, known as the unmistakability doctrine, holds that contracts limiting the government's future exercises of regulatory authority are strongly disfavored and therefore will be recognized only when the limitation on future regulatory authority is set out in clear terms.[87] According to the plurality, the unmistakability doctrine did not apply because the agreements concerning goodwill did not constrain the federal government from regulating the thrifts (as Congress did when it enacted FIRREA). The question, Justice Souter wrote, is "whether the doctrine of unmistakability is applicable to any contract claim against the Government for breach occasioned by a subsequent Act of Congress. The answer to this question is no."[88] The plurality found that the agreements obligated the government to pay damages in the event it changed regulatory policy with respect to the capital requirements.[89]

Justice Souter's decision was based, in part, upon his view of the economics of the acquisitions. He described acquirers of troubled savings and loan institutions as "healthy."[90] He reasoned that a healthy entity would not "assume[] the obligations of thrifts with liabilities that far outstripped their assets" unless it received an unmistakably clear promise from the federal government that it

83. *See, e.g.*, *id.* at 860 ("We took this case to consider the extent to which special rules, not generally applicable to private contracts, govern enforcement of the governmental contracts at issue here.").

84. *Id.* at 919-24 (Scalia, J., concurring in judgment).

85. *Id.* at 924-37 (Rehnquist, J., dissenting).

86. *Id.* at 871-72.

87. *Winstar*, 518 U.S. at 871-72; *see, e.g.*, Bowen v. Pub. Agencies Opposed to Soc. Sec. Entrapment, 477 U.S. 41, 52 (1986) ("'[S]overeign power . . . governs all contracts subject to the sovereign's jurisdiction, and will remain intact unless surrendered in unmistakable terms.'") (quoting Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 148 (1982)).

88. *Winstar*, 518 U.S. at 871.

89. *Id.* at 887.

90. *Id.* at 848.

would not modify its regulatory accounting rules in a way that would jeopardize the acquisition.[91] Therefore, even though the documents held to be binding contracts were less than clear on the specific promise relating to the regulatory treatment of supervisory goodwill as regulatory capital, Justice Souter nevertheless concluded that, under the circumstances, the government's promise need not have been more clear.[92] He acknowledged that the Court's decision could indirectly increase the cost of regulation but concluded that this was simply part of the price the United States had to pay for pursuing its goals through regulatory contract.[93]

In dissent, Chief Justice Rehnquist made two points. First he noted that, ex ante, it is almost impossible to determine whether an award of damages would amount to an exemption from the statute or regulation responsible for the change in regulatory treatment.[94] He therefore dismissed the test proposed by Justice Souter as unworkable.[95] Second, Chief Justice Rehnquist criticized the majority opinions for not distinguishing between the short-term and long-term risks and benefits available to an acquiring entity. In his view, the short-term benefits available to an acquiring entity could have been adequate consideration for an acquiring entity even if

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91. *Id.*

92. *Id.* at 870 n.15.

93. *Winstar*, 518 U.S. at 883. Justice Breyer offered his own interpretation of the unmistakability doctrine. He essentially concluded that although the three cases presented the type of question to which the unmistakability doctrine would apply, he was persuaded by the contracts at issue that the parties agreed that the government would be liable for breach in the event that Congress abrogated the regulatory treatment promised in the earlier agreements. *Id.* at 918 (Breyer, J., concurring).

In his concurring opinion, Justice Scalia offered a different view of the unmistakability doctrine. He disagreed with the emphasis the plurality placed on the contracts at issue as "risk-shifting" agreements to avoid application of the government's special defenses. *Id.* at 919 (Scalia, J., concurring). Instead, Justice Scalia acknowledged application of the unmistakability doctrine, but asserted that "the doctrine has little if any independent legal force beyond what would be dictated by normal principles of contract interpretation." *Id.* at 920 (Scalia, J., concurring). He then concluded that, under the facts and circumstances and given the agreements between the parties, the promises made by the government to the savings and loan institutions were sufficiently unmistakable. *Id.* at 920-21 (Scalia, J., concurring).

94. *Winstar*, 518 U.S. at 927 (Rehnquist, C.J., dissenting).

95. *Id.* (Rehnquist, C.J., dissenting).

there was long-term uncertainty about whether the government would maintain the promised regulatory treatment.[96]

The Court also rejected the government's argument that the breach was excused by the sovereign acts doctrine.[97] Under *Horowitz v. United States*,[98] government actions, legislative or executive, that are "public and general" do not violate contracts entered into by the government with private persons.[99] The plurality rejected the sovereign acts defense for two reasons. First, the plurality held, "the facts of this case do not warrant application of the doctrine."[100] *Horowitz* and its Civil War predecessors articulated—and rested upon—the notion that the government had "dual and distinguishable capacities": one as sovereign lawmaker, or regulator; the other as ordinary contractor, or nonregulator.[101] In the "modern administrative state," however, "the Government's 'regulatory' and 'nonregulatory' capacities were fused in the instances under consideration."[102]

Given this fusion of governmental capacities, the question for the Court became how to "identify instances in which the Government seeks to shift the costs of meeting its legitimate public responsibilities to private parties."[103] The plurality set out the following criteria for making that determination:

> [G]overnmental action will not be held against the Government for purposes of the impossibility defense so long as the action's impact upon public contracts is, as in *Horowitz*, merely incidental to the accomplishment of a broader governmental objective. The greater the Government's self-interest, however, the more suspect becomes the claim that its private contracting partners ought to bear the financial burden of the Government's own improvidence, and where a substantial part of the impact of the Government's action rendering performance impossible falls on its

96. *Id.* at 935-36 (Rehnquist, C.J., dissenting).
97. Justice O'Connor did not join this part of the plurality opinion.
98. 267 U.S. 458, 461 (1925).
99. *Id.* at 461.
100. *Winstar*, 518 U.S. at 891.
101. *Id.* at 892-93. The Civil War cases are Deming v. United States, 1 Ct. Cl. 190 (1865), and Jones v. United States, 1 Ct. Cl. 383 (1865).
102. *Winstar*, 518 U.S. at 894.
103. *Id.* at 896.

> own contractual obligations, the defense will be unavailable.[104]

The plurality concluded that FIRREA was not sufficiently "public and general" because the statute was intended to eliminate the "very accounting gimmicks the acquiring thrifts had been promised," and that a finding that the statute was public and general would insulate the government from liability under those agreements.[105] In reaching this conclusion, the plurality cited the legislative history of the statute.[106]

The second reason the sovereign acts doctrine did not apply, the plurality held, is because "the doctrine would not suffice to excuse liability under this governmental contract allocating risks of regulatory change in a highly regulated industry."[107] According to the plurality, even if FIRREA was a "public and general" act, the sovereign acts doctrine still would not apply because the government could not show that the "nonoccurrence of a change in the regulatory capital rules was a basic assumption" of the thrifts' agreements with the Bank Board and FSLIC.[108]

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104. *Id.* at 898 (citations omitted).

105. *Id.* at 900.

106. *Id.* at 902 n.48.

107. *Winstar*, 518 U.S. at 892.

108. *Id.* at 907. The court quotes the Restatement (Second) of Contracts § 261, which provides that "[w]here, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary." *Id.* at 904. After quoting this section, Justice Souter stated that:

> [S]ince the object of the sovereign acts defense is to place the Government as contractor on par with a private contractor . . . the Government, like any other defending party in a contract action, must show that the passage of the statute rendering its performance impossible was an event contrary to the basic assumptions on which the parties agreed, and must ultimately show that the language or circumstances do not indicate that the Government should be liable in any case. . . . [W]e find that the Government as such a contractor has not satisfied the conditions for discharge in the present case.

Id. at 904-05 (citation omitted).

Justice Scalia wrote separately on the sovereign acts doctrine, dispensing with this argument in a single paragraph. *Id.* at 923-24 (Scalia, J., concurring). The

Once again, Chief Justice Rehnquist made two points in his dissent. First, he argued that it was problematic for the Court to rely upon legislative history to divine Congress's intent in passing this legislation.[109] Second, Chief Justice Rehnquist criticized the majority's reliance on the idea that the government sought to avoid its own financial obligations in passing FIRREA.[110] He believed that, with such a comprehensive statute, there was confusion over who in the government would save money and how; for this reason, in his view, focusing on the avoidance of financial obligations did not produce a clear result.[111]

IV. THE ECONOMICS OF LEVERAGE IN THE SUPREME COURT DECISION AND IN THE SUBSEQUENT DAMAGES DECISIONS

A. *Why the Goodwill Damages Decisions Are About Corporate Finance*

In the damages trials following the Supreme Court remand in *Winstar*, there has been extensive testimony from economists, finance professors, and other expert witnesses related to the value of counting supervisory goodwill as regulatory capital.[112] In the goodwill damages cases, the United States has presented many of its arguments through the testimony of Dr. Miller, who was awarded the Nobel Prize in Economics in 1990.[113]

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sovereign acts doctrine, in his view, was based upon a single, abbreviated opinion, *Horowitz*, and did not add anything to the government's defense beyond the protection afforded by the unmistakability doctrine. Accordingly, he concluded that the doctrine did not permit the government to "repudiate its contractual obligations" in these cases. *Id.*

109. *Winstar*, 518 U.S. at 933 (Rehnquist, C.J., dissenting).

110. *Id.*

111. *Id.*

112. *See* Merton H. Miller & Keith Sharfman, *The Economic Expert Witness*, 3 Green Bag 297, 298 (2000).

113. Dr. Miller, who died in 2000, testified at trial in *Glendale Federal Bank v. United States*, 43 Fed. Cl. 390 (1990), *aff'd in part, vacated in part*, 239 F.3d 1374 (Fed. Cir. 2001), *after remand*, 54 Fed. Cl. 8 (2002), *California Federal Bank v. United States*, 43 Fed. Cl. 445 (1999), *aff'd in part, rev'd in part*, 245 F.3d 1342 (Fed. Cir. 2001), *dismissed on remand*, 54 Fed. Cl. 704 (2002), *LaSalle Talman Bank v. United States*, 45 Fed. Cl. 64 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003), *Bluebonnet Savings Bank v. United States*, 47 Fed. Cl. 156 (2000), *rev'd*, 266 F.3d 1348 (Fed. Cir. 2001), *after remand*, 52 Fed. Cl. 75 (2002), and *Bank United of Texas v.*

In an article written after he provided expert testimony in a number of goodwill damages cases, Dr. Miller and his colleague David Ross explained that:

> The[] cases go to the heart of modern applied corporate finance. Even where the arguments may seem to be about the treatment of so-called "supervisory goodwill" and other similar regulatory accounting concepts, . . . they are actually about corporate capital structure, especially the role and value of leverage. The court cases are thus concerned mainly with issues the finance profession has been wrestling with for the last 40 years or more.[114]

Consider the following example. A regulatory capital requirement of three percent, measured as a ratio of regulatory capital to assets, requires $3 for every $100 in assets (which are a thrift's investments, traditionally home loans). Thrift X does not have any supervisory goodwill on its balance sheet. Assuming no other regulatory accounting conventions, Thrift X is required to have $3 in tangible capital, such as cash or some equity security, in order to maintain $100 in investments on its balance sheet. (Note that Thrift X need not fully leverage; it may wish to have a "regulatory capital cushion" and may make a business decision to hold only $80 in investments even though, with $3, it may add more assets to its balance sheet.) Now compare Thrift X with Thrift Y, and assume that the only difference between the two thrifts is that Thrift Y has $1 in supervisory goodwill that may count as regulatory capital pursuant to an agreement with the government. For Thrift Y to hold $100 in investments, it need only have $2 in tangible capital because it already has $1 in regulatory capital in the form of supervisory goodwill. All other things being equal, Thrift Y, with supervisory goodwill, could leverage more than Thrift X; to put it another way, Thrift Y could maintain the same size as Thrift X with less tangible capital. That is why, as Miller and Ross state, the goodwill damages

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United States, 50 Fed. Cl. 645 (2001), *appeal pending*. Dr. Miller has been described as "the father of modern corporate finance." *Players: Merton Miller, 1923-2000*, DERIVATIVES STRATEGY, July 2000, *available at* http://www.derivativestrategy.com/magazine/archive/2000/0700play.asp.

114. Merton H. Miller & David Ross, The Economics of the *Winstar* Cases 2 (June 23, 2000) (unpublished manuscript, on file with the author).

cases are about "corporate capital structure," in particular "the role and value of leverage."[115]

The plurality opinion in *Winstar* acknowledged that the recognition of supervisory goodwill as regulatory capital would allow a thrift to make more investments and stated that this possibility was an inducement for thrifts to enter into agreements with the government.[116] In fact, because the *Winstar* plurality viewed the acquired savings and loan institutions as "ailing," it described supervisory goodwill as "attractive" to acquiring institutions.[117] Justice Souter stated, "[f]rom the acquiring thrift's perspective, . . . the treatment of supervisory goodwill as regulatory capital was attractive because it inflated the institution's reserves, thereby allowing the thrift to leverage more loans (and, it hoped, make more profits)."[118] With this qualifying language, Justice Souter recognized that an increase in the number of loans made by a thrift did not guarantee greater profits.[119]

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115. *Id.*

116. United States v. Winstar Corp., 518 U.S. 839, 850-51 (1996).

117. *Id.* at 847, 850-51. One misunderstanding of the Supreme Court in *Winstar*, corrected by the subsequent damages decisions, is that "healthy" thrifts did not acquire "weak" thrifts. In the early 1980s, there were few economically "healthy" thrifts because the interest rate spike devastated the entire industry. *See* Citron, *Lessons*, *supra* note 4, at 20-24.

118. *Winstar*, 518 U.S. at 850-51.

119. According to Justice Souter, supervisory goodwill had value to acquirers for two other reasons. First, the regulators' recognition of supervisory goodwill as regulatory capital enabled the acquiring institution to remain in capital compliance after the acquisition. Justice Souter stated that this regulatory accounting treatment was "critical to make the transaction possible in the first place, because in most cases the institution resulting from the transaction would immediately have been insolvent under federal standards if goodwill had not counted toward regulatory net worth." *Id.* at 850; *see also* Cal. Fed. Bank v. United States, 43 Fed. Cl. 445, 461 (1999) ("[A]ll that we could determine from witnesses on both sides concerning the value of this contract was 'it would help keep the regulators off our backs.'"), *aff'd in part, rev'd in part*, 245 F.3d 1342 (Fed. Cir. 2001), *dismissed on remand*, 54 Fed. Cl. 704 (2002); LaSalle Talman Bank v. United States, 45 Fed. Cl. 64, 78 (1999) (analogizing supervisory goodwill to S&H Green stamps "only recognized at the company store"), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003). The value of this benefit was minimal, however, in a regulatory regime that practiced industrywide forbearance. As the Supreme Court noted in *Winstar*, FSLIC had neither the resources nor the incentive to shut down insolvent savings and loan institutions and adopted a number of measures to give economically insolvent thrifts the appearance of solvency. *Winstar*, 518 U.S. at 846-48.

The accounting treatment of supervisory goodwill after an acquisition also enabled an acquiring thrift to generate income on paper through what the Supreme

Justice Souter's observation about the relationship between supervisory goodwill and a thrift's ability to make more loans, and the ability of a thrift to make more loans and earn more profits, captured what has become the most contested issue between the United States and the thrift claimants in the damages trials: whether the claimed breach of contract caused a thrift to lose profits on its business operations.

B. The Debate over Leverage in the Goodwill Damages Decisions

The Supreme Court remanded the *Winstar* cases to the Court of Federal Claims for damages proceedings.[120] In breach of contract cases involving private parties, expectancy is the general measure of damages.[121] In the academic literature, the expectation measure is favored because it is said to promote efficiency.[122] According to David Friedman:

> An individual will breach a contract if his private benefits from breach are greater than his private costs. He ought to breach (from the standpoint of economic

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Court described as "accretion of the discount." *Id.* at 852. The amortization/accretion mismatch worked as follows: under the purchase method of accounting, the discount on an acquired thrift's loans (the amount by which those loans are marked down to reflect their actual value) is "accreted"—taken into income—over the estimated life of the loans (typically, about seven years). Conversely, the goodwill created by marking the acquired thrift's assets and liabilities to market is amortized, or expensed, over a longer period. Although an acquiring thrift did not receive an economic benefit from the income added to its balance sheet through accretion of the discount, it nevertheless received the benefit of appearing to be more healthy in the short-term. *Id.* at 851-53.

120. *Winstar*, 518 U.S. at 910.

121. RESTATEMENT (SECOND) OF CONTRACTS § 347 (1979). In order to recover expectancy damages, the claimant must satisfy the elements of foreseeability, causation, and certainty with respect to the claimed damages. *Id.* With respect to foreseeability, Farnsworth notes that "[p]roblems of foreseeability do not usually arise unless the injured party is a buyer who cannot cover, so that loss turns on loss of profits in collateral transactions that have been disrupted by the breach." E. FARNSWORTH, CONTRACTS § 12.14 at 248 (1990).

122. *See* Hadfield, *supra* note 4, at 510; *see also* Miller & Ross, *supra* note 114, at 14 ("In principle, expectation damages are the preferred remedy from an economics perspective because this remedy encourages efficient breaches and discourages inefficient breaches.").

> efficiency) if social benefits—total benefits to everyone affected, himself included—are greater than social costs. The seller's lost profit [or the buyer's lost surplus] is one of the costs of breach.[123]

For example, A has a contract to sell B 10 widgets at $7 a widget. Then, on the day A is to perform, A has the opportunity to sell 10 widgets to C for $9 a widget, while B is able to purchase the 10 widgets from D for $8 a widget. Because A is better off breaching the contract and selling the widgets to C, even after paying B $10 in damages for having to pay a higher price to purchase the widgets from D, efficiency is promoted through the breach of contract and the award of expectation damages. In this situation involving private parties, according to Professor Hadfield, expectation damages function as an "invisible hand, guiding private decisions to coincide with socially optimal decisions, namely efficient allocation of resources to their highest valued use."[124]

The Court of Federal Claims and its predecessors, in cases in which common law measures for breach of contract are employed, have used the expectation measure to award damages for breach.[125] In the goodwill damages cases, the courts have generally allowed the thrift claimants to seek damages under all three measures of recovery—expectation, reliance, and restitution—though the bulk of the trial testimony has concerned claims for lost profits.[126] In seeking to be placed in the position they would have been in absent the phase-out of supervisory goodwill, the thrifts have presented detailed claims of what investments they would have made, what those investments would have earned, how their operations would have been run, and ultimately what profits they would have made absent the breach.[127]

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123. Hadfield, *supra* note 4, at 510 (quoting David D. Friedman, *An Economic Analysis of Alternative Damage Rules for Breach of Contract*, 32 J.L. & ECON. 281, 283-84 (1989)) (alteration in original).

124. Hadfield, *supra* note 4, at 511.

125. *See, e.g.*, Estate of Berg v. United States, 687 F.2d 377, 379 (Ct. Cl. 1982).

126. Glendale Fed. Bank v. United States, 239 F.3d 1374, 1379-83 (Fed. Cir. 2001) (discussing in detail the measures of recovery under contract law), *after remand*, 54 Fed. Cl. 8 (2002).

127. *See, e.g.*, Glendale Fed. Bank v. United States, 43 Fed. Cl. 390, 400-01 & n.3 (1999), *aff'd in part, vacated in part*, 239 F.3d 1374 (Fed. Cir. 2001), *after remand*, 54 Fed. Cl. 8 (2002); LaSalle Talman Bank v. United States, 45 Fed. Cl. 64 87-102 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL

The first trial involved Glendale Federal Savings Bank, a large California thrift that acquired a Florida thrift, First Federal of Broward, in 1981.[128] After a lengthy trial, the trial court entered a $909 million judgment in favor of Glendale in 1999.[129] The trial court rejected Glendale's claim of lost profits damages, and instead combined an award of restitution with what it described as "non-overlapping reliance damages."[130] Subsequently, the United States appealed, and the Federal Circuit vacated the judgment in part, reversing the trial court's decision on restitution and remanding the case for further proceedings on reliance damages.[131]

In addition to *Glendale*, there have been at least a dozen damages decisions so far in the Federal Circuit and in the Court of Federal Claims.[132] In each trial, the court has been required to conduct a careful examination of the financial condition of the acquiring entity after the enactment of FIRREA, when the acquiring entity was required to respond to the government's breach of contract.[133] This inquiry is relevant to claims for expectation damages, in which the court evaluates the acquiring entity's claim of what position it would have been in, and more specifically what profits it would have made, had the government not breached the contract.

105250 (Fed. Cir. Jan. 14, 2003); Cal. Fed. Bank v. United States, 43 Fed. Cl. 445, 457 (1999), *aff'd in part, rev'd in part*, 245 F.3d 1342, 1349-50, *dismissed on remand*, 54 Fed. Cl. 704 (2002); Bank United of Tex. v. United States, 50 Fed. Cl. 645, 651-53 (2001), *appeal pending*.

128. *Glendale*, 43 Fed. Cl. at 393. After the merger Glendale grew quickly and, in fact, was in capital compliance after the enactment of FIRREA in 1989. However, it fell out of capital compliance in 1992. It recapitalized by issuing $451 million in stock in 1993. *Id.* at 393-94.

129. *Id.* at 410.

130. *Id.* at 409.

131. *Glendale*, 239 F.3d at 1384. For the decision after remand, see *Glendale Fed. Bank v. United States*, 54 Fed. Cl. 8 (2002).

132. *See* Citron, *Lessons*, *supra* note 4, at 4 n.12 (collecting cases).

133. *See, e.g.*, Glendale Fed. Bank v. United States, 43 Fed. Cl. 390, 400-01 & n.3 (1999), *aff'd in part, vacated in part*, 239 F.3d 1374 (Fed. Cir. 2001), *after remand*, 54 Fed. Cl. 8 (2002); LaSalle Talman Bank v. United States, 45 Fed. Cl. 64, 87-102 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003); Cal. Fed. Bank v. United States, 43 Fed. Cl. 445, 457 (1999), *aff'd in part, rev'd in part*, 245 F.3d 1342, 1349-50, *dismissed on remand*, 54 Fed. Cl. 704 (2002); Bluebonnet Sav. Bank v. United States, 47 Fed. Cl. 156, 158-67 (2000), *rev'd*, 266 F.3d 1348 (Fed. Cir. 2001), *after remand*, 52 Fed. Cl. 75 (2002); Bank United of Tex. v. United States, 50 Fed. Cl. 645, 651-54 (2001), *appeal pending*.

C. *The Miller & Modigliani Propositions in the Court of Federal Claims*

As described above, the Court believed that "healthy" thrifts like Glendale acquired "ailing" thrifts, thereby solving a problem for the government by taking a troubled thrift off its hands.[134] In exchange, the Court believed, the government provided favorable regulatory treatment—the goodwill promise—that could make the thrift more profitable.[135] Although the plurality opinion did not equate supervisory goodwill with profitability, at least two trial courts have asserted that there was a direct relationship between the additional investments permitted by the recognition of supervisory goodwill as regulatory capital and greater profits.[136] In *Glendale*, the court stated that "the supervisory goodwill and the long amortization was designed to fill the capital hole, permit Glendale to maintain its ability to leverage its existing capital, give the thrift the ability to generate income to replace the amortizing goodwill and, ultimately, make the whole enterprise profitable."[137] In *LaSalle Talman Bank v. United States*,[138] the court stated that the goodwill "agreements enabled the thrifts to keep their doors open and—equally importantly—gave them the additional opportunity to generate operating profits to the extent they could leverage net positive capital resulting from the addition of supervisory goodwill to their books."[139]

Yet, the court did not award the thrift claimant lost profits in either case. In each case, the trial court concluded that the evidence demonstrated that the thrift's claim of lost profits due to the phase-out of supervisory goodwill as regulatory capital was speculative.[140] The failure to prove the lost profits claims in those cases—and subsequent cases as well[141]— illustrates anecdotally a fundamental point: the government did not really make an acquiring thrift any

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134. United States v. Winstar Corp., 518 U.S. 839, 847 (1996).

135. *Id.* at 847-51.

136. *See Glendale*, 43 Fed. Cl. at 394; *LaSalle*, 45 Fed. Cl. at 78.

137. *Glendale*, 43 Fed. Cl. at 394.

138. 45 Fed. Cl. 64 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003).

139. *Id.* at 78.

140. *Id.* at 89-102; Glendale Fed. Bank v. United States, 239 F.3d 1374, 1380 (Fed. Cir. 2001), *after remand*, 54 Fed. Cl. 8 (2002).

141. *See, e.g.*, Bank United of Tex. v. United States, 50 Fed. Cl. 645 (2001), *appeal pending*.

more profitable by allowing it to count supervisory goodwill as regulatory capital. That is because, quite simply, more loans do not always mean more profits for an S&L. In fact, as the thrift industry learned during the interest rate spike of the early 1980s and the recession of the early 1990s, more loans can lead to more losses if borrowers default.

The idea that additional borrowing capacity, in and of itself, does not make a firm more profitable is a fundamental principle of corporate finance. In the goodwill damages cases, the United States has presented this argument through the expert testimony of Dr. Miller. According to Dr. Miller and Mr. Ross:

> The M&M Propositions (1958), one of the key foundations of the field of finance, tell us, among other things, that the market value of any firm, defined as the sum of the market values of all its securities, is independent of the mix of debt and equity used to finance its assets. Or, to put it more directly, the two effects, risk and return, cancel out exactly in terms of market value so that leverage, per se, has no market value in an M&M world.[142]

As Dr. Miller and Mr. Ross have elaborated:

> The phrase "leverage has no market value" should not be taken as suggesting, however, that the degree of leverage being assumed is of no concern to investors generally or to investors in the S&L mergers in particular. The S&L investors presumably bargained with the regulators for the capital ratio concessions in those mergers—concessions whose removal, after all, gave rise to the *Winstar* cases. Nor were the S&L investors necessarily being irrational in doing so. These concessions made it possible for the investors

142. Miller & Ross, *supra* note 114, at 26-27; *see also* Allen N. Berger et al., *The Role of Capital in Financial Institutions*, 19 J. BANKING & FIN. 393, 393 (1995) ("The point of departure for all modern research on capital structure is the Modigliani and Miller (1958) (M&M) proposition that in a frictionless world of full information and complete markets, a firm's capital structure can not affect its value."); Miller, *supra* note 2, at 486 (asserting the applicability of the M&M Propositions to banks).

> to defer or avoid the transactions costs associated with raising an equivalent amount of real capital. The M&M propositions, moreover, do not deny that a leveraged portfolio, whether on personal account or by investing in an S&L[,] does indeed magnify both the gains and risks on that portfolio; and that on net, that the *expected* rate of return on a leveraged investment is positive, the more so the greater the risk. But, and this is the key, all points on the risk-return spectrum are equivalent. No particular value of leverage carries a premium in an M&M, efficient-markets world. It makes no more sense to say that a highly leveraged investment is *always* better than a lower leveraged investment than to say that growth stocks are *always* better than public utilities. And, by the same token, forcing a reduction in the degree of leverage, as in the *Winstar* cases, does not cause damages.[143]

Applying the principles of corporate finance in the damages cases would obviate the need to conduct a trial on lost profits damages. A thrift plaintiff satisfying the requirements for liability and damages would recover the costs or expenses associated with replacing the phased-out supervisory goodwill. (Indeed, Miller and Ross argue that "the costs of raising capital are an upper bound on the value of any lost profits.")[144] Although this is the result courts generally have arrived at when evaluating claims for lost profits based upon a reduced ability to leverage, they have not done so until *after* conducting damages trials.

The courts' reluctance to embrace principles of corporate finance, even while arriving at the results dictated by those principles, is exemplified by the history of *California Federal Bank v. United States*.[145] Although the Federal Circuit later reversed the decision, the trial court in *California Federal Bank* initially declined to allow the thrift to present its lost profits claim because of its understanding of foreseeability with respect to how the phase-out

143. Miller & Ross, *supra* note 114, at 27; *see also* Miller & Sharfman, *supra* note 112, at 298 (discussing supervisory goodwill as an illusory asset).

144. Miller & Ross, *supra* note 114, at 15.

145. 43 Fed. Cl. 445 (1999), *aff'd in part, rev'd in part*, 245 F.3d 1342 (Fed. Cir. 2001), *dismissed on remand*, 54 Fed. Cl. 704 (2002).

would impact a thrift.[146] The court's pretrial order stated that the government "knew that breaching this agreement would cause plaintiff to adjust its capital ratio. That is, it knew that plaintiff would have to reduce its assets or increase its capital. But it could not foresee what effect this adjustment would have on plaintiff's profits."[147] In the trial court's view, even if the supervisory goodwill would in fact allow additional investments, that fact alone was not sufficient to allow a lost profits claim, given the uncertainty of the outcome of the investments.[148] In articulating this view, the trial court endorsed the views of Dr. Miller.[149]

In reversing the trial court's grant of summary judgment against California Federal Bank on its lost profits claim, the Federal Circuit stated:

> The subject of the contract between Cal Fed and the government was Cal Fed's assumption of the net liabilities of the acquired thrifts in exchange for the promised favorable regulatory treatment. The continued use of supervisory goodwill as regulatory capital for the entire 35-40 year amortization period initially promised was therefore a central focus of the contract and the subject of the government's breach. Profits on the use of the subject of the contract itself, here supervisory goodwill as regulatory capital, are recoverable as damages.[150]

146. *Cal. Fed. Bank*, 43 Fed. Cl. at 457.

147. *See id.* The court reasoned that:

> Banking was a volatile and dynamic business at the time of the breach. These factors make expectancy damages particularly speculative. In these circumstances, plaintiff cannot prove clearly and with certainty that it would have made profitable loans and other profitable investments with the "lost" capital. The Government promised to permit the use of goodwill as capital, but it did not guarantee plaintiff that its use of the additional leverage would be profitable.

Id.

148. *Id.* at 457-59.

149. *See also id.* at 461 (crediting Dr. Miller's testimony on cost of replacing capital).

150. *Cal. Fed. Bank*, 245 F.3d at 1349. The trial court in *California Federal Bank* also attempted to distinguish the lost profits presentation in the goodwill damages case from earlier cases allowing the recovery of lost profits; according to

On remand, California Federal Bank "offered one expert witness and several fact witnesses" to prove its lost profits claim.[151] The trial court rejected this claim in its entirety, concluding that "[p]laintiff did not satisfy any of the legal requirements that would entitle the bank to lost profits."[152]

D. *Culture Clash (?)*

As the history of *California Federal Bank* demonstrates, the thrifts have contested the correctness of this articulation of corporate finance principles. Among other things, they have asserted that corporate finance principles do not apply to savings and loans institutions. The details of this debate are discussed below. For now, it is relevant that the courts—including the Federal Circuit, in its decision reversing the entry of summary judgment in favor of the government in *California Federal Bank*—have emphasized due process in allowing lost profits claims to be heard and in taking trial testimony on the relevance of principles of corporate finance to the damages claims. One common feature of the judicial decisions, whether they ultimately agree with Dr. Miller's views or not, has been the emphasis on giving thrifts the opportunity to be heard on their damages claims.[153] The emphasis on due process is one defining aspect of the judicial culture, and one that has been decisive in the goodwill damages decisions.

Another apparent divergence of the goodwill damages decisions from the principles of corporate finance has emerged from the decisions allowing thrifts to pursue claims for lost profits damages. This dispute centers on the correct time for measuring lost

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the trial court, the former presented a situation in which recovery would be permitted despite a lack of specificity as to the exact composition and volume of the investments and accompanying liabilities, which the court viewed as too speculative when compared with the earlier cases. *Cal. Fed. Bank*, 43 Fed. Cl. at 457-58. This reasoning was rejected on appeal, in the court of appeals' statement that "'[i]f a reasonable probability of damage can be clearly established, uncertainty as to the amount will not preclude recovery.'" *Cal. Fed. Bank*, 245 F.3d at 1350 (quoting Locke v. United States, 283 F.2d 521, 524 (Ct. Cl. 1960)).

151. Cal. Fed. Bank v. United States, No. 92-138C, 2002 WL 31863805, at *3 (Fed. Cl. Dec. 17, 2002).

152. *Id.* at *12.

153. *See, e.g.*, *Cal. Fed. Bank*, 245 F.3d at 1350 ("The Court of Federal Claims erred by not permitting Cal Fed to present its evidence [as to the existence and quantum of lost profits] at a trial based on its legal conclusion that the proof would be too speculative.").

profits damages. The thrift claimants have insisted—and the courts have agreed—that lost profits damages should be determined as of the date of trial, that is, on an ex post basis. The rationale for this approach is that by taking into account "what actually happened to the industry after FIRREA," the parties and the Court have the benefit of more information in attempting to determine whether a claim for lost profits damages is speculative.[154] Consistent with this emphasis on due process, the courts have favored the ex post approach in order to be able to review all of the potentially relevant information in determining what would have happened absent the breach.

For the thrift claimants, an ex post approach enables a claimant to benefit from the general decline in interest rates after the enactment of FIRREA, so that if a plaintiff is able to construct a portfolio of assets that avoids the consequences of the real estate recession of the early 1990s—a task that may be accomplished safely with the benefit of hindsight—that plaintiff may show substantial lost profits on the wide spreads available from such a portfolio of foregone assets and liabilities.[155] The hindsight problem is the principal objection to the ex post measure. As Miller and Ross state: "The *ex post* approach to lost profits damages is thus not only highly speculative, but inherently biased. Or, as the legal theorist would put it, the *ex post* approach to damages, by virtue of its inevitable asymmetry, deters efficient breaches."[156]

As to the particulars of the debate over the application of the M&M principles in the goodwill damages cases, the most popular argument against the application of the principles of corporate finance has been that, because savings and loan institutions benefit from the availability of deposit insurance, ordinary principles of corporate finance do not apply.[157] This is said to be true for two related reasons: the first is that because deposits—which are, along with borrowings and other debt instruments, part of a thrift's liabilities—are insured, they are a risk-free liability; it follows that, because deposits are risk-free, deposit insurance amounts to a

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154. Miller & Ross, *supra* note 114, at 14.

155. Miller & Ross, *supra* note 114, at 14.

156. Miller & Ross, *supra* note 114, at 14-15; *see also* Franklin M. Fisher & R. Craig Romaine, *Janis Joplin's Yearbook and the Theory of Damages*, 5 J. ACCT. AUDITING & FIN. 145 (1990).

157. Miller, *supra* note 2, at 484-85.

subsidy.[158] As articulated in one article, the M&M proposition that a firm's capital structure does not affect its value "contrasts sharply with the intuitive notion that a firm with risk-free debt could borrow at an interest rate below the required return on equity, reducing its weighted average cost of financing and increasing its value by substituting debt for equity."[159]

The argument that the M&M Propositions did not apply to the goodwill damages cases due to the availability of deposit insurance apparently was accepted by the trial court in *LaSalle*, which stated: "The assumption behind plaintiff's presentation is that one reason supervisory goodwill has value is that it permits leveraging, i.e., using this capital to attract disproportionately more in low-interest deposits, which in turn permit lending at higher yields."[160] Similarly, the trial court in *Glendale* said that thrifts are "different[] because they have access to low-cost . . . (retail deposits) . . . ."[161]

Mere invocation of the availability of deposit insurance is not dispositive, however. Miller and Ross note academic literature, particularly a 1990 article measuring the value of deposit insurance to banks, that "find[s] the value of [deposit] insurance to be not a single, one-size-fits-all number, but a *function* that depends on the

158. *See, e.g.*, Myron L. Kwast & S. Wayne Passmore, The Subsidy Provided by the Federal Safety Net: Theory, Measurement and Containment, 381, 382, *in* FEDERAL RESERVE BANK OF CHICAGO, PAYMENT SYSTEMS IN THE GLOBAL ECONOMY: RISKS AND OPPORTUNITIES (1998) (paper presented at the 34th Annual Conference on Bank Structure and Competition in May 1998). Kwast and Passmore assert that:

> Because of banks' access to the safety net [which includes deposit insurance], bank creditors are willing to accept lower risk premiums on bank liabilities, thus lowering a bank's weighted average cost of capital relative to what would otherwise be the case. For deposits fully insured by the FDIC, this risk premium is essentially reduced to zero . . . .

Id.

159. Berger et al., *supra* note 142, at 393.

160. LaSalle Talman Bank v. United States, 45 Fed. Cl. 64, 79 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003).

161. Glendale Fed. Bank v. United States, 43 Fed. Cl. 390, 401 n.4 (1999), *aff'd in part, vacated in part*, 239 F.3d 1374 (Fed. Cir. 2001), *after remand*, 54 Fed. Cl. 8 (2002).

bank's capital structure and the risk of its asset portfolio."[162] In fact, Kuester and O'Brien specifically "find that for most firms, the value of the *insurance* is close to zero. That means, of course, that for them, the *net* value of the insurance is actually *negative*, once allowance is made for the premiums that the S&L must pay to FSLIC."[163] However, for "very risky firms with low capital ratios and risky asset portfolios," the value of deposit insurance is high because "the insurance serves mainly to keep them afloat for a little while longer (creating the equivalent of a 'free option' for the shareholders) until the regulators can put them out of their misery (or until they can sell their franchises to stronger firms)."[164] Miller and Ross acknowledge that more stringent capital requirements "could reduce the term of the option, thereby reducing its value."[165] Yet this possibility, which could apply, at most, to only a fraction of the thrifts in the savings and loan industry, does not establish the sort of market imperfection that renders the M&M Propositions inapplicable.

Other arguments made by the trial court in response to the M&M Propositions include the existence of the savings and loan industry. In *Glendale*, the trial court explained that it disagreed with Dr. Miller's testimony because, in part, "[b]anks are ultimately in the business of making money by lending money, and generating a return based on the spread between interest earning assets and interest earning liabilities."[166] Similarly, in *LaSalle*, the trial court stated: "Although there have been periods when the interest rate spread has been negative—the early 1980s is an obvious example—these periods are exceptions to the normal, positive spread that forms

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162. Miller & Ross, *supra* note 114, at 33 (citing K.A. Kuester & J.M. O'Brien, *Market Based Deposit Insurance Premiums*, (Fed. Reserve Sys., Finance and Economics Discussion Series No. 150, 1990) (proceeding of a conference on bank structure and competition)); *see also* Berger, *supra* note 142, at 405 ("Kuester and O'Brien . . . estimated that fair premiums for most firms would be very low, less than 1 basis point, while a few very risky outliers had fair premia in the 1000's of basis points. While this approach requires a number of simplifying assumptions, the result that most banks are very safe and a few banks are extremely risky is consistent with the rest of this literature . . . and suggests that the 8-basis-point maximum FDIC differential does not capture the existing risk differences.").

163. Miller & Ross, *supra* note 114, at 33.

164. Miller & Ross, *supra* note 114, at 33.

165. Miller & Ross, *supra* note 114, at 34.

166. *Glendale*, 43 Fed. Cl. at 401 n.4.

the foundation for the entire savings and loan industry."[167] Yet this rationale overlooks the massive taxpayer bailout of the savings and loan industry necessitated by the extensive losses suffered by thrifts on real estate investments. It also is irrelevant to the question posed by a thrift's claim for lost profits damages, which is whether the additional leverage permitted by the recognition of supervisory goodwill as regulatory capital prevented the thrift from making profitable investments.

Another assertion made by the trial court in *LaSalle* was that "Professor Miller's hypothesis that leverage has no value, which underlies the first of the Modigliani & Miller propositions, is premised upon numerous assumptions which he did not establish, including that capital markets are perfectly efficient and individual investors can borrow at the same rate as financial institutions."[168] To the contrary, no one has established that capital markets are so insufficiently efficient that the M&M Propositions do not apply. The securities laws, for example, operate on the assumption of efficient capital markets. The second point appears to be a restatement of the deposit insurance argument, which was addressed above. Moreover, the court did not elaborate upon either point and did not explain why either point rendered the M&M Propositions inapplicable to the damages claim it had to evaluate. Indeed, although the trial court did not credit Dr. Miller's testimony, it nevertheless rejected the thrift's claim for lost profits (finding that it made more profits after the enactment of FIRREA than before) and awarded the thrift essentially the transaction costs associated with its acquisition by a large bank that recapitalized the thrift as part of the acquisition.[169] The court even acknowledged that "one of the ironies of this case is that plaintiff's economic distress caused it to obtain replacement capital in a way that ultimately made it more profitable than it would have been otherwise."[170]

Ultimately, the Federal Circuit in *California Federal Bank* established what appears to be the definitive judicial approach to this question, concluding that whether the additional leverage permitted by the recognition of supervisory goodwill as regulatory capital would have resulted in greater profits is a question of fact for

167. LaSalle Talman Bank v. United States, 45 Fed. Cl. 64, 80 (1999), *aff'd in part, vacated in part*, Nos. 00-5005, 00-5027, 2003 WL 105250 (Fed. Cir. Jan. 14, 2003).

168. *Id.* at 80.

169. *Id.* at 80, 87-102, 120.

170. *Id.* at 81.

resolution at trial.[171] In so concluding, the appellate court neither accepted nor rejected the principles of corporate finance with respect to the value of leverage. Instead, it simply recognized—as did the Supreme Court—the possibility that greater leverage could lead to additional profits and allowed a claimant the opportunity to prove that it would have made investments resulting in greater profits absent the phase-out.[172]

V. CONCLUSION

In his discussion of supervisory goodwill and profitability, Justice Souter arguably did no more than recognize that the ability to make more loans—more investments for a thrift—could enable the thrift to make more profits. However, his suggestion overlooks the risks associated with additional leverage, in particular the risk of greater investment losses, and overvalues the recognition of supervisory goodwill as regulatory capital as an economic inducement for a thrift to engage in an acquisition. As no plaintiff so far has been able to substantiate a lost profits claim due to the phase-out of supervisory goodwill, the goodwill damages decisions are not inconsistent with Justice Souter's suggestion allowing for the possibility that additional loans could result in greater profits. Yet the results in the cases, in which every claim for lost profits damages due to a decrease in leverage so far has been rejected as speculative, demonstrate that the plurality's views with respect to the economic value of supervisory goodwill were incomplete, if not incorrect. Paradoxically, then, in the goodwill damages decisions, the trial courts—which are said to be expert in fact finding and tend to eschew reliance upon broad theoretical propositions in resolving particular cases—have confirmed the relevance of the M&M Propositions even as they have rejected their general application: although the M&M Propositions have not been embraced, they have effectively dictated the results of the goodwill damages decisions thus far, in which no claimant has been awarded more than its mitigation costs on a claim for expectancy damages.

171. Cal. Fed. Bank v. United States, 245 F.3d 1342, 1350 (Fed. Cir. 2001), *dismissed on remand*, 54 Fed. Cl. 704 (2002).

172. *Id.*