# The Quiet Fall of The House of Smith

11-27-73

By Leroy F. Aarons
Washington Post Staff Writer

SAN DIEGO, Nov. 26—The third week in October was the week Archibald Cox got fired, Elliot L. Richardson and William D. Ruckelshaus resigned, impeachment fever reached its peak, and the country suffered the largest bank failure in its history.

In the swirl of excitement around Washington, that last event, the demise of the U.S. National Bank of San Diego, was but dimly perceived, like a faint tremor in the midst of an earthquake.

Even the fact that the bank was ranked 83d in the nation, held nearly $1 billion in deposits and $1.2 billion in assets, and was controlled by financier and one-time Nixon friend C. Arnholt Smith, failed to penetrate the national consciousness.

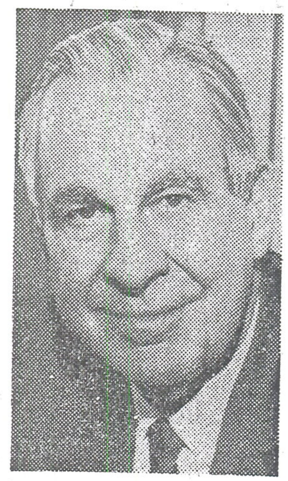
But in the weeks that followed, the aftershocks of USNB's collapse have rippled to shake the foundation of international banking, create jitters for federal bank regulation agencies and stimulate talk of reform in Congress.

Any bank failure creates jumpy nerves in financial circles, but the size, nature and timing of USNB's demise left the industry incredulous and shaken. If a mighty tree such as USNB could fall from rot that had gone undetected, what of the other giants in the forest?

Both the House and Senate banking committees have scheduled investigations focusing on the adequacy of federal bank supervision methods. The House Bank Supervision Subcommittee will hear testimony on Tuesday from James E. Smith, U.S. comptroller of the currency, and R. Frank Wille, chairman of the Federal Deposit Insurance Corp.

The comptroller's office has direct supervision of the nation's 4,600 national

See SMITH, A8, Col. 1



C. ARNHOLT SMITH
... banking magnate

SMITH, From A1

banks, and the FDIC assumes responsibility for insured assets once a bank goes under.

The House subcommittee is seeking an answer to the question stirring in banking and governmental circles since USNB failed, leaving nearly $400 million in questionable loans outstanding: Why were USNB's troubles not detected sooner; and, if they were, why wasn't action taken earlier than it was?

Equally disturbing was the scent of internal corruption that emerged from the Oct. 18 collapse. USNB stock was publicly traded, but control was firmly in the hands of Smith and his family. Smith was chairman of the board and president until early this year.

When the FDIC took USNB into receivership on Oct. 18, it found nearly $400 million in loans of doubtful collectibility — all of them held by Smith-related companies. The questionable loans represented two-thirds of the bank's entire loan and business portfolio.

Internatioanl Furor

In another respect, the bank's collapse caused an international furor when it was discovered that of the $400 million, $92 million was in letters of credit issued by USNB to foreign banks. Those banks, now facing losses in the millions, have begun to retaliate. One of them, National Westminster Bank, Ltd., of London was reported to have decided not to renew at least 40 lines of credit to U.S. banks — totaling $110 million.

The figures did not come as a total surprise. Smith's mighty empire had begun to crumble five months earlier when the Securities and Exchange Commission filed a voluminous and complex lawsuit charging Smith and his associates with using the bank and Smith's Westgate-California Corp. for a variety of self-dealing and self-enriching schemes over the last five years.

When USNB collapsed, Smith decided not to go to trial on the SEC suit. He acceded to a consent agreement removing him from control of Westgate-California, the huge conglomerate he had founded and developed through a series of proliferating subsidiaries and acquisition to a $220 million-a-year business in a dozen years.

Toppled from Westgate and from the bank he had purchased 40 years ago when it had $2 million in assets, the 74-year-old Smith was watching his lengthy dominance wind to a humiliating close. He also faces a $22 million tax lien from the IRS and possible criminal prosecution in a federal grand jury investigation now assessing the magnate's tangled affairs in San Diego.

Rumors of trouble within the Smith operation had existed for years in San Diego financial circles. As far back as April, 1969, the Wall Street Journal published a lengthy article outlining some of the suspicious dealings. Two years later, Westgate's auditors raised serious questions about transactions between USNB and various Westgate subsidiaries.

If the bank regulatory agencies are supposed to prevent bank failures, why did U.S. National Bank fail? Are their examination methods inadequate? Their examiners not diligent or zealous enough? Or can a bank's management intent on deception succeed in juggling the books sufficiently to fool the most persevering investigators?

Some of these questions may be answered in Tuesday's testimony. Others are shielded behind the supersecrecy of bank examiner reports which are not even open to scrutiny by the General Accounting Office, the congressional watchdog agency.

The USNB affair is too complex for the answers to be simple or easy. Investigations will probably show there are heroes and fools alike. One of the heroes must be William Martin, the examiner from the comptroller's office who stumbled onto something suspicious in June, 1972, and spent three months pursuing it under enormous pressure and harassment from officers of the prestigious USNB, including Smith himself. The results of his work helped expose the USNB's "system," and greatly advanced the SEC investigation.

On the other hand, there are indications that the comptroller's office in recent years may have been lulled into a sense of false security, and the examination standards could have deteriorated.

For example, former Comptroller William Camp, a career employee who retired in March of this year, had discontinued the practice of requiring periodic memos on the status of the nation's top 200 banks because, according to Deputy Comptroller Justin Watson: "Comptroller Camp had been quite familiar with the banks and felt they (the memos) were not necessary."

Camp's successor, James E. Smith, who took office last July, has reinstituted the memos. Smith recently told a Senate committee that the comptroller's examination practices hadn't been systematically re-evaluated since the office's creation 110 years ago.

C. Arnholt Smith, once dobbed "Mr. San Diego of the Century, dropped out of high school, took a job as a grocery clerk, and then as a minor official in what later became the Bank of America. He rose to a vice presidency.

He began acquiring struggling businesses during the depression. One of those businesses was U.S. National Bank, which had only $2 million in assets at the time, but in the '50s and '60s USNB grew in size to become one of the nation's largest, capitalized at $60 million.

Smith's influence and power grew in proportion. Always a behind-the-scenes man, he rarely appeared in public. He is a striking figure, tall, tanned and silver-haired, dressed always in his favorite brown. But his reach was all-inclusive: trusted subordinates were placed on city and county boards and commissions. Statewide and nationally, he supported Republicans, while his friend and business associate, John Allessio (later convicted of tax evasion) did his bit for Democratic candidates.

Once, in 1958, Smith backed a Democrat for state comptroller. After the man's election, USNB's share of state business doubled. "He appreciated what we had done for him and he reciprocated," said Smith in a rare moment of candor.

One of the men he met and helped in the early congressional days was Richard M. Nixon. The relationship blossomed over the years, and in 1968 Smith was reported to have riased $1 million for the presidential campaign, a quarter of it his own contribution.

In recognition of the close ties, Mr. Nixon invited the Smiths to watch the election returns from his hotel suite in New York and they were among the first visitors to the White House. The relationship soured, at least publicly, however, when Smith's troubles began to surface, especially in a March, 1972, Life magazine article alleging that he had illegally filtered corporate campaign funds for the Nixon race through a secret account. Mr. Nixon was warned off Smith by state Republican leaders, and a 1972 personal contribution was returned.

But before his trouble started, Smith held sway over an enormous financial and political empire. In 1960 he created Westgate-California Corp. from a tuna fishing boat company, some real estate and a chunk of USNB stock. The new corporation rapidly expanded, acquiring Yellow Cab companies in 13 cities, Air California, an intrastate air taxi, and moved into real estate with shopping centers, office buildings, and the lavish Westgate complex in downtown San Diego, which includes the opulent Westgate Plaza Hotel.

The first public glimpse behind the Smith facade was the Wall Street Journal's trail-blazing article of April 16, 1969.

The article detailed with prophetic accuracy how "Mr. Smith and certain relatives and associates have profited handsomely from transactions with Westgate-California and U.S. National Bank, both of which are publicly owned." (Although, the Journal was to note, the voting stock in both instances was controlled by Smith and his associates.)

Uncannily, the five-column-long expose did not come to the attention of SEC enforcement officials, who say they did not become aware of the Smith empire until tipped by a Los Angeles Times reporter nearly a year-and-a-half later. When SEC enforcement people began probing in November, 1971, they quickly discovered a key filing by Haskin and Sells, auditors for Westgate, right in the National Archives.

In that filing, part of the Form 10-K required of all corporations dealing in securities, the auditing firm said that Westgate had at times borrowed from USNB beyond the legal limit and had recorded profits by selling notes and land to long-time associates Hollis Roberts, a syndicate farmer in the San Joaquin Valley, and M. J. Coen, a former Westgate director and Kansas City financier.

"I remember looking at that annual report," said SEC enforcement chief Irving Pollack, "at that pattern of self-dealing, and it was almost like somebody saying, 'Hey, stupid, there's something going on here. Get going.' "

SEC got going, but it was 18 months before it felt secure enough to file its lawsuit; even then, investigators say, they hadn't fully untangled the ingenious Smith skein.

But, essentially, it was all in the 30-page SEC complaint; a pattern of self-dealing between Westgate, USNB and various friends and relatives of Smith, notably Roberts and Coen. Smith was "on all sides" of the transactions, he and his associates "capitalizing on their positions as managers and controlling persons of USNB and Westgate to systematically appropriate the assets" for their own benefit. To camouflage "their fraudulent appropriation," they "created ostensible profits for these entities."

Financing for these transactions would be arranged "by C. A. Smith through borrowings at USNB" and "concealed from Westgate's auditors and the investigating public by channeling the borrowings through numerous corporate entities . . . and the sales were carefully structured to appear as arms length cash transactions."

The SEC outlined 15 examples of how the operation worked. In each case, the SEC says, Smith arranged financing for the purchasers through borrowings from USNB. In many cases, the SEC alleges, Westgate "loaned" to various asociates its assets interest-free so they could be used as collateral for loans made by USNB and authorized by Smith. At least $20 million in loans listed to Westgate by USNB were never recorded in Westgate's books, the SEC says.

The SEC alleged that these practices went back to 1969 at least. Other sources say the practices may have begun as early as 1964 or 1965. The question is, how was the bank able to hide the self-dealing loans from bank examiners for so long?

One answer lies in the total control Smith exercised over the loan portfolio. A former bank official told The Washington Post: "Smith made all of the decisions with respect to lending. He would merely tell some mechanic to draw papers. He'd prepare the notes himself, draw the loan, probably write the credit memo himself or have it done by a low-level guy."

Paul Tenney, a USNB vice president and commercial loan officer, gave this revealing response to questioning a year ago from SEC about dealings between USNB and M. J. Coen, one of the defendants in the SEC suit, described as a Smith "nominee" who participated in the fraud:

"Mr. Coen has a long and successful history of bank relations. He has had many paid loans, and because of this relationship developed with our chairman (Smith) over the years, and as a friend he goes to him as his banker and he discusses with him his credit needs, and when they have reached a decision, Mr. Smith will either call me or have a note drawn for me to process, at which time I will then develop from Mr. Smith the purpose, the repayment and also from Mr. Coen to amplify and expand the purposes of the loan."

Thus when federal bank examiners arrived, unannounced as they were, the loan files for their scrutiny would be complete.

"Some of those credit memorandum write-ups were terrific," recalled Michael McConihe, one of the SEC attorneys on the project. "They included an appraisal of the property, often done by Smith, a forecast of future plans and so on. I really felt one of the bank officers should have gotten a writing award.

Added Deputy Comptroller Justin Watson, "We don't talk to the borrowers. Unless you find a discrepancy we make the assumption the banker is honest to start with. When you get a conspiracy, you're going to whip an examiner, an auditor or anybody for awhile."

Nonetheless, it appeared that bank examiners suffer under other handicaps. For instance, banks are not required to maintain copies of borrowers' SEC reports in their loan files: thus, it would be unlikely that a bank examiner knew about the strongly worded Haskin and Sells reservation to the 1971 Westgate audit. Furthermore, banks are not required to be audited by independent CPAs. Thus, an examiner checking USNB's ledgers would have to rely on the word of the bank's internal auditors.

Despite this, a year after the Wall Street Journal article, an examiner in April, 1970, had an early warning when he found that USNB had questionable loans amounting to 37 per cent of the bank's total capital value. Of these, 16 per cent or $7 million were loans to Westgate companies.

The 37 per cent questionable loans, while high, are not in the comptroller's "danger" zone, which begins at 50 per cent. By the next examination, the percentage of "classified" loans was down to 20 per cent. There was a slight increase to 25 per cent in 1971, but nothing sufficient to alert anyone.

"There were rumors, sure," said A. E. Larson, Western regional administrator. "But they don't know what the facts are. I think the Wall Street Journal was right in characterizing Smith as a 'swinger,' but they didn't say anything in 1969 that would indicate in 1973 the bank would have to be closed."

Thus it was not until June, 1972, with the Martin examination, that the bank's peculiar cryptography was deciphered, and that was, at first, an accident. One of Martin's team noticed that $20 million in loans to Westgate listed by USNB was unrecorded on Westgate's financial statement. That led Martin on the long path of checking the recipients of each recorded loan, something, apparently, that examiners before him had never troubled to do.

The young, 30-year-old Texas native, a soft-spoken tenacious man reminiscent of the Jack Nicholson character in "Easy Rider," began to discover to his horror that loans to one Westgate subsidiary were being tossed around to others in a pattern the SEC was ultimately to document in its lawsuit. Thus, instead of there being 150 independent entities, each borrowing within its legal limits, there was a connecting network of related companies which, taken jointly under law, were phenomenally oversubscribed.

USNB, Martin told his incredulous superiors, had questionable loans equal to 372 per cent of its capital value—roughly $180 million, all to Smith-related entities! The jump from 25 per cent in the previous examination was too drastic to ignore. USNB was obviously in danger of folding.

Oddly, around the time Martin was making his discoveries, the comptroller was approving a new acquisition on the part of USNB, this one the failing Fidelity Bank of Beverly Hills. Officials explained that they hadn't yet grasped the enormity of the problem when they approved the merger in mid-July, 1972.

Regional administrator Larson told The Washington Post that the big buildup of faulty loans came between 1971 and 1972, but the comptroller's office in Washington was not able to verify that by the weekend. In any case, the comptroller in 1972, despite the frightening report, decided to continue to work with Smith.

Smith assured it that with the sale of the San Diego Padres, refinancing of the money-losing Westgate Plaza Hotel and other measures, he could make good the bad loans.

But by January of this year, when Martin again went into the bank, the percentage of shaky loans had then, the comptroller had referred the case to the U.S. attorney, FBI auditors were inside the bank, and the comptroller had a full-time force watching the bank's day-to-day activities.

Then in March, the comptroller issued a secret cease-and-desist order deposing Smith as president and ordering USNB to collect its listed loans. The bank was hanging by a thin thread.

On May 31, over the objections of the comptroller and the FDIC, the SEC filed its lawsuit, naming both Westgate and USNB (the bank regulators wanted the SEC to leave the bank unmentioned for fear of a run by depositors). The suit caused USNB to lose $100 million in deposits, forcing it to begin borrowing as much as $70 million a day from the Federal Reserve and other banks to keep a cash supply on hand.

In August still another comptroller audit showed that $45 million of USNB's loans were uncollectable and another $45 million were probable future losses. With its capital value at between $50 million and $60 million, that meant USNB was insolvent. Still the comptroller hung on while the FDIC worked feverishly to put together a package that would salvage the good assets of the bank and protect the depositors.

Secret negotiations began with several banks in September. By mid-October, Crocker National Bank of San Francisco was high bidder on a proposal that would turn USNB's good deposits over to Crocker for $90 million, with the FDIC picking up responsibility for the questionable loans.

The deal was closed on Thursday, Oct. 18, a day early because both CBS and the Wall Street Journal had gotten wind of the story.

When the announcement came, Crocker hastily plastered signs on USNB's doors, "Now we're Crocker Bank," and the bank opened the next day to an amazingly untroubled public. There was no run on the bank, and the depositors' money was salvaged. The main losers will be USNB's stockholders — the largest of whom is C. Arnholt Smith and family — the FDIC, and possibly the overseas banks holding letters of credit.

The comptroller and FDIC point to their resuce operation with pride, claiming it justified keeping the bank afloat as long as it was. "It's a matter of timing," said Deputy Comptroller Watson. "If the Crocker deal had fallen through, then we would have been in worse trouble. People would say, 'Why didn't you close the bank sooner?'"

Still, comptroller officials admit that they failed somewhere along the line. "When the football game is over, we were supposed to have won. We didn't, so we must have done something wrong," said Westbrook Murphy, a deputy counsel.