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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. report	Pillsbury Madison and Sutro report re: Certain Real Estate Loans and Investments Made by Madison Guaranty Savings & Loan [Federal Rules of Criminal Procedure 6 (e)] (43 pages)	12/19/1995	P3/b(3)
002. report	Pillsbury Madison and Sutro report re: Supplemental Report to the Resolution Trust Corporation [Federal Rules of Criminal Procedure 6 (e)] (102 pages)	12/13/1995	P3/b(3)

COLLECTION:

Clinton Presidential Records
First Lady's Office
Lissa Muscatine
OA/Box Number: 20089

FOLDER TITLE:

Madison Guaranty Savings and Loan [1]

2015-0275-S
rc1968

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

THE WHITE HOUSE

WASHINGTON

M E M O R A N D U M

TO: THE EDITORIAL BOARD
FR: MARK FABIANI
SPECIAL ASSOCIATE COUNSEL TO THE PRESIDENT
RE: FINAL PILLSBURY REPORT
DATE: 2/13/96

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As you may know, on December 28, 1995 the law firm of Pillsbury, Madison & Sutro issued the final and comprehensive Whitewater report for the Resolution Trust Corporation (RTC). The report confirmed what the President and First Lady have said all along about the Whitewater investment and cleared the President and First Lady of any civil liability for Whitewater.

(Pillsbury, Madison & Sutro was retained by the RTC in 1994 to work on the Whitewater matter. You may recall the controversey surrounding the selection of Pillsbury and Pillsbury partner Jay Stephens. The Pillsbury firm and Mr. Stephens investigated this matter for two years at a cost of approximately $4 million.)

Enclosed please find a three page summary of the Pillsbury report prepared by the White House and the final Pillsbury report on Whitewater. You may want to pay particular attention to pages 76-78 of the report dated December 13, 1995.

If you have any questions, please do not hesitate to contact me at (202) 456-7909.

THE WHITE HOUSE

WASHINGTON

STATEMENT

Mark D. Fabiani
Special Associate Counsel to the President

On December 28, 1995, the law firm of Pillsbury, Madison & Sutro issued a final and comprehensive report on Whitewater for the Resolution Trust Corporation (RTC). The Pillsbury report was the result of an intensive two-year investigation that cost approximately $4 million.

The Pillsbury report confirms what the President and First Lady have said all along: they invested money in Whitewater, and they lost more than $40,000; they were fully liable on the loans they took, and they paid those loans back; they were passive investors, not actively involved in the management of the investment; and they did not pressure anyone to make loans that benefited Whitewater Development or Madison Guaranty.

The Pillsbury report concluded that, "President Clinton and Hillary Clinton had little knowledge and no control over the Whitewater project." The report recommended that the RTC stop its Whitewater investigation.

With this final report, Whitewater has now been examined for four years now by an unprecedented number of reporters, two Independent Counsels, Congress and the Resolution Trust

Corporation at a total cost of over $27 million. The President and First Lady have cooperated fully with every legitimate inquiry. Thirty-five thousand pages of documents have been offered to the Senate. Full access to witnesses has been given to the Senate during each of the 50-plus days of its hearings over the last seven months. There is nothing more the White House can do. After all of this, there has been absolutely no showing of illegal or even unethical conduct.

Despite these facts, our opponents have constantly hopped, skipped and jumped from one charge to another. No sooner does the White House bat down one charge than its opponents shift ground to charges that are even vaguer and harder to understand. For example, in recent weeks Republican critics have charged the White House with discovering documents only after the statute of limitations date had passed. This assertion was flatly wrong; the media had already reported that an agreement had been reached with the RTC extending the statute of limitations.

The White House has cooperated fully with all the legitimate inquiries of the Senate Committee because a full airing of the facts will show -- as the RTC report concluded -- that the vague, ever-shifting Whitewater allegations have no merit. We will continue to answer the Committee's legitimate questions.

The Pillsbury Reports on Whitewater

** **The RTC has cleared the Clintons of any civil liability for Whitewater.**

- "[T]here is no basis to sue them."
- "[T]here is no basis to charge the Clintons with any kind of primary liability for fraud or intentional misconduct. This investigation has reveal no evidence to support any such claims."
- "Nor would this record support any claim of secondary or derivative liability for the possible misdeeds of others. . . . There are legal theories by which one can become liable for the conduct of others . . . however, these theories have no application to the Clintons."
- "To hold one liable for conspiracy or aiding and abetting, the RTC must plead and prove . . . a general awareness of the wrongful acts being committed by others and an intention to assist in the commission of the primary offenses. There is no evidence here that the Clintons had any such knowledge or intent."
- "[I]t is recommended that no further resources be expended on the Whitewater part of this investigation."

** **The reports prepared by Jay Stephens' law firm, Pillsbury, Madison & Sutro, for the RTC confirm what the Clintons have long said about their investment in Whitewater.**

- The Clintons were passive investors.

  "[T]he evidence is essentially consistent with [the Clintons'] assertion" that they were passive investors and relied upon the McDougals to manage and operate Whitewater.

  "For the relevant period (ending in 1986), the evidence suggests that the McDougals and not the Clintons managed Whitewater."

  "The evidence does not suggest that the Clintons had managerial control over the enterprise, or received annual reports or regular financial summaries. Instead, and as the Clintons suggest, their main contact with Whitewater seems to have consisted of signing loan extensions or renewals."

- The Clintons lost at least $40,000 in Whitewater.

  The Clintons lost approximately $41,192 due to their investment in Whitewater.

- The Clintons had no knowledge of any money flowing from Madison into Whitewater.

  "T]here is no basis to assert that the Clintons knew anything of substance about the McDougals' advances to Whitewater, the source of the funds used to make those advances or the source of the funds used to make payments on bank debt."

"[T]here is no evidence that the Clintons knew anything of substance about the transactions as to which the RTC might be able to establish liability as to people other than the Clintons."

** **The Pillsbury reports constitute the most definitive and authoritative review of the Clintons' involvement in Whitewater.**

- The Pillsbury Report was the result of an intensive two-year investigation that cost approximately $4 million.

- Despite making public, unsubstantiated accusations about Whitewater, Republicans refused to release the reports and relented only after increasingly vocal calls for their release by the White House and Democrats in Congress.

- Republican attempts to discredit the reports are absurd.

  Republican claims that the reports merely conclude that litigation would not be cost-effective ignore repeated findings as to the lack of any evidence of wrongdoing or knowledge of wrongdoing by the Clintons.

  Efforts to diminish the value of the reports based on the subsequent discovery of the Rose billing records overlook (a) the fact that the billing records do not pertain to the Clintons' investment in Whitewater and (b) the fact that the RTC already knew of Mrs. Clinton's work for Madison Guaranty, including her work on the option agreement between Madison Financial and Seth Ward.**

GENERAL REPORT ON THE INVESTIGATION OF MADISON GUARANTY SAVINGS & LOAN AND RELATED ENTITIES

Prepared For

RESOLUTION TRUST CORPORATION

Prepared By

PILLSBURY MADISON & SUTRO LLP
Los Angeles and San Francisco, California

With Financial and Economic Analysis Support From

TUCKER ALAN INC.
Seattle, Washington

December 28, 1995

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I. SCOPE AND FOCUS OF THE INVESTIGATION.

On February 4, 1994, the Resolution Trust Corporation ("RTC") issued an Order of Investigation in the matter of Madison Guaranty Savings and Loan, McCrory, Arkansas ("Madison Guaranty"). The Order of Investigation stated (among other things) that the investigation would seek to determine whether

> former officers, directors and others who provided services to, or otherwise dealt with, Madison Guaranty . . . its successors or affiliates, may be liable as a result of any actions, or failures to act, in connection with or which may have affected Madison, its successors or affiliates . . . .

The Order was issued consistent with 12 U.S.C. § 1441a(b)(14), as modified by the RTC Completion Act of 1993, Public Law 103-204. That statute extended the limitations period applicable to RTC claims arising from fraud, intentional misconduct resulting in unjust enrichment and intentional misconduct resulting in substantial losses to the institution.

The focus of the investigation was shaped by several factors. First, a number of the officers, directors and other people involved with Madison Guaranty and related entities had been released from liability or discharged in bankruptcy, or had only minimal assets to satisfy any judgment that the RTC might obtain against them. Second, the losses associated with a number of the real estate loans and projects were, standing alone, too small to make it likely that litigation could be cost-effective. Third, it became apparent that funds had been transferred among individuals and entities associated with Madison Guaranty or with Madison Guaranty's principal owners, Jim and Susan McDougal, in ways that could not readily be justified or explained.

In light of these factors, (1) the investigation of real estate loans and projects focused primarily on the two transactions presenting the strongest combination of facts and possible sources of recovery (Castle Grande and 1308 Main Street, Little Rock); (2) the investigation of other real estate loans and projects looked for patterns and practices of misconduct that might make it cost-effective and not unduly complex to add these transactions to any litigation that might be brought based on Castle Grande and 1308 Main Street; and (3) the investigation of Whitewater included an effort, using forensic accountants, to trace funds back to Madison Guaranty and, in so doing, to look for patterns and practices of misconduct in the funds transfers among individuals and entities associated with Madison Guaranty or with Jim and Susan McDougal.

In February 1994, the RTC retained Pillsbury Madison & Sutro LLP ("PM&S") as outside counsel to assist in the investigation. Thereafter, the RTC retained Jordan & Keys as outside counsel to assist in the investigation and

Tucker Alan Inc. as forensic accountants to provide financial and economic analysis support.

II. EXTENT OF INVESTIGATION TO DATE.

Pursuant to the Order of Investigation, over 350 boxes of documents from the following sources have been collected and examined:

1. Records of Madison Guaranty and Madison Financial
2. Records of the Office of Thrift Supervision
3. Records of the Federal Home Loan Bank Board
4. Reports of Borod & Huggins and Gerrish & McCreary
5. Aetna Life & Casualty Company
6. Arkansas Securities Department
7. Citizens Bank of Jonesboro
8. William Jefferson Clinton and Hillary Rodham Clinton
9. First Commercial Bank
10. First National Bank of Wynne (fka Bank of Cherry Valley)
11. First Ozarks National Bank (fka Citizens Bank of Flippin)
12. J. W. Fulbright
13. Madison Bank and Trust
14. McCartney, Manning, McDonald & Guinn, Inc.
15. James B. McDougal
16. Meadors & Adams
17. Mitchell, Williams, Selig & Tucker
18. Rose Law Firm
19. Searcy County Bank
20. Security Bank of Paragould
21. Stephens Security Bank
22. Stogniew & Associates
23. Virginia Surety Co., Inc.
24. Worthen Bank
25. Betsy Wright, Wexler Group

In addition, Jordan & Keys obtained other documents from additional witnesses.

Beyond the sources of documents listed above, the following individuals have produced documents either by voluntary production or by subpoena:

1. Lisa Aunspaugh
2. George Betts
3. Jim Clark
4. Stephen Cuffman
5. Harry Don Denton

6. Mary Freeman
7. Sarah Hawkins
8. Larry Kuca
9. Sheffield Nelson
10. Dean Paul
11. George N. Plastiras
12. R. D. Randolph
13. Sue Strayhorn

A number of other witnesses have responded that they either retained no documents pertinent to the investigation or had previously turned over their documents to the Office of the Independent Counsel without retaining copies.

In March 1994, the RTC moved for production of documents in the hands of the Independent Counsel. The motion requested Madison Guaranty documents and the Quapaw Title Company records formerly in the possession of the RTC that had passed to Central Bank & Trust, which purchased much of Madison Guaranty. That motion was granted and an agreed order was entered on May 25, 1994. A similar motion was filed on October 4, 1994, seeking documents which had been turned over to Independent Counsel by various witnesses. On November 2, 1994, an order was entered allowing the RTC to obtain those documents.

The RTC has issued administrative subpoenas for documents or a combination of documents and testimony as follows:

Aetna Life & Casualty Company
George Betts
R. J. Brown
Citizens Bank of Jonesboro
William Jefferson Clinton and Hillary Rodham Clinton
Bonnie Crocheron
Stephen Cuffman
Harry Don Denton
First Commercial Bank
First National Bank of Wynne (fka Bank of Cherry Valley)
First Ozarks National Bank (fka Citizens Bank of Flippin)
Mary Freeman
J. W. Fulbright
Eugene Pat Harris
Sarah Hawkins
John Latham
Madison Bank & Trust
McCartney, Manning, McDonald & Guinn, Inc.
Mitchell, Williams, Selig & Tucker
Jim McDougal

Susan McDougal
Meadors & Adams
Sheffield Nelson
Dean Paul
Charles Peacock
Peoples Bank & Trust
George N. Plastiras
Pulaski Bank
R. D. Randolph
Rose Law Firm
Savers Savings
Security Bank of Paragould
Stephens Security Bank
Jim Guy Tucker
Union National Bank
Virginia Surety
Worthen Bank & Trust
Betsy Wright

In addition, documents were obtained from other sources:

RTC criminal referrals
Documents from other sources assembled by PM&S
FDIC Reports of Examination and other documents
Records of Ingersoll & Bloch
Records of litigation between Madison Guaranty and Bill Henley
Records of *Meux v. Earth Movers*
Records of *Newgent, et al. v Great Southern Land Co. et al.*
Records of *United States v. James B. McDougal*

Forty-five depositions and interviews of individuals have been conducted. These witnesses are:

Lisa Aunspaugh
Babette Baka
George Betts
Karen Bruton
Gary Bunch
Paul Castleberry
Andrew Clark
Jim Clark
Bonnie Crocheron
Betty Crum
Steve Cuffman
Harry Don Denton
Vernon Dutton

Jack Files
Davis Fitzhugh
Mary Freeman
Marshall Grant
Eugene Pat Harris
Sarah Hawkins
Pat Heritage
Webster Hubbell
Charles James
Robert Keller
Paul Kerr
Larry Kuca
James McDougal
Susan McDougal
Lisa McEntire
Steve Paar
Dean Paul
Robert Palmer
George N. Plastiras
Lisa Raglin
R. D. Randolph
John Selig
Barbara Spears
James B. "Breck" Speed III
Sue Strayhorn
Tom Tanner
R. David Thomas, Jr.
Thomas P. Thrash
Tommy Trantham
Chris Wade
Seth Ward
Bob Wilson
Greg Young

Of these witnesses, the McDougals declined to answer questions, invoking the Fifth Amendment. Wade consented to an initial interview but refused a second interview, invoking the Fifth Amendment.

Interrogatories were served on William J. and Hillary R. Clinton and Christopher Wade. The Clintons answered the interrogatories propounded to them. Wade has not answered his interrogatories. Initially he indicated through counsel that he would submit to an interview. Later, after he became dissatisfied with his plea arrangements and sentencing, he indicated through counsel that he would invoke the Fifth Amendment.

As a result of this investigation, several reports were prepared detailing findings. These reports are:

- *Madison Guaranty Savings & Loan and Whitewater Development Company, Inc., A Preliminary Report to the Resolution Trust Corporation* (Apr. 24, 1995).

- *Madison Guaranty Savings & Loan and Whitewater Development Company, Inc., A Supplemental Report to the Resolution Trust Corporation* (Dec. 13, 1995).

- *A Report on Certain Real Estate Loans and Investments Made by Madison Guaranty Savings & Loan and Related Entities* (Dec. 19, 1995).

- *A Report on the Representation of Madison Guaranty Savings & Loan by the Rose Law Firm* (Dec. 28, 1995).

- *A Report on the Rose Law Firm's Conduct of Accounting Malpractice Litigation Pertaining to Madison Guaranty Savings & Loan* (Dec. 28, 1995).

In addition, co-counsel (Jordan & Keys) and RTC lawyers handled other parts of the investigation and issued reports of their own covering topics such as other real estate loans and investments, check kiting and the representation of Madison Guaranty by the law firm of Mitchell, Williams, Selig & Tucker.

III. <u>HISTORICAL BACKGROUND - MADISON GUARANTY SAVINGS AND LOAN</u>.

A. <u>The regulatory history</u>.

In October 1980, Jim and Susan McDougal acquired control of a commercial bank, Madison Bank & Trust Company ("Madison Bank"), formerly known as the Bank of Kingston. Jim McDougal soon became disenchanted with Madison Bank because, as a commercial bank, it did not provide a vehicle through which he could invest in real estate. Changes in the law meant that a savings and loan association could be such a vehicle.

In January 1982, the McDougals purchased an interest in Woodruff County Savings and Loan Association, which they later renamed Madison Guaranty Savings & Loan. Much of the acquisition was financed by bank loans, as had been the McDougals' acquisition of Madison Bank. With these two acquisitions, McDougal took on more than a half million dollars of personal debt. Madison Bank and Madison Guaranty did not earn enough to service that debt, which increasingly burdened the McDougals. The McDougals' cash-flow problems came to a head between 1984 and 1986.

At acquisition, Madison Guaranty was a small traditional rural savings and loan on the brink of failure. McDougal once said that the Association's losses at acquisition would have exhausted its net worth within four months. McDougal's response was an attempt to grow the thrift out of its problems. In the first full year of McDougal's tenure, Madison Guaranty's total assets grew from $6.6 million (at December 31, 1982) to $17.0 million (at December 31, 1983). To achieve this asset growth, Madison Guaranty initially relied heavily on costly brokered deposits. By and large, Madison Guaranty used its new deposits to invest in real estate loans ($8.5 million at December 31, 1983) and to invest in Madison Financial's projects ($1.2 million at December 31, 1983).

Many of the direct investments were investments in real estate acquisition and development projects made through a newly created service corporation, Madison Financial Corporation ("Madison Financial"), which Madison Guaranty formed in February 1982. Madison Financial participated in real estate development projects both in Arkansas and as distant as the Campobello project in New Brunswick, Canada. These projects followed a pattern established by McDougal back in the 1970s. Typically, McDougal would locate tracts of land near lakes or streams, buy these tracts at a low price, subdivide the property and sell lots as vacation or retirement home lots on an installment basis, taking notes in return.

For the most part, Madison Guaranty financed Madison Financial's activities. Frequently Madison Guaranty's aggregate investment in Madison Financial exceeded the limits imposed by Arkansas law. Madison Financial maintained a checking account at Madison Guaranty, which was regularly overdrawn. In time, the negative balances grew so large that the balance shown on monthly statements started with a comma: There was not sufficient room on the statement to show a seven-figure negative number. Ultimately, Madison Guaranty simply deemed the overdraft an additional investment. By that point, it exceeded $2 million.

As Madison Guaranty moved into real estate loans and investments, payments to affiliates of McDougal and payments between and among various real estate projects grew. Relatively large commissions typically were paid to Susan McDougal or her brothers, among others. Lots often were sold to McDougal's business associates in transactions fully financed by Madison Guaranty. In addition, money often moved between and among seemingly unrelated entities and ventures.

In January 1984, the FHLBB started a special limited examination of Madison Guaranty. The report of examination sent to Madison Guaranty's

Board of Directors on June 1, 1984 was sharply critical of the Association. Noting that scheduled items were almost double the association's net worth, it stated that "[t]he viability of the institution is jeopardized through the institution's current investment and lending practices in real estate development projects." It also noted improper recognition of substantial profits from real estate sales. The examiners determined that approximately $565,000 of gains recognized by Madison Financial on the sale of real estate were improper. Adjusting Madison's books by that amount would have more than eliminated the net worth of the institution: It would have created a capital deficit of $70,000. The relevant accounting issue under 12 C.F.R. § 563.23-1(f)(3)-(4) (1984)[1] was remediable, however, and management made changes that it contended allowed it to recognize the profits despite the criticism.

The report of examination also noted loan underwriting and documentation problems; poor appraisal practices; loans to affiliates; excessive concentration in real estate development projects; loans to borrowers without equity; over-reliance on brokered deposits; violations of regulations; poor records, systems and controls; and inexperienced management. In response, management filed a plan for addressing most of these deficiencies; for the most part, the FHLBB deemed this plan satisfactory.

The 1984 examination led to a supervisory agreement, to which Madison Guaranty's Board of Directors consented in July 1984. The supervisory agreement required compliance with net worth and affiliated party transaction regulations, and better policies and procedures.

In October 1984, Jim and Susan McDougal resigned as directors and officers of Madison Guaranty. They remained majority shareholders; Jim McDougal remained chairman and president of Madison Financial until July 1986; and by most accounts other than his own Jim McDougal continued to dominate Madison Guaranty.

In March 1986, the FHLBB began another examination of Madison Guaranty. The problems recognized in the 1984 report of examination not only remained but had become much worse. On June 19, 1986, the FHLBB wrote to the Board of Directors of Madison Guaranty to report on its interim findings. This letter alleged a violation of the July 19, 1984 supervisory agreement and noted Madison Guaranty's continued failure to comply with the FHLBB's net worth requirements.

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1 This regulation limited the recognition of gains on sales of real estate owned by a thrift. The subsections cited permitted current recognition of the gain on a seller-financed transaction only if the loan was secured by a first lien on the property, conformed to all the FHLBB's regulations for such loans (12 C.F.R. § 545.6, et seq.) and did not involve "preferential loan terms."

On July 11, 1986, the FHLBB called Madison Guaranty's Board of Directors to a meeting in Dallas. The directors were instructed to remove Jim McDougal as chairman and president of Madison Financial (he had resigned his Madison Guaranty offices in 1984) and John Latham as chairman of Madison Guaranty. McDougal and Latham resigned. A month later, the FHLBB entered a cease and desist order ("C&D") against Madison Guaranty. Shortly thereafter, the FHLBB undertook a special limited examination to determine whether Madison Guaranty's new management had complied with the C&D. The report determined that new management was attempting to comply with the C&D but had not complied in all respects and was paying itself excessive compensation.

Between 1984 and 1986, Madison Guaranty was audited by Frost & Company. In July 1986, Frost & Company was replaced by the accounting firm now known as KPMG Peat Marwick. By May 1987, KPMG Peak Marwick had concluded that the financial statements for 1985 audited by Frost & Company materially misstated Madison Guaranty's financial condition. As restated by KPMG Peat Marwick in an audit report issued May 22, 1987, Madison Guaranty's financial statements for 1985 showed a regulatory net worth of negative $4.78 million as of December 31, 1985. Thus, after the issuance of KPMG Peat Marwick's audit report in May 1987, Madison Guaranty was known to be insolvent.

The FHLBB did not take over Madison Guaranty until February 1989, in large part because the Federal Savings and Loan Insurance Corporation ("FSLIC") lacked the money needed to take over all failed thrifts, and many other institutions presented worse problems and larger losses. On February 28, 1989, the FHLBB found that Madison Guaranty was insolvent and that grounds existed to appoint FSLIC Madison Guaranty's conservator. After the enactment of FIRREA, the RTC succeeded FSLIC as Madison Guaranty's conservator. On November 30, 1989, the Office of Thrift Supervision placed Madison Guaranty in receivership and appointed the RTC receiver.

B. Analysis of Madison Guaranty's failure.

This section presents a financial analysis, prepared by Tucker Alan Inc., of the failure of Madison Guaranty. This analysis is based primarily on the annual audited financial statements of Madison Guaranty from December 31, 1982 through December 31, 1987,[2] and the 1984 and 1986 FHLBB reports of examination.

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2 The 1982 and 1983 financial statements were audited by Deloitte Haskins & Sells. The 1984 and 1985 financial statements were audited by Frost & Company. Frost & Co. also prepared the Clintons' personal tax returns from 1978 through 1983. KPMG Peat Marwick audited Madison Guaranty's 1986 and 1987 financial statements, as well as the interim period ending June 30, 1986. KPMG Peat Marwick also re-audited the 1985 financial statements and made substantial modifications to Frost & Company's work.

1. <u>Summary</u>.

- **Madison Guaranty grew rapidly with little capital.** Total assets increased from \$6.6 million as of December 31, 1982 to \$17.0 million by December 31, 1983, \$49.0 million by December 31, 1984 and \$109.7 million by December 31, 1985. Madison Guaranty had very little capital or loan loss reserves to absorb losses. By December 31, 1985, according to Frost & Company, Madison Guaranty had just \$1,841,905 of regulatory capital (1.9% of deposits) and \$150,000 of loan loss reserves.

- **Madison Guaranty's "core" operations were unprofitable.** Initially growth was funded by high-cost, short-term brokered deposits. As Madison Guaranty grew, it did not generate enough of an interest margin to cover substantially increasing operating expenses.[3] This alone (even without loss-causing real estate investments) could have caused Madison Guaranty's failure soon after it was acquired by McDougal.

- **Madison Guaranty was dependent on profits booked on sales of real estate.** Madison Guaranty recognized \$1,978,383 in gains from the sale of real estate in 1983 and 1984. Madison Guaranty's regulatory net worth was just \$700,000 by December 31, 1984. Without these real estate gains, Madison Guaranty's net worth would have been negative \$1,278,383 by the end of 1984.

- **Madison Financial's real estate projects ultimately lost substantial sums of money.** Madison Financial's first big real estate project (Maple Creek) ultimately caused a principal loss of approximately \$3.1 million to Madison Guaranty. Later projects, including Castle Grande, Campobello and six other real estate developments, ultimately caused more principal losses totaling approximately

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3 Interest margin is the lifeblood of a sound thrift; it "pays the bills." Interest margin is the difference between interest income earned on loans and investments and interest expense incurred from deposits and other borrowings. "Core" operations are the normal and recurring functions of the thrift and generally include the interest margin and *recurring* sources of fee income (such as normal customer service charges) less normal operating expenses. Core operations exclude income sources that are dependent on business cycles (such as loan fees) or are *nonrecurring*, such as gains on sales of assets such as loans, investments or real estate.

$6.6 million.[4] These losses added to Madison Guaranty's insolvency.

- **Whitewater did not meaningfully contribute to Madison Guaranty's failure.** As discussed in the reports on Whitewater, at most $88,022 in funds traceable to Madison Guaranty was deposited into Whitewater. This did not cause Madison Guaranty's failure; that was caused by the much more substantial problems summarized above and discussed in further detail below.

2. 1982: The first year of McDougal control.

At the beginning of 1982, Madison Guaranty had total assets of $3,873,310 and capital for financial reporting purposes of $74,473. By the end of 1982, total assets had grown to $6,595,244, and capital for financial reporting purposes was $83,817.

In 1982, Madison Guaranty lost $95,656. Contributing to that loss was a $101,882 negative interest margin. In all the years of McDougal control, poor interest margins were a chronic financial problem; this greatly contributed to Madison Guaranty's failure.

3. 1983-1984: Rapid growth and questionable profits.

Madison Guaranty's total assets grew to $17,059,979 by the end of 1983. This represented a large increase but it seems almost modest compared to what was to occur thereafter. By the end of 1984, Madison Guaranty's total assets had grown to $48,961,154. In 1983 and 1984, little was done to provide and build reserves for the risk inherent in Madison Guaranty's rapid loan growth and development risk (real estate investments). As of December 31, 1984, Madison Guaranty had a total loan loss reserve of just $75,000.

Madison Guaranty reported profits of $117,127 in 1983. Within the revenues that generated that profit were gains on the sale of real estate totaling $1,000,068.

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4 Losses described in this section are derived from damages calculations prepared by RTC Investigations. The calculations include cash investment losses consisting of unrecovered acquisition and development costs and related loan losses; prejudgment interest and other lost opportunity earnings components have been *excluded*. On this basis, principal losses are estimated as of July 1995 as follows: Maple Creek, $3.1 million; Castle Grande, $1,051,207; Campobello, $2,934,452; Brittany Point, $259,374; Lake Faircrest, $677,200; Greentree Farms, $105,911; Fair Oaks, $404,143; Gold Mine Springs, $262,390; and Eden Park, $483,796.

Madison Guaranty reported a loss of $74,046 in 1984 and had virtually no interest margin, just $48,047. This loss would have been substantially greater but for $978,315 of gains on sale of real estate recognized during the year.

Thus, during the two-year period ending December 31, 1984, Madison Guaranty recognized net income of just $43,081. Without the real estate sales profits of $1,978,383 described above, Madison Guaranty would have lost $1,935,302.[5] This would have substantially more than absorbed its regulatory capital, reported to be $700,000 as of December 31, 1984.

Real estate profits in 1983 and 1984 masked the explosion of Madison Guaranty's operating expenses. During McDougal's first year of control, 1982, the thrift incurred just $213,984 of operating expenses, including an incredibly low $86,793 of compensation cost. In 1983, operating costs increased to $990,523 (including $375,175 in compensation expense). Operating costs in 1984 increased even further to $1,554,589 (including $578,633 in compensation expense). Of total operating costs in 1983 and 1984, approximately one-half was spent by Madison Financial: $524,730 in 1983 and $721,247 in 1984.

From an accounting and regulatory point of view, the real estate profits presented two main issues: revenue recognition issues and loss contingency issues. The revenue recognition issues (mentioned above) centered on the fact that Madison Guaranty financed nearly all of Madison Financial's real estate sales, many of which were to friends and insiders who put up no real equity of their own.[6] The loss contingency issues centered on the failure of Madison Guaranty and its audits to recognize losses once its real estate projects began to turn sour.

Without its reported profits on real estate sales, Madison Guaranty was insolvent by December 31, 1983. Reported regulatory net worth at that time was just $354,994, bolstered by real estate profits of $1,000,068. Without these profits, regulatory net worth would have been a negative $645,074. Because Madison Guaranty's core operations were substantially unprofitable, only new capital infusions or other business opportunities would have restored Madison Guaranty to solvency. That never happened.

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5 This calculation is an approximation. It is possible that certain incremental expenses might not have been incurred absent those sales (e.g., legitimate sales commissions), or that management might have controlled certain expenses had it not been for these real estate profits. Even so, the financial impact would still have been substantial.

6 There were other issues as well. Project cost accounting often was arbitrary. Large commissions were paid to friends and insiders. Contracts were awarded without any serious bidding or negotiation over price.

4. <u>1985: More rapid growth and more large reported real estate profits.</u>

Madison Guaranty's total assets grew from $48,961,154 at the end of 1984 to $109,680,561 at the end of 1985. Madison Guaranty reported net income of $829,614 in 1985. Included in gross income was $1,857,684 from the sale of real estate. Without that income, Madison Guaranty would have lost more than $1 million.

Once again, Madison Guaranty had a thin net interest margin, just 70 basis points, or $460,513. This compares to operating expenses that had grown from $1,554,589 in 1984 to $2,826,278 in 1985 (including $1,231,606 in compensation). Thus, Madison Guaranty's core operations continued to be substantially unprofitable. Even with the substantial real estate development profits recognized by the institution, Madison Guaranty's reported regulatory net worth of $1,841,905 was below its minimum requirement of $3,691,000, as reported in its December 31, 1985 financial statements audited by Frost & Company.

Between McDougal's acquisition and December 31, 1985, Madison Guaranty reported profits on the sale of real estate of $3,836,067. This compares to aggregate reported net income for the same period (1982 through 1985) of $777,039. These profits were derived from projects that ultimately resulted in losses to Madison Guaranty of approximately $9.3 million. In future years, Madison Guaranty would have to recognize $13.1 million in losses to turn these $3.8 million in gains into $9.3 million in losses. That process did not begin, however, until after the replacement of Frost & Company in 1986.

As noted, Madison Guaranty reported net income of $829,614 for the year ended December 31, 1985. Frost & Company agreed with that number and issued an unqualified opinion. After FHLBB examiners discovered that Frost & Company's engagement partner had borrowed money from Madison Guaranty during the engagement, KPMG Peat Marwick was hired to perform the 1986 audit. As part of its services, KPMG Peat Marwick also performed its own audit of Madison Guaranty's 1985 financial statements. Its conclusions were quite different.

Instead of net income of $829,614, KPMG Peat Marwick concluded that Madison Guaranty should have reported a net *loss* of $5,188,718. With this restatement, Madison Guaranty's regulatory net worth became a negative $4,776,427, approximately $8,600,000 below minimum capital requirements.

5. 1986-1987: More losses.

Madison Guaranty's assets did not grow substantially after 1985. Total assets grew marginally to $114,606,063 by the end of 1986, then shrank to $109,330,064 by the end of 1987.

Madison Guaranty lost $4,801,661 in 1986 and $3,674,129 in 1987. These losses included provisions for loan and real estate losses totaling $3,902,375. In total, KPMG Peat Marwick required $9,546,367 of loss provisions and gain reversals for 1985 through 1987.

Madison Guaranty's deficit regulatory net worth at December 31, 1987 was $12,186,000. According to RTC Investigations, later loan and real estate losses when combined with operating and liquidation costs would ultimately increase this deficit to approximately $60 million.

From an economic point of view, Madison Guaranty's failure was the result of almost no capital and reserves, thin interest margins and substantially unprofitable core operations combined with unsuccessful real estate speculation and questionable payments to insiders. The McDougals' real estate activities were gambles resulting from the need to find income to mask the thrift's core problems while at the same time funding the money they paid to their relatives, insiders and themselves. The gamble failed, but by the time it did, the deficit at Madison Guaranty had grown from a few hundred thousand dollars in 1982 to approximately $60 million today.

IV. RESULTS OF THE INVESTIGATION.

The results of the investigation are set forth in the five reports listed above on page 6. Those results should be read in light of the reports' discussions of the methodology employed in this investigation and its limitations.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. report	Pillsbury Madison and Sutro report re: Certain Real Estate Loans and Investments Made by Madison Guaranty Savings & Loan [Federal Rules of Criminal Procedure 6 (e)] (43 pages)	12/19/1995	P3/b(3)

COLLECTION:

Clinton Presidential Records
First Lady's Office
Lissa Muscatine
OA/Box Number: 20089

FOLDER TITLE:

Madison Guaranty Savings and Loan [1]

2015-0275-S
rc1968

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. report	Pillsbury Madison and Sutro report re: Supplemental Report to the Resolution Trust Corporation [Federal Rules of Criminal Procedure 6 (e)] (102 pages)	12/13/1995	P3/b(3)

COLLECTION:

Clinton Presidential Records
First Lady's Office
Lissa Muscatine
OA/Box Number: 20089

FOLDER TITLE:

Madison Guaranty Savings and Loan [1]

2015-0275-S
rc1968

RESTRICTION CODES

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