The Honorable Marsha J. Pechman

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON

THE FEDERAL DEPOSIT INSURANCE CORPORATION, as RECEIVER of WASHINGTON MUTUAL BANK, Plaintiff, v. KERRY K. KILLINGER, STEPHEN J. ROTELLA, DAVID C. SCHNEIDER, LINDA C. KILLINGER, and ESTHER T. ROTELLA, Defendants.	Case No.: 2:11-cv-00459-MJP PLAINTIFF FDIC'S MOTION FOR PROTECTIVE ORDER **Note on Motion Calendar: August 26, 2011** **[Local Civil Rule 7(d)(2)]**

Plaintiff Federal Deposit Insurance Corporation, as Receiver of Washington Mutual Bank ("FDIC"), by and through its undersigned attorneys, hereby submits this Motion for Protective Order to prevent the Defendants from impermissibly expanding the scope of discovery and obtaining documents not relevant to a claim or defense in this case, specifically, certain internal documents of the FDIC and Office of Thrift Supervision ("OTS") regarding Washington Mutual Bank ("WaMu"). For the reasons stated below, the motion should be granted.

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

I. INTRODUCTION.

The FDIC alleges in its detailed Complaint that Defendants Kerry Killinger, Stephen Rotella and David Schneider grossly mismanaged WaMu's single family residential lending by pursuing a "Higher Risk Lending Strategy" while recklessly managing the risks attendant to that strategy, causing billions of dollars in losses to WaMu. Rather than proffering facts that contradict these allegations, the Defendants seek to deflect attention from their own misconduct by blaming the Bank's regulators. Witness the opening sentence of Rotella and Schneider's Motion to Dismiss: "This lawsuit amounts to a pure public relations stunt designed to deflect criticism away from the FDIC, which has been—and continues to be—under fire for its regulatory failures with respect to WaMu and refuses to take any responsibility for its central role in the financial crisis." Addressing the potential jury pool as well as the Court, Rotella and Schneider assert that the OTS and the FDIC engaged in a "reckless and widely criticized seizure and sale of a well-capitalized bank" that allegedly had "catastrophic effects on Seattle's local economy."

Consistent with this strategy, the Defendants seek discovery of information not relevant to a claim or recognized defense; they demand discovery of internal documents from the OTS and the FDIC related to their duties as the Bank's primary and secondary regulators and the decision to close and sell the Bank.[1] The Defendants' discovery requests are outside the scope of permissible discovery under Rule 26 and they have not shown good cause to expand that scope. As discussed below, the law is well settled that directors and officers ("D&Os") are charged with the legal duty to oversee the safety and soundness of a financial institution. Bank regulators have no legal duty to the D&Os of a bank. This "no duty rule" prohibits D&Os from defending allegations against them by accusing Bank regulators of malfeasance or acquiescing to unsafe and unsound acts. In sum, courts have held that regulators' actions are simply not relevant to the defense of D&O liability actions as a matter of law and public policy.

[1] The FDIC was actually WaMu's secondary regulator. The OTS was its primary regulator and was the regulator that placed WaMu into receivership.

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KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

This issue has arisen now because the Defendants insist on obtaining discovery of the FDIC's internal WaMu-related documents, as well as internal OTS documents,[2] regardless of whether such documents were provided to the Defendants or to other WaMu personnel.[3] The case law set forth below provides ample authority for the FDIC's refusal to produce internal FDIC or OTS documents and communications that were never shared with the Defendants or other WaMu personnel. The Defendants seek production of the disputed documents for the sole purpose of confusing and diverting attention from the real issues in this case. It is the Defendants who are on trial in the instant case, not WaMu's former regulators. Permitting the Defendants to obtain discovery outside the scope of Rule 26 without good cause will greatly increase the costs on all parties and place an undue burden on the FDIC. Thus, the FDIC respectfully requests that the Court issue an order prohibiting the Defendants from obtaining discovery of any regulatory documents or information that WaMu's regulators did not share with the Bank prior to its failure. As many courts have held, this case should not include a "mini-trial" regarding the regulators' actions that would distract a jury from the real issue in this case, which is whether the Defendants are liable for the mismanagement of WaMu.

II. THE PARTIES HAVE MET AND CONFERRED ON THIS ISSUE BUT HAVE NOT REACHED AGREEMENT.

The FDIC is filing this motion as a last resort. Its counsel has met and conferred with the Defendants' counsel on this and a number of other discovery issues, and has reached an agreement on many issues but not the present one. *See* Certification of Henry Pietrkowski ("Pietrkowski Cert.") ¶ 2, attached hereto as Ex. A.

The FDIC served its responses and objections to Kerry and Linda Killingers' First Request for Production on July 11, 2011. *See* Ex. B hereto. Many of these objections

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[2] There is a separate issue as to whether OTS documents are in the "possession, custody, and control" of the FDIC, but the FDIC is not raising that issue in this motion because it is premature and may not be necessary for the Court to address.

[3] The FDIC has agreed to produce any OTS or FDIC documents found in WaMu's files – without conceding the relevance or admissibility of such documents. Thus, the discovery dispute here involves only regulatory documents that were not previously provided to the Bank.

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

questioned the relevance of the Killingers' requests for internal regulatory documents and communications of the FDIC, OTS and other government agencies. *See, e.g.*, Ex. B, FDIC's Resps. to Request for Production Nos. 2-6, 12-19, 21-26, 31-37, 39, 43. The FDIC also objected to the relevance of the Killingers' requests for documents relating to the OTS's seizure of the Bank and the subsequent sale of many of the Bank's assets to JP Morgan Chase. *See, e.g.*, Ex. B, FDIC's Resps. to Request for Production Nos. 9, 23-27.

On July 25, 2011, counsel for the Killingers sent a letter to the FDIC's counsel raising various disagreements with the FDIC's objections, including its relevance objections mentioned above. Ex. A, Pietrkowski Cert. at ¶ 4. On August 2, 2011, counsel for all parties in this action (including counsel for Rotella and Schneider) met and conferred by phone for approximately two hours regarding the various discovery issues raised by the July 25 letter, including these relevance issues. *Id.* at ¶ 5. On August 8, 2011, the FDIC's counsel sent a letter to the Killingers' counsel in response to the July 25 letter, following up on issues raised during the August 2 meet-and-confer call. *Id.* at ¶ 6. On August 9, 2011, counsel for all parties participated in a second meet-and-confer call that lasted over an hour. *Id.* at ¶ 7. On August 10, 2011, counsel for the Killingers sent a letter to the FDIC's counsel responding to the FDIC's August 8 letter and addressing other issues raised at the second meet-and-confer conference. *Id.* at ¶ 8. On August 15, 2011, the FDIC's counsel sent a letter responding to the Killingers' August 10 letter, which concluded that they were at an impasse on the discoverability of the OTS's and FDIC's internal regulatory documents and communications, including those related to the seizure of the Bank and sale of assets to JP Morgan Chase Bank. *Id.* at ¶ 9. This motion for protective order followed.

III. THE "NO-DUTY" RULE PRECLUDES BANK MANAGERS FROM PLACING THE ACTIONS OF REGULATORS AT ISSUE.

Courts have recognized that in cases like this, where the FDIC sues bank officers and directors, the actions of bank regulators such as the FDIC or OTS may not be placed at issue or used by D&O defendants to evade liability. The statutory scheme establishing federal bank regulators and the public policies underlying this scheme compel this result.

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

These policies were well-articulated in *FSLIC v. Roy*, No. JFM-87-1227, 1998 WL 96570 *3 (D. Md. June 28, 1988), which has been quoted in dozens of subsequent federal district and circuit court opinions:

> Banking is a business which directly affects the public welfare, and the law places a heavy duty upon the officers and directors of banking institutions to manage their affairs properly. If officers and directors have negligently recommended and approved a significant number of loans in their institutions' portfolio ... they have breached this duty .... Nothing could be more paradoxical or contrary to sound policy than to hold that it is the public which must bear the risk of errors of judgment made by its officials in attempting to save a failing institution - a risk which would never have been created but for defendants' wrongdoing in the first instance.

Accordingly, courts consistently have held that the conduct of bank regulators, even if negligent, may not be used by D&Os in the defense of claims against them. As one court stated: "FDIC's own conduct cannot be used to defeat or reduce a recovery to the insurance fund because the FDIC does not act to benefit bank officers or directors. Moreover, the FDIC's conduct in fulfilling its mandate involves discretionary decisions that should not be subjected to judicial second guessing." *FDIC v. Isham*, 782 F. Supp. 524, 532 (D. Colo. 1992); *see also FDIC v. Bierman*, 2 F.3d 1424, 1439 (7th Cir. 1993) (finding that *Isham* and *Roy* were "most compatible with the congressional scheme when that scheme is viewed in its totality"); *FDIC v. Mijalis*, 15 F.3d 1314, 1323-24 (5th Cir. 1994) (adopting the "cogent analysis" of *Bierman* and noting that "[m]any courts have held . . . the risk of errors in judgment by FDIC personnel should be borne by the directors and officers who were wrongdoers in the first instance . . . .") (citing *RTC v. Fleischer*, 835 F. Supp. At 1322 (D. Kan. 1993); *FDIC v. Burdette*, 718 F. Supp. 649, 663 (E.D. Tenn. 1989)).

Courts often refer to this concept as the "no-duty" rule, *i.e.*, that bank regulators owe no duty to the D&Os of the banks they regulate. The "no-duty" rule actually is a narrower application of the broader federal policy underlying the creation of the FDIC, OTS and other banking regulatory bodies. *See Burdette*, 718 F. Supp. at 664 ("The rule that there is no duty owed to the institution or wrongdoers by the FSLIC/Receiver is simply a means of expressing

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

the broad public policy that the banking laws creating the FSLIC and prescribing its duties are directed to the public good."). By not allowing the FDIC's or other regulators' conduct to become a sideshow, the "no-duty" rule "paints a bright line that maintains the court's focus on the persons whose alleged wrongdoing brought about the insolvency in the first instance." *FDIC v. Raffa*, 935 F. Supp. 119, 124 (D. Conn. 1995) ("*Raffa*") (citing *RTC v. Ascher*, 839 F. Supp. 764, 766 (D. Colo. 1993)).

Raffa is on point here. In *Raffa*, the FDIC-Receiver sued former officers of a failed bank on theories of negligence, gross negligence, and breach of fiduciary duty. The defendant officers asserted a variety of affirmative defenses, virtually all of which pertained to either the FDIC's conduct as a regulator before the bank closed or its conduct as a receiver after it closed. These included, *inter alia*, contributory negligence on the part of the FDIC, reliance on the FDIC, estoppel, and ratification. The court followed the reasoning of *Roy, Isham* and *Bierman*, holding that allowing the state-law defenses asserted by the defendants would conflict with federal banking policies, regardless of whether they concerned pre- or post-closing regulatory conduct. Accordingly, the court held that all "[a]ffirmative defenses that call into question the conduct of the FDIC are prohibited," and it struck those defenses to the extent that they implicated the FDIC's conduct. *Raffa*, 935 F. Supp. at 126-28 (striking the defense of contributory negligence on part of FDIC and the defense of FDIC reliance because "FDIC has no duty to warn a bank of improprieties revealed during its examination;" striking the causation defense because "the FDIC's conduct is not on trial;" and striking the defense that FDIC had "approved or ratified the defendants' actions" as "another attempt to estop the FDIC by challenging its discretionary acts").[4]

While cases like *Raffa* were decided in the context of motions to strike affirmative defenses, the rationales underpinning those decisions are broader in scope. Defendants should

[4] Though it has been argued that the Supreme Court's decision in *O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994), displaced the no-duty rule, this argument was explicitly rejected in *Raffa* and other cases. *See Raffa*, 935 F. Supp. at 124-26; *see also FDIC v. Oldenburg*, 38 F.3d. 1119 (10th Cir. 1995); *RTC v. Edie*, No. 94-772 (DRD), 1994 WL 744672 (D.N.J. Oct. 4, 1994); *FDIC v. Healey*, 991 F. Supp. 53 (D. Conn. 1998); *RTC v. Gravee*, No. 94 C 4589, 1995 WL 599056 (N.D. Ill. Oct. 5, 1995).

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KARR TUTTLE CAMPBELL
A Professional Service Corporation
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be prevented from presenting any evidence of regulator actions in support of their defense, whether to cast blame on the regulators or to show that the regulators acquiesced in or supported the Defendants' decisions. In the trial in *Mijalis*, the district court not only denied defendants' jury instruction for an affirmative defense against the FDIC, it also prohibited defendants from introducing evidence attacking the causation element of the FDIC's case-in-chief. The defendants claimed that they should have been allowed to introduce evidence of the FDIC's conduct "in order to show that [defendants'] gross negligence was not the proximate cause of the damages." *Mijalis*, 15 F.3d at 1327. The Fifth Circuit affirmed this denial and agreed with the FDIC that to allow defendants to attack causation by implicating the FDIC's conduct was simply an end-run around their disallowed affirmative defenses. *Id.*[5]

Similarly, the court stated in *RTC v. Youngblood*, 807 F. Supp. 765, 773 (N.D.Ga.1992):

> [T]he defendants are free to assert crossclaims against one another or to implead those third parties who they believe should bear responsibility for the losses allegedly incurred by First Federal. However, under the "no-duty" rule, the RTC's conduct is not on trial, whether under the label of proximate cause or affirmative defense.

See also Raffa, 935 F. Supp. at 128 (denying defendants' attempt to assert an affirmative defense based on causation, noting that "such an assertion is not an affirmative defense because the defendants do not bear the burden of establishing causation . . . [T]o the extent the FDIC's damages were caused by *other* persons, entities or events, such claims may be asserted at trial to rebut the FDIC's burden of proof.") (emphasis added).

In short, the "no duty" rule precludes D&Os from placing regulatory conduct at issue as a defense in their cases, and thus forecloses the path on which Defendants have embarked.

[5] The defendants were still free to introduce evidence that other factors – including changes in tax laws, declines in collateral values, and a poor economy – were intervening causes of damages. *Mijalis*, 15 F.3d at 1327-28.

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KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

IV. APPLYING THE "NO-DUTY" RULE TO THIS CASE, DEFENDANTS SHOULD NOT BE PERMITTED TO OBTAIN INTERNAL REGULATORY DOCUMENTS NEVER PROVIDED TO WAMU.

In light of Defendants' declared intent to put the regulators on trial, the "no-duty" rule should be enforced in this case during the discovery stage. WaMu-related documents in the files of the FDIC or the OTS that never were provided to the Defendants or other Bank personnel should not be discoverable because they are irrelevant to a claim or defense and are not reasonably calculated to lead to the discovery of admissible evidence in this case. Defendants should not be allowed to create a sideshow or "mini-trial" regarding what regulators did or thought about WaMu or the decision to close and sell the Bank in conformance with their statutory obligations.

A "district court may issue any protective order 'which justice requires to protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense,' including any order prohibiting the requested discovery altogether." *River v. NIBCO,* 364 F.3d 1057, 1063 (9th Cir. 2004). Courts have issued protective orders where the requested discovery is irrelevant to any valid claim or defense. *See, e.g., Bailon v. Seok AM No. 1 Corp.*, No. C09-05483JRC, 2009 WL 4884340, at *5 (W.D. Wash. Dec. 9, 2009); *Compaq Computer Corp. v. Packard Bell Electronics, Inc.*, 163 F.R.D. 329, 335-36 (N.D. Cal. 1995) ("Obviously, if the sought-after documents are not relevant nor calculated to lead to the discovery of admissible evidence, then *any burden whatsoever* imposed upon Acer would be by definition 'undue.'") (emphasis in original); *cf. Jimenez v. City of Chicago,* 733 F. Supp. 2d 1268, 1273 (W.D. Wash, 2010) (Pechman, J.) (ruling on motion to quash subpoena, holding that "[t]he compulsion of production of irrelevant information is an inherently undue burden") (citing *Compaq*, 163 F.R.D. at 335-36).

Here, Defendants seek discovery that is not relevant to a valid claim or defense. Their demand is at odds with federal banking law and policy, and would subject the FDIC to undue burden and expense. The clear import of the "no-duty" cases discussed above is that, as a matter of law and public policy, defendants in bank mismanagement cases may not point to

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

regulator actions to excuse or avoid liability for their own conduct, *e.g.*, it is not a valid defense. Bank D&Os have duties to properly manage a federally-insured bank, while regulators do not. This policy is well grounded on a number of considerations, including that the standard of care expected of a director or officer should not vary depending on the particular regulators assigned to that bank. Indeed, the failure of a regulator to adequately use its enforcement authority is not a license for the D&Os to mismanage a bank with impunity. Moreover, allowing D&Os to use evidence of regulator actions to excuse their own conduct could result in mini-trials that focus on the regulators rather than the Defendants. *See Raffa*, 935 F. Supp. at 127 ("Under the 'No Duty' rule, the FDIC's conduct is not on trial").

In the case of WaMu, there has been public criticism of its regulators, especially its primary regulator, the OTS. For instance, a recent report of the Permanent Subcommittee on Investigations of the United States Senate criticized the OTS for identifying significant problems at WaMu but not requiring management to fix them.[6] But assuming *arguendo* that the OTS should have been tougher on WaMu's management, such conduct does not provide comfort to the Defendants who had an independent duty to properly manage the Bank regardless of whether they were ordered specifically to do so by their regulators.

Moreover, assuming *arguendo* that the regulatory record demonstrated that the OTS supported or acquiesced in the management actions at issue in this case, this would not support an inference that management's actions were reasonable. An alternative inference would be that the OTS's judgments were not well-informed or that OTS regulators were lax in their

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[6] It stated:

> OTS records show that, during the five years prior to its collapse, OTS examiners repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, and requested corrective action. Year after year, WaMu promised to correct the identified problems, but failed to do so. OTS, in turn, failed to respond with meaningful enforcement action, choosing instead to continue giving the bank inflated ratings for safety and soundness.

Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (April 13, 2011) at 161. The Senate's 639-page report uses WaMu as its case study on high-risk lending.

Law Offices
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A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

enforcement efforts. It might also be inferred that the Defendants knew this and were exploiting it. The parties potentially could litigate the relative strengths of these inferences and the result would be a mini-trial on whether the regulators were acting competently and/or were well-informed, and how the Defendants perceived and handled their relationship with the regulators. But such a result would be contrary to public policy and the law, which holds that the regulators have no duty to manage the banks that they regulate, and that regulator conduct is not a defense to charges of D&O mismanagement. A mini-trial on regulator performance is exactly what is prohibited by the "no duty" rule. *See, e.g.*, *Raffa*, 935 F. Supp. at 128 (striking defense that FDIC had "approved or ratified the defendants' actions" as "another attempt to estop the FDIC by challenging its discretionary acts").

As stated above, notwithstanding the "no-duty" rule, the FDIC is willing to produce FDIC and OTS regulatory documents in the FDIC's possession that were found in WaMu's files, without conceding that such documents are relevant or admissible at trial. This includes official regulatory reports and other communications provided to WaMu's management. However, the Defendants insist that the FDIC also search for and produce internal FDIC and OTS documents that were *never* provided to WaMu.[7] When asked what such documents might show that would be helpful to the Defendants' case, counsel for Killinger posited the possibility of internal regulatory documents that praise the management team at WaMu.

The Defendants' request for discovery outside the scope of Rule 26 is a fishing expedition for documents whose legal significance would be nullified by the "no duty" rule. At a minimum, the "no duty" rule must preclude Defendants from pointing to internal regulatory documents as a defense to their own mismanagement where the Defendants were unaware of those documents. Moreover, the question of what inferences should be drawn from any regulatory documents presents the potential for a mini-trial focused on the regulators rather

[7] The FDIC has access to millions of WaMu documents, and significant regulatory documents that were provided to WaMu very likely would be amongst those WaMu files.

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

than the Defendants (*e.g.*, what was the basis for any internal regulatory statements – were they speculative or founded on fact?).

In addition to the Defendants' desire to use pre-failure regulatory conduct as a defense in this case, they also seek to make an issue of the seizure of WaMu and the subsequent sale of its assets. This subject is clearly not relevant to a claim or defense. The FDIC's case against the Defendants is based on their mismanagement of the Bank before it went into receivership. Even if the decisions to seize WaMu and sell its assets were subject to judicial review, and they are not, they are not valid defenses to the allegations against the Defendants.

In short, the Defendants are intent on putting WaMu's regulators on trial, and their discovery requests are beyond the scope of Rule 26 because the conduct of regulators is not a valid defense to the allegations contained in the Complaint. A protective order thus is appropriate.

V. ANY POSSIBLE RELEVANCE OF THE INTERNAL REGULATORY DOCUMENTS IS GREATLY OUTWEIGHED BY THE UNDUE BURDEN OF LOCATING AND REVIEWING THESE DOCUMENTS FOR PRIVILEGE.

WaMu was a huge bank that maintained millions of documents. Around the time of its seizure, it was the largest thrift formerly regulated by the OTS,[8] and among the eight largest financial institutions insured by the FDIC. Complying with the Defendants' document requests would place a substantial burden on the FDIC, which would be unreasonable in light of the lack of relevance of the documents sought.

The FDIC has located a substantial number of OTS documents found in WaMu's files and will provide those to Defendants.[9] However, it would be unduly burdensome for the FDIC to compile every internal document, email, note, etc., regarding WaMu and review them

[8] The OTS recently was phased out and its functions shifted to other agencies, including the Office of Comptroller of the Currency.

[9] Defendants may already have many of these documents through discovery in the class action securities litigation filed in this Court, in which they were defendants.

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

document by document for applicable privileges before production. The same considerations apply to the OTS's internal documents regarding WaMu.[10]

This burden might be justified if the documents were likely to be relevant to a claim or defense in this case, but they are not. *Compaq*, 163 F.R.D. at 335-36 ("Obviously, if the sought-after documents are not relevant nor calculated to lead to the discovery of admissible evidence, then *any burden whatsoever* imposed upon Acer would be by definition 'undue.'") (emphasis in original). The requested protective order would protect the FDIC from incurring unnecessary costs. Also, by limiting the scope of document production, the protective order will streamline other discovery and avoid wholly irrelevant issues from being the focus of this case. An order now recognizing the "no duty" rule would relieve the parties from the burden of conducting discovery on irrelevant regulatory issues that would not be admissible at trial.

VI. CONCLUSION

For all of the foregoing reasons, the FDIC respectfully requests that its Motion for a Protective Order be granted. A draft Protective Order is attached hereto.

Respectfully submitted: August 15, 2011.

Respectfully submitted,

FEDERAL DEPOSIT INSURANCE CORPORATION, as Receiver for WASHINGTON MUTUAL BANK, *Plaintiff*

s/ Henry Pietrkowski
One of Its Attorneys

Barry S. Rosen (admitted *pro hac vice*)
Duane F. Sigelko (admitted *pro hac vice*)
Mark S. Hersh (admitted *pro hac vice*)
Henry Pietrkowski (admitted *pro hac vice*)
James A. Rolfes (admitted *pro hac vice*)

[10] In the event this motion is denied in any part, the FDIC expressly requests a reasonable amount of time in which the FDIC and OCC (as OTS's successor) can assert all applicable privileges with respect to internal regulatory documents, including, but not limited to, the deliberative process privilege, bank examination privilege, attorney-client privilege, common interest privilege, and work product doctrine.

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100

REED SMITH LLP
10 South Wacker Drive
Suite 4000
Chicago, IL 60606
(312) 207-1000

Bruce E. Larson, WSBA #6209
Walter E. Barton, WSBA #26408
Dennis H. Walters, WSBA #9444
KARR TUTTLE CAMPBELL
1201 Third Avenue, Suite 2900
Seattle, WA 98101
Telephone: (206) 223-1313
gbarton@karrtuttle.com

Leonard J. DePasquale (admitted *pro hac vice*)
Counsel, Federal Deposit Insurance Corporation
3501 North Fairfax Drive, VS-B-7058
Arlington, VA 22226
(703) 562-2063

CERTIFICATE OF SERVICE

I hereby certify that on August 15, 2011, the foregoing was electronically filed with the Clerk of the Court using the CM/ECF system which will send notification of such filing to all counsel of record who receive CM/ECF notification, and that the remaining parties shall be served in accordance with the Federal Rules of Civil Procedure.

/s Walter E. Barton
WSBA #26408
KARR TUTTLE CAMPBELL
Of Attorneys for Plaintiff
1201 Third Avenue, Ste. 2900
Seattle WA 98101
Telephone: (206) 223-1313
Fax: (206) 682-7100
E-mail: gbarton@karrtuttle.com

Law Offices
KARR TUTTLE CAMPBELL
A Professional Service Corporation
1201 Third Avenue, Suite 2900, Seattle, Washington 98101-3028
Telephone (206) 223-1313, Facsimile (206) 682-7100