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STATE OF MINNESOTA
IN COURT OF APPEALS
A09-1962

Fidelity Holding Company,
Respondent,

vs.

REZ, Inc., f/k/a Fidelity Bancshares, Inc.,
Appellant.

Filed June 22, 2010
Affirmed
Schellhas, Judge

Hennepin County District Court
File No. 27-CV-09-9197

Thomas H. Boyd, Winthrop & Weinstine P.A., Minneapolis, Minnesota (for respondent)

David L. Sasseville, Amy R. Mason, Lindquist & Vennum P.L.L.P., Minneapolis, Minnesota (for appellant)

Considered and decided by Schellhas, Presiding Judge; Connolly, Judge; and Muehlberg, Judge.*

* Retired judge of the district court, serving as judge of the Minnesota Court of Appeals by appointment pursuant to Minn. Const. art. VI, § 10.

U N P U B L I S H E D O P I N I O N

SCHELLHAS, Judge

Appellant, who sold a bank to respondent, argues that the district court erred by misinterpreting an escrow agreement relating to the sale and granting summary judgment to respondent. We affirm.

FACTS

Appellant REZ Inc. (seller) owned 100% of the issued and outstanding shares of Fidelity Bank (the bank). On May 13, 2005, seller agreed to sell to respondent Fidelity Holding Co. (buyer) all bank shares. Pursuant to the parties' purchase agreement, the parties closed on the sale on November 29, 2005. At the closing, buyer paid seller $57,000,000; seller and buyer entered into an escrow agreement; and, pursuant to the terms of the escrow agreement, buyer placed $6,500,000 in an escrow account.

The purpose of the escrow agreement was "to provide assurance to Buyer that the future earnings of [the bank] generated over the next two years [following the purchase] in the ordinary course of business consistent with past practices w[ould] average at least $8,250,000 annually." If the future earnings generated over the next two years fell short of $8,250,000 annually (shortfall), buyer would be entitled to a payment out of the escrowed funds of 7.7 times the amount of the shortfall, up to a maximum of $6,500,000, with the remainder to be delivered to seller and interest to be distributed pro rata between seller and buyer. The terms of the escrow agreement provided that the shortfall, if any, was to be calculated by subtracting the bank's average annual "Pro Forma Income" over the two calendar years following closing—2006 and 2007—from the agreed-upon

$8,250,000 benchmark. The escrow agreement defined pro forma income for a given year as the bank's "Pretax Income" for that year with four specifically enumerated adjustments: dividend adjustment, excess insider payments, excess labor costs, and expansion costs.

The escrow agreement defined "Pretax Income" as "the pretax income of the Bank," and provided that "[f]or purposes of determining . . . Pretax Income, Seller and Buyer shall use the Bank's quarterly Reports of Condition and Reports of Income (collectively, the 'Call Reports') prepared at each calendar quarter end." Call reports are reports that the bank "prepares pursuant to federal law and submits to the FDIC as part of its adherence to federal regulatory requirements." Call reports are prepared pursuant to the Federal Financial Institutions Examination Council's Instructions for Preparation of Consolidated Reports of Condition and Income (General Instructions) and must comply with Generally Accepted Accounting Principles (GAAP). According to Jerry Felicelli, a CPA working for the bank's independent auditor, the bank's call reports appear to have been prepared in accordance with the General Instructions, which require adherence to the GAAP.

The parties attached a worksheet to the escrow agreement and agreed to use the worksheet to calculate the purchase-price adjustment. For calendar years 2006 and 2007, the years at issue, the worksheet provided blanks for pretax income and the four adjustment factors: dividend adjustment, excess insider payments, excess labor costs, and expansion costs. Pro forma income would be determined by adjusting pretax income based on the four agreed-upon adjustment factors. The pro forma income for 2006 and

2007 would be added together and then divided by two to calculate the average pro forma income. Buyer completed the worksheet to determine the average pro forma income and then subtracted that figure from the $8,250,000 benchmark to calculate the shortfall. Buyer calculated the shortfall to be $478,770 and multiplied the shortfall by 7.7, arriving at a payment due buyer from the escrow funds in the amount of $3,686,526.

The escrow agreement limited the ways by which buyer could modify the bank's policies during 2006 and 2007. First, buyer agreed that during the term of the escrow agreement, it would "not cause the Bank to make any material changes in the Bank's loan or investment policies unless such changes [were] consented to by James W. Morton . . . , the President of the Bank, such consent not to be unreasonably withheld." Second, the escrow agreement provided:

> In calculating the Bank's Year One Pretax Income and Year Two Pretax Income, the Bank's loan and lease loss reserve shall be calculated consistent with the Bank's loan and lease loss reserve policy in effect as of the date of the Purchase Agreement; provided, the Buyer shall not be required to increase the Year One Pretax Income or Year Two Pretax Income of the Bank due to any excess amount in the Bank's loan and lease loss reserve, unless and only to the extent that, [the] Bank made contributions to the loan loss reserve after the date hereof.

A loan-loss reserve is a "[v]aluation reserve against a bank's total loans on the balance sheet, representing the amount thought to be adequate to cover estimated losses in the loan portfolio." Thomas P. Fitch, *Dictionary of Banking Terms* 273 (4th ed. 2000).

Since 1986, the bank had a program known as the Mortgage Loans In Transit (MLIT) program. The MLIT program provided short-term loans to the bank's

residential-mortgage-originator customers so that the originators could make loans to residential mortgagors. The bank then purchased the mortgages and notes from the originators. In practice, 100% of MLIT-program loans were repurchased by the originators to be sold into the secondary market "within a matter of days, or at the outside, weeks"; therefore, the bank did not establish a loan-loss reserve for these loans. According to Morton, this practice was approved by the FDIC and the bank was not required to post any loan-loss reserves for these loans.

At the time of the May 13, 2005 purchase agreement, the bank had a written loan-loss-reserve policy that specified the percentage of the value of each type of the bank's loans that generally would be maintained as a loan-loss reserve. The policy stated: "Mortgage Loans in Transit – 0%." But, in addition, the policy stated that "[a]dditional allocation based upon management assessments of specific credits may also be made" and that "[t]he minimum Loan Loss Reserve will be maintained at a level no less than 1.5% of total loans excluding Mortgage Loans in Transit plus a reasonable reserve for Mortgage Loans in Transit." The bank's written policy provided that the adequacy of the loan-loss reserve was to be "reviewed on a minimum of a quarterly basis" and adjusted based on current economic conditions, among other things.

Due to general economic decline, as of November 30, 2007, the bank had incurred more than $3 million in year-to-date write-downs and write-offs associated with its MLIT program. At a meeting on January 24, 2008, the bank's board of directors resolved to implement a loan-loss reserve for the MLIT program for 2007 in the amount of $149,000, a change to the written policy that provided for a loan-loss reserve of zero for the MLIT

program. The change to the policy resulted in a $149,000 retroactive charge against the bank's 2007 earnings. Although the minutes from the board meeting reflect that the motion to amend the MLIT loan-loss-reserve policy was unanimously approved, Morton disputes that he consented to the amendment. Morton states, rather, that he protested the change, along with one other member of the board. But according to bank director Craig Flom, who was present at the board meeting, "The decision was made with the concurrence of [Morton]."

In February 2008, buyer provided seller with the completed purchase-price-adjustment worksheet, including "workpapers." Flom completed the worksheet. To calculate the 2006 pretax income, Flom took the net income stated in the call reports filed by the bank with the FDIC for 2006 plus $209,000 of excess loan-loss reserve pursuant to the second sentence of paragraph 3 of the escrow agreement. Similarly, to calculate the 2007 pretax income, Flom took the net income stated in the call reports for 2007, which had been adjusted downward for the $149,000 MLIT loan-loss reserve for 2007.

The net income stated on the bank's 2006 and 2007 call reports, from which Flom calculated pretax income for use on the worksheets, included downward adjustments for the amortization of the core-deposit intangible in the amounts of $562,211 in 2006 and $518,963 in 2007. Felicelli explained Flom's approach:

> The purchase method of accounting requires that the acquiring entity allocate the cost of the acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at the date of the acquisition. This "push down accounting" which establishes the new accounting basis for a bank in its separate financial statements is required by the Call Report instructions if a bank's voting

> stock becomes at least 95% owned by the acquiring entity. . . . [A] core deposit intangible asset qualifies as an intangible asset that must be recognized as an asset apart from goodwill. The core deposit has a finite life and must be amortized (expensed) over this period using a method that reflects the pattern in which the economic benefit of the asset is consumed.

According to Felicelli, the deduction of amortization of the core-deposit intangible to arrive at the net income reported on the call reports was not discretionary.

Seller objected to buyer's calculation, and the parties were unable to resolve their differences. They agreed to waive the alternative-dispute-resolution provisions of the escrow agreement, thereby allowing the commencement of an action in district court in which buyer sought a declaration of its rights under the escrow agreement and a determination as to the disposition of the escrow deposit. The parties stipulated to the appointment of a consensual special magistrate (CSM), pursuant to Minn. Stat. § 484.74, subd. 2a (2008), and the district court ordered the appointment of a CSM. Thereafter, both parties moved for summary judgment.

The CSM issued findings of fact, conclusions of law, and an order granting summary judgment to buyer, directing that $3,686,526 of the escrowed principal be distributed to buyer and that the remainder be distributed to seller, and directing that the accrued interest be distributed pro rata to the parties. The district court adopted the CSM's decision, and this appeal follows.

D E C I S I O N

Seller challenges the district court's grant of summary judgment to buyer, arguing that the district court misinterpreted the escrow agreement. Summary judgment is

appropriate when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that either party is entitled to a judgment as a matter of law." Minn. R. Civ. P. 56.03. "On appeal from summary judgment, we ask two questions: (1) whether there are any genuine issues of material fact and (2) whether the [district court] erred in [its] application of the law." *State by Cooper v. French*, 460 N.W.2d 2, 4 (Minn. 1990). A genuine issue of material fact exists if the evidence would "permit reasonable persons to draw different conclusions." *Gradjelick v. Hance*, 646 N.W.2d 225, 231 (Minn. 2002). We view the evidence in the record "in the light most favorable to the party against whom judgment was granted." *Fabio v. Bellomo*, 504 N.W.2d 758, 761 (Minn. 1993).

Deductions for the Amortization of the Core-Deposit Intangible

Seller first argues that the district court erred by permitting buyer to calculate pretax income on the worksheets to include deductions for amortization of the core-deposit intangible. Whether the terms of the escrow agreement permitted buyer to do so presents a question of contract interpretation, which an appellate court reviews de novo. *See Valspar Refinish, Inc. v. Gaylord's, Inc.*, 764 N.W.2d 359, 364 (Minn. 2009) ("Contract interpretation is a question of law that we review de novo.") (quoting *Travertine Corp. v. Lexington-Silverwood*, 683 N.W.2d 267, 271 (Minn.2004)).

"The primary goal of contract interpretation is to ascertain and enforce the intent of the parties." *Valspar*, 764 N.W.2d at 364. "Where there is a written instrument, the intent of the parties is determined from the plain language of the instrument itself." *Travertine*, 683 N.W.2d at 271. Contract language is given its plain and ordinary

meaning, read in the context of the instrument as a whole. *Brookfield Trade Ctr. v. County of Ramsey*, 584 N.W.2d 390, 394 (Minn. 1998).

While "the general rule is that recitals are not the basis of a binding agreement," *State by Crow Wing Env't Prot. Ass'n v. City of Breezy Point*, 394 N.W.2d 592, 596 (Minn. App. 1986) (citing *Berg v. Berg*, 201 Minn. 179, 188, 275 N.W. 836, 842 (1937)), *review denied* (Minn. Dec. 17, 1986), we consider recitals as well as operative clauses in attempting to ascertain the parties' intent, *Downing v. Indep. Sch. Dist. No. 9*, 207 Minn. 292, 299, 291 N.W. 613, 616 (1940). "[W]hen so considered, language which has a distinct meaning standing alone may, in the connection used, become doubtful or its meaning modified by other parts of the instrument, including particular recitals." *Downing*, 207 Minn. at 299, 291 N.W.2d at 616 (quotation omitted). But the specific terms of a contract govern over the general in the event of a conflict. *Burgi v. Eckes*, 354 N.W.2d 514, 519 (Minn. App. 1984); *accord Egner v. States Realty Co.*, 223 Minn. 305, 314, 26 N.W.2d 464, 470 (1947) ("[T]he definite prevails over the indefinite.").

The purchase-price-adjustment calculation on the worksheet began with the pretax income for each of years 2006 and 2007. The escrow agreement and worksheet provided that the worksheet should be completed based on definitions provided in the escrow agreement. The escrow agreement contained the following definitions of pretax income:

> (a) "Year One Pretax Income" shall mean the pretax income of Bank for Year One. For purposes of determining the Year One Pretax Income, Seller and Buyer shall use the Bank's quarterly Reports of Condition and Reports of Income (collectively, the "Call Reports") prepared at each calendar quarter end during Year One.

> (b) "Year Two Pretax Income" shall mean the pretax income of the Bank for Year Two. For purposes of determining the Year Two Pretax Income, the parties shall use the Call Reports prepared at each calendar quarter end during Year Two.

The district court concluded, and we agree, that these definitions unambiguously provided that each year's pretax income is to be taken directly from the call reports for that year, and that the pretax income was to be adjusted only as expressly provided in the escrow agreement and worksheet.

The escrow agreement provided that in calculating pretax income, "the Bank's loan and lease loss reserve shall be calculated consistent with the Bank's loan and lease loss reserve policy in effect as of the date of the Purchase Agreement," and the worksheet included four specific adjustments to pretax income to be made in determining pro forma income: dividend adjustment, excess insider payments, excess labor costs, and expansion costs. The specific enumeration of these adjustments demonstrates that the parties did not intend for pretax income to be determined other than as stated in the call reports. Since deductions for amortization of the core-deposit intangible were included in the call reports, they necessarily also were to be included in the worksheet's pretax income.

Seller argues that Recital E of the escrow agreement demonstrates a contrary intent. Recital E provides: "The purpose of this Escrow Agreement is to provide assurance to Buyer that the future earnings of [the bank] generated over the next two years *in the ordinary course of business consistent with past practices* will average at least $8,250,000 annually." Seller argues that because the intent of the parties to a contract must be gleaned from the instrument as a whole, including the recitals, *see*

Downing, 207 Minn. at 299, 291 N.W. at 616, pretax income must be calculated based on the bank's earnings "in the ordinary course of business consistent with past practices," using the call reports only as "the initial source of the data points—square one." Seller argues that amortization of the core-deposit intangible does not arise in the ordinary course of business because it is a "creature[] of 'pushdown/purchase price' accounting rules that spring into existence, if at all, only in the wake of the sale and purchase of a bank." According to seller, the pretax income stated on the worksheets should not have been adjusted downward for amortization of the core-deposit intangible.

Even if we deemed seller's argument to have merit, which we do not, seller would have demonstrated only an ambiguity in the escrow agreement. But seller has never argued, either before the CSM, the district court, or on appeal, that the escrow agreement is ambiguous, and we are not inclined to embrace such an argument sua sponte on appeal. Moreover, we do not construe the general statement of purpose in Recital E of the escrow agreement to form the basis of a binding obligation on buyer that can unseat the specific direction in the operative clauses of the escrow agreement to use the call-report figures in calculating pretax income. We conclude that the district court did not err by granting summary judgment to buyer with respect to buyer's permissible deduction for amortization of the core-deposit intangible in calculating the pretax income on the worksheet.

Deduction for MLIT Loan-Loss Reserve

Seller also argues that the district court erred by permitting buyer to implement a loan-loss reserve for the MLIT program for 2007, which reduced the earnings for 2007 by $149,000.

The escrow agreement provided that "during the term of this Escrow Agreement [buyer] will not cause the Bank to make any material changes in the Bank's loan or investment policies *unless such changes are consented to by [Morton], the President of the Bank, such consent not to be unreasonably withheld*." (Emphasis added.) And we recognize that the general level of the loan-loss reserve for the MLIT program at the time the parties entered into the purchase agreement was zero. But the policy also specifically provided that "[a]dditional allocation based upon management assessments of specific credits may also be made," and that "[t]he minimum Loan Loss Reserve will be maintained at a level no less than 1.5% of total loans excluding Mortgage Loans in Transit plus a reasonable reserve for Mortgage Loans in Transit." Under the policy in effect when the parties entered into the purchase agreement, the bank was required to review the adequacy of the loan-loss reserve on at least a quarterly basis and adjust the policy based on current economic conditions, among other things.

Seller argues that by instituting an MLIT loan-loss reserve of greater than 0%, buyer made a material change to the bank's policies and therefore Morton's consent was required to make the change. Despite the fact that both parties moved for summary judgment, seller now argues that genuine issues of material fact as to whether Morton consented to the change precluded summary judgment. As discussed above, the bank's

policy provided for change to the level of the MLIT loan-loss reserve. Therefore, the change approved by the board of directors in January 2008 did not constitute a material change to the bank's policy that required Morton's consent. Although Morton disputes that he gave his consent, contrary to the board minutes of the meeting in January 2008, this dispute does not constitute a genuine issue of material fact that precluded summary judgment because the existing policy expressly provided for review and adjustment. The district court did not err by granting summary judgment to buyer.

Affirmed.