American Association of Credit Union Leagues

PROTECTING THE RIGHTS AND INTERESTS OF CREDIT UNION MEMBERS

August 2005

Protecting the Rights and Interests of Credit Union Members

Table of Contents

Introduction

As the 21st century unfolds, it is clear that the credit union system is facing major challenges and concerns that include relentless assaults from the banking industry designed to limit the ability of credit unions to serve their members. Some within the credit union system maintain that such pressures force credit union officials to consider alternative business models. Other credit union officials observe that, when looking at alternative business models, credit union boards may not be appropriately fulfilling their fiduciary duties to the members. Many feel that members' interests may not be adequately protected and that personal financial gain for credit union insiders is the driving force for conversions. One thing is clear…a conversion ends the existence of a credit union and all the benefits it affords to its members. That being the case, credit union-to-thrift/bank conversions have significant implications for the entire credit union system.

In response, the AACUL Executive Board established the Cooperative Business Model Task Force and provided the following charge:

> *"To identify and evaluate the credit union member issues and Credit Union System implications of credit union conversions to Mutual Savings Banks."*

Given this charge, the task force quickly identified four major areas of focus for its work:

- Development of strategies that will expose the dilution of members' influence, rights and economic interests in their credit union.
- Identification and prioritization of charter enhancements critical to the long-term viability of the credit union charter.
- Identification of a range of options for leagues to implement during all stages of a conversion process.
- Development of a library of information and tools for leagues to use in addressing all aspects of conversions.

What follows are the findings and recommendations of the Task Force. This paper was submitted to the AACUL Executive Board on August 22, 2005. Members of the Task Force include:

Mike Mercer (GA), Chairman
Dave Adams (MI)
Guy Hood (FL)
Scott Sullivan (NE)
Gary Wolter (AL)
Dave Chatfield (CA/NV), Vice Chairman
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Preamble

Credit unions were created for the benefit of their members. In order to achieve singular focus on the well-being of the members, credit unions were organized around cooperative, non-profit, democratic governance principles. The credit union structure, the laws, the regulations and all of the support systems are designed to provide members with an alternative to the for-profit suppliers of financial services. The decision to abandon the credit union charter is a major event.

Members own their credit union. They are not simply creditors and/or debtors…as some have suggested. As owners, members have the right to do anything that's legal, safe and sound while the credit union is in existence. This includes the right to change the credit union's form of organization…even into a for-profit firm. As owners, the members also have the right to liquidate the assets, pay off the account holders and split up what's left of the remaining equity. These rights, along with all the others, should never be eliminated by law or regulation.

Members own the equity in their credit union. A credit union's reserves and retained earnings are not, as a few contend, forms of institutional equity…temporarily "rented" by the living account holders. The average member stake in the equity of American credit unions is over eight hundred dollars. In addition to the existing book equity, members "own" the rights to all future equity accumulations. This value is evidenced by the willingness of the capital markets to pay more than book value for the ownership rights of converted credit unions.

Directors owe their fiduciary liability singularly to the membership. Above all, directors have the obligation to protect the ownership rights and economic interests of credit union members. In the context of a major decision such as conversion or liquidation, credit union directors must evidence the highest duty of care for the interests of members.

Conversion to a bank or thrift is profound change. This paper examines many of the ways in which a member's legal rights are changed at the point of conversion from a credit union to a mutual thrift. It will be observed that ownership interests are diluted and economic interests are jeopardized immediately…well before the typical (some say inevitable) step of an initial public offering. In the conversion sequence, primary fiduciary duty shifts from the member (credit union) to the institution (mutual thrift) and, eventually, to the shareholder (stock institution).

No evidence has been presented that can demonstrate that any conversion has advanced the ownership rights or economic interests of members. To the contrary, substantial evidence exists that both have been substantially reduced. In fact, the evidence raises questions about the abuse of fiduciary care (for the members) in the creation of a proposal to approve conversion.

The ability for insiders (directors and senior management) to obtain disproportionate benefit creates an extreme conflict of interest. The significance of the potential for insider enrichment raises the significant question of whether a proposal for conversion can even be initiated by credit union directors.

Notwithstanding, members have the inalienable right to vote in favor of abandoning the credit union charter, even if it dilutes their rights and interests…even if it enriches insiders. However, it is apparent that members are highly disadvantaged in understanding their options and poorly represented (by conflicted directors) in the deliberations that precede a vote to convert the credit union to a mutual thrift or commercial bank.

This paper outlines a number of actions that could substantially benefit the members in their exercise of democratic process in the event of a proposal to abandon the non-profit, cooperative credit union form of organization.

Process and Review

In responding to its charge and the four overall areas of focus, the Task Force spent a significant amount of time at the beginning of its deliberations developing consensus around the core, underlying principle on which its work would be based. While these discussions were lengthy and wide-ranging, time and again the Task Force settled on the basic premise that members own their credit union, and therefore, the focus of the report should be on protecting the rights of those members.

In studying members' influence, rights and economic interests in the conversion process, considerations were divided into five topic areas: legal rights of members; fiduciary duties of credit union boards; current economic interests of members; their future economic interests; and whether there are concerns about unjust enrichment attendant to the conversion process. Because of a lack of preexisting comprehensive work regarding these issues, the task force undertook substantial research and analysis.

Lengthy consideration was given to whether credit union members unknowingly surrender important rights when their institution switches to a mutual savings bank. It also considered whether members are aware of their rights and understand their unique relationship to the credit union as its owners. The Task Force concluded that there are important and enduring differences in the rights of credit union members. Such credit union member rights are different in nature and scope from the interests of mutual savings bank depositors and flow from the distinct characteristics of a credit union. It also determined that significant flaws exist in the current conversion process and that members' ability to appreciate what is at stake has been jeopardized**.**

The Task Force also thoroughly considered whether fundamental legal rights of credit unions members have been at risk through the failure of credit union board members to execute their fiduciary responsibilities. It began its review in this area by looking at what those duties are and whether they are different from the obligations owed by savings bank directors to their depositors. Recognizing that these issues are not well settled, black letter law, the Task Force nonetheless determined that board members have important fiduciary duties to their members. These duties are largely unknown to credit union members and different from the responsibilities mutual savings bank directors owe their depositors. It also concluded that credit union members are typically not well informed about their ownership interests and thus, may not be in a position to appreciate the highly significant ownership rights they will lose upon conversion. Most significantly, the Task Force determined that the rights of credit union members have been undermined not only by the failure of some credit union board members to exercise their fiduciary duties but also by bank regulators, either through proactive efforts or negligence.

The Task Force determined that other highly relevant areas for its deliberations must include a consideration of current and future economic interests of members. To that end, the Task Force revisited seminal studies from the U.S. Treasury Department and other key references that document the unique combination of characteristics a credit union

offers its members. These characteristics combine to generate enormous financial benefits for those who are fortunate enough to belong to a credit union.

Drawing on research developed by CUNA's Economics and Research area, the Task Force quantified economic benefits of credit union members and determined that because of more favorable pricing policies, credit union members received benefits of more than $6 billion in 2002. That amounts to about $75 per member per year, or $160 per member household per year. This is in effect the annual dividend on membership that is relinquished when a credit union converts to a thrift charter. The Task Force concluded that, unlike capital for other institutions, the net worth of a credit union truly belongs to its members.

It was also documented that mutual savings banks cannot operate like credit unions, thus causing members to forfeit key economic advantages. In fact, the Task Force commissioned a study on the pricing behavior of former credit unions that have converted to mutual savings banks. That study is in the process of being finalized, however, preliminary results show that these institutions began pricing more like for-profit institutions relatively shortly after the conversion took place.

In most cases, the Task Force found that a credit union converting to a mutual savings bank later completes the process and converts to a stock association or holding company with a stock institution. It is when a mutual savings bank that was a credit union converts to stock form that the rights of the members of the previous credit union are totally relinquished. The Task Force concluded that members are generally unaware of their current and future economic benefits as part of a credit union, due in part because directors have not ensured members are informed of the economic advantages credit union membership affords.

In reviewing the conversion processes to both mutual savings banks and then to stock institutions, careful consideration was given to how the directors and management of a credit union might be able to abuse the process to benefit personally and unfairly. The Task Force concluded that there are numerous opportunities for unjust enrichment to be obtained by credit union management and boards, and that rather than developing policies that limit or prohibit such unfair results, at least one savings bank regulator has facilitated the process. The Task Force determined that it is critical to the protection of members' rights that officers and directors not be permitted to obtain disproportionate personal financial gain from a conversion and that the members of the credit union should have the opportunity to have their equity distributed to them prior to conversion.

With regard to the five areas the Task Force considered - legal rights of members, fiduciary responsibilities of credit union boards, current economic interests of members, future economic interests of members, and unjust enrichment - the Task Force identified a range of options and solutions to as many of the concerns identified as possible, and those are noted throughout the report.

It should be noted that a significant amount of time was also spent on the three other areas addressed in this report – charter enhancements, options for leagues, and

development of a library of information of the conversion process and related issues. The findings in these areas are documented and discussed in later parts of this report.

Findings and Actions

A. Protection of Members' Influence, Rights and Economic Interests

This section of the report addresses the first area of focus addressed by the task force:

- *Development of strategies that will expose the dilution of members' influence, rights and economic interest in their credit union…*

In order to clearly outline the issues associated with protecting rights and interests of credit union members, the task force developed a framework that separates these issues into five categories:

i. Legal Rights of Members
ii. Fiduciary Obligations of Credit Union Boards
iii. Current Economic Interests of Members
iv. Future Economic Interests of Members
v. Unjust Enrichment

Each of the following sections contains discussion and recommendations on these topics. Please note that in some cases, a particular recommendation may be applicable to more than one topic, and therefore will appear in more that one area.

i. LEGAL RIGHTS OF MEMBERS

OWNERSHIP RIGHTS OF CREDIT UNION MEMBERS – OWNERSHIP RIGHTS OF MUTUAL SAVINGS BANK DEPOSITORS

Introduction

Whether credit union members relinquish significant rights when their institution converts to a mutual savings bank is a central question in the consideration of the complex issues surrounding such conversions. Related issues are whether credit union members understand their ownership interests and appreciate the fundamental differences between their rights and the interests of mutual savings bank depositors.

To address these questions, this section examines credit union membership rights and contrasts them with the interests of mutual savings bank depositors. It discusses what entities have authority to protect members' interests and how that authority has been executed. This section considers relevant court cases, regulations of the Office of Thrift Supervision, and the role of OTS in the conversion process. It reviews current disclosure requirements under National Credit Union Administration rules and whether such disclosures properly inform members of their rights, or have the unintended consequence

of providing inadequate, imprecise or even inaccurate information to credit union members.

Attention has also been given to the mutual holding company (MHC) structure. Under this arrangement, the mutual institution forms a new, wholly owned stock institution and all of the former mutual's assets and liabilities are transferred to the stock bank. The owners of the former mutual become the owners of the MHC. For example, in a recent credit union conversion, a credit union was seeking to become a MHC and the members of the credit union would become the owners of the MHC. However, important differences remain between the rights of the owners of the MHC and the owners of the former mutual institution that parallel the distinctions between depositors in a mutual savings bank and members of a credit union. This includes the use of proxy voting by MHCs, which is prohibited for federal credit unions and for many state credit unions.

As the analysis indicates, there are material flaws in the current process that jeopardize members' ability to understand what is at stake in a conversion. A number of steps could be taken that would improve the process for informing credit union members of their rights as well as enhance their ability to protect member interests fully. The section concludes by offering several recommendations to correct deficiencies in the conversion process.

Analysis and Discussion

How Do The Rights of Credit Union Members Compare to Mutual Savings Bank Depositors? Do Credit Union Members Relinquish Important Rights in A Conversion to Mutual Savings Bank?

- **Mutual Savings Bank Depositors Have Limited Interests Under Statutory and Regulatory Provisions**

Provisions governing federal mutual savings associations are contained in the Home Owners' Loan Act (HOLA) (12 USC 1461 et seq.) and Office of Thrift Supervision (OTS) regulations (12 CFR 500.1 et seq.) Except in the event of a conversion from a state savings association to a federal savings association, the HOLA contains **no** statutory requirements that confer voting rights on federal mutual savings association members.

Rather, the OTS has assumed the role of regulating the extent to which the interests of depositors are protected and has included some provisions in agency rules, charter requirements and standard bylaws purporting to address these interests. Regrettably, OTS's record demonstrates it has not always fulfilled its regulatory duties to protect depositors' interests.

While such provisions are enforceable, they generally carry less weight when challenged in court than do statutory provisions. *First State Bank v. United States*, 599 F. 2d 558, 564 (Third Cir. 1979) Interestingly, in 1996, many of the regulatory provisions regarding such issues were moved to OTS's *Thrift Activities Regulatory Handbook* (referred to in

this document as the *Regulatory Handbook)*, which generally has less legal stature than a regulation or statute.

According to the *Regulatory Handbook,* the "federal mutual charter grants certain rights to mutual members..." It states that depositors have the right to vote, amend the charter, amend the bylaws, nominate and elect directors and other rights (*Regulatory Handbook*, Section 110, Capital Stock and Ownership*).* (Contrary to the language in the *Regulatory Handbook,* bylaw amendments can be approved by either a majority of the depositors' votes cast at a meeting or by a majority of the directors, so there is no right of the depositors to approve bylaw amendments,12 CFR 544.5(b)(15).)

However, despite what is stated in the *Handbook,* the standard charter required of mutual saving banks is actually silent on most of the provisions listed as "rights" in the *Handbook,* (12 CFR 544.1; Sec.9, Model Bylaws, OTS Form 1577, *Applications Processing Handbook*).

Instead, the details of corporate governance for mutual savings banks, including the fundamental authority of depositors to elect board members, are provided in their bylaws. The contents of these bylaws are generally determined by the OTS. Credit unions also follow bylaw provisions as generally directed by their state or federal regulators, except that as discussed below, certain rights for credit union members, such as the authority to elect the board, are detailed in the Federal Credit Union Act. Having such provisions in the statute serves to protect members' interests by making it more difficult for their rights to be eroded through regulatory changes.

While there are a number of differences between bylaws for mutual savings banks and credit unions, the most significant difference is that proxy voting is permitted for all votes in a savings bank. In proxy voting, depositors sign away their votes to directors and management.

In general, OTS rules permit an institution's management to solicit proxies that are of unlimited duration, which are commonly referred to as "running proxies." The use of such perpetual proxies is a governance device designed to continue the control of managers and directors, and are typically provided to management at the time depositors open an account at the institution. There are some limitations on the use of proxies but such provisions are designed to protect management, not the interests of the depositors. For example, proxies that are for a duration of more than eleven months or are solicited at the institution's expense can only be held by the board of directors, or a committee appointed by the majority of the board. This limitation prevents others from exercising control of the institution (12 CFR 544.4(b)(6)).

However, in the mid-1990's, both the OTS and the Federal Deposit Insurance Corporation amended their rules with regard to mutual-to-stock conversions to prohibit the use of running proxies for these types of transactions (12 CFR 563b.260; 12 CFR 333.4(c)(3)). The agencies stated at the time that the depositor vote should be solicited by a proxy specifically designed for the proposed conversion transaction.

Federal credit unions are prohibited from using proxy votes under the Federal Credit Union Act (12 USC 1760). Thus, in a mutual saving bank, the board, which directs all policies and operations of the institution, can be elected through control of proxies, and any other decisions that require, at least on a pro forma basis, the involvement of depositors can be manipulated through the use of proxies.

As stated clearly in the Office of Thrift Supervision's *Regulatory Handbook***:**

> In practice, members **delegate voting rights AND (**emphasis added) **the operation of federal mutual saving associations through the granting of proxies** typically given to the board of directors…or a committee appointed by a majority of the board.(Section 110, Capital and Stock Ownership.)

Thus the use of proxy voting, and the control it affords the directors and management over the voting process and outcome is a substantial difference between a credit union and mutual savings bank, the significance of which may not be sufficiently emphasized in required disclosures to members prior to a conversion vote. (State credit unions have limited use of proxy voting.)

Unlike the Federal Credit Union Act, the HOLA contains very few provisions that address the interests of depositors. Indeed, this scant treatment in the HOLA contrasts sharply with the FCU Act, which clearly provides statutory rights for credit union members in a number of situations, including:

- Election of the credit union's board (12 USC 1761);
- Conversion to a mutual savings bank (12 USC 1785(b)(2);
- Termination of federal insurance (12 USC 1786(a)(1);
- Conversion from federal insurance (12 USC 1786(d)(2); and
- Removal of members (12 USC 1764).

Another important legal distinction between credit unions and mutual saving banks relates to the apportionment of votes. In a credit union, members have one vote, regardless of the amount they have in the credit union. Under OTS rules for a federal mutual savings bank charter, voting privileges can generally be apportioned based on one vote for each $100 in an account, up to 1000 votes. In 1998, OTS changed it regulations to permit mutual savings banks to amend their bylaws to allow from one to 1000 votes per member.

While it would take an act of Congress to change the rights of credit union members that are expressly addressed in the Federal Credit Union Act, mutual savings bank depositors' privileges are addressed in documents such as OTS rules and the institution's charter that are more readily changed.

The authority of OTS appears very broad as it relates to the interests of depositors. Nonetheless, rather than developing policies that shield depositors, this review of OTS's actions demonstrates that the agency has not made the protection of such interests a priority. More precisely, OTS has treated depositor interests, including depositor voting, as a mere privilege, not a right, that could be bestowed, diminished, or amended by the OTS or by changing the bank's charter or bylaws.

Court Opinions, Congress Reinforce Depositors' Limited Interests

What courts have said about the ownership "rights" of federally chartered mutual thrift depositors clearly supports the view that such interests are limited and materially different from the ownership of credit union members. It is important to note that, OTS and its predecessor agency, the Federal Home Loan Bank Board, have often taken an active role to defend a narrow interpretation of depositors' ownership rights.

An illustrative case is *Ordower v. Office of Thrift Supervision*, 999 F.2d 1183, 1185 (7th Cir. 1993) mutual savings bank depositors challenged OTS 's approval of a conversion from a mutual savings bank to stock form. The court stated:

> Nominally the customers own the mutual, but it is ownership in name only.

A June 2002 OTS Office of Chief Counsel opinion reflects this view of the limited rights of depositors, stating:

> In sum, the federal courts have concluded that owners of federal mutual savings associations have only very limited equity interests in those institutions, and those interests do not include any rights as owners to demand a distribution of the institution's capital.

In *York* v. *Federal Home Loan Bank Board* (624 F. 2d 495 (1980), depositors in a federal mutual savings association challenged the authority of the Federal Home Loan Bank Board (FHLBB, OTS' s predecessor) to approve their institution's plan to convert to stock form under the FHLBB's conversion regulations. The plaintiff argued that the proposed conversion would deprive the depositors of their property rights in the association while providing windfalls to those purchasing conversion stock. The court rule against the depositors, holding that:

> …[A]lthough the depositors are the legal "owners" of a mutual savings and loan association, their interest is essentially that of creditors of the association and only secondarily as equity owners. Depositors' rights are circumscribed by statute and regulation. They are not allowed to realize or share in profits of the association, but are entitled only to an established rate of interest. [At the time of this decision, federal savings institutions were uniformly limited by Regulation Q on the amount of interest they could pay on deposits.] The depositors do not share in the risk of loss since their deposits are

> federally insured and their only opportunity to realize a gain of any kind would be in the event the savings and loan association dissolved or liquidated.... In fact federal regulations prohibit savings and loans from dissolving without [FHLBB] approval, and no solvent association has ever secured approval for dissolution. Thus, it is apparent that depositors will not be deprived of property rights by conversion to a federal stock organization. Depositors' only actual rights, their rights as creditors, will remain unchanged by the conversion.

The OTS' *Regulatory Handbook* reinforces this position:

> …[M]utual account holders have only a contingent interest in the surplus of mutual savings associations in the event of liquidation (Section 110, Capital Stock and Ownership).

This is true, despite the fact that OTS requires converting banks to establish a liquidation account (12 CFR 563b.450-563b.485). Such an account is purported to represent the interests of eligible account holders in the institution's net worth at the time of the conversion. (It does not affect actual net worth, and eligible account holders do not retain any voting rights based on their liquidation accounts.)

Under OTS regulations, a liquidation account is required because, in the event of a complete liquidation, each savings account holder must receive a distribution in the amount of his or her account (12 CFR 563b.450-563b.485). Only in the event of such a liquidation would the distribution occur, *Paulsen v. Commisioner of Internal Revenue,* 469 U.S. 131, 138 (1985); *Ordower,* 999 F.2d at 1185. However, depositors have no right to compel the institution to liquidate, *Id.* at 1187. In *Ordower*, the court concluded:

> …[B]efore conversion, the account holders can obtain a share of the institution's net worth only if the mutual liquidates.

The court also noted that the depositors are prevented from forcing such liquidation, (999 F.2d at 1187).

This differs dramatically from the rights of credit union members, which under NCUA regulations, can vote to liquidate their institution (12 CFR 710.3).

If a mutual thrift converts to a stock form, it must include a directive in its new charter that it has established and will maintain a liquidation account for the benefit of its savings account holders in its new charter. However, as noted by outside counsel to CUNA, this account is a "complete legal fiction" and has no value to the account holder for purposes of the conversion transaction.

In another case, *Goldberg* v. *Philadelphia Savings Fund Society* , 9 Phila. 459 (Pa. Ct. Com. Pl. 1983), the court agreed that mutual accountholders are not entitled to any form

of compensation when a mutual savings bank converts. In this case, depositors opposed the conversion to a stock association and filed an action to stop the proposed conversion.

The depositors argued to no avail that ownership of the bank and its net worth was vested exclusively in them as the bank's depositors. They also argued that that conversion would have illegally deprived them of their equity in the bank without notice, hearing, or compensation.

The court stated:

> The fundamental rights of the depositors as creditors of this institution ... will, in reality, be unchanged by the approved plan of conversion. Any effort to equate the proposed conversion to a liquidation (in which case a different result might obtain) is, therefore, unrealistic.

The *Goldberg* court commented on the negative practical effects of an opposite result, noting that:

> to compel ... some form of payment or compensation to the depositors for their alleged 'ownership' interest in the surplus accumulated would ... frustrate and thwart the legislative intent [of recapitalizing the industry] in permitting such a conversion in the first place.

This issue of the rights of depositors also arises in the context of MSBs that are not converting. In *Guitard v. Gorham Savings Bank, et al*., 2002 Me. Super. LEXIS 82 (Superior Court of Maine, Cumberland County), a group of depositors sued a Maine-chartered MSB because they felt that they had a right to a distribution of capital from the savings bank. This was because the savings bank was well-capitalized based on requirements of the federal banking regulators.

The court held that:

> The Law Court's recognition that depositors in a mutual savings bank have only what that court described as a "nebulous and contingent" interest above and beyond the right to their deposits plus contractual interest…supports the conclusion that plaintiffs in this case do not have a right to compel the Bank to exercise its discretion to pay dividends out of accumulated profits. The assumption that depositors have the same rights as shareholders appears unwarranted since depositors -- unlike shareholders -- have not invested money in the bank and do not have funds at risk…

This position limiting the interests of depositors is also confirmed in OTS' *Regulatory Handbook:*

> The ability to exercise control over a mutual saving association by its members (depositors, parenthesis added) is not coextensive with the rights of stockholders of ordinary corporations (Section 110, Capital and Stock Ownership).

Finally, on this point of the limited interests of savings bank depositors, an excerpt from a 1951 Senate Finance report regarding the taxation of mutuals is instructive and supports the conclusions discussed above that courts have reached:

> The mutuality argument assumes that, in the long run, the investments of each member are equal to the debts he has owed the organization. It also assumes that the membership in each organization is fixed and that eventually each member will receive a proportionate share of the accumulated earnings of the organization. These assumptions might have been valid for the original S&L associations which terminated after they had fulfilled their purposes for the original membership groups. They are not generally valid, however, for the present day associations.

- **Material Interests of Members Are Lost When A Conversion Occurs**

It is clear from a survey of legal cases, relevant statutes and regulatory provisions that there are material differences between the rights of credit union members and the interests of depositors in a mutual savings bank. Such credit union distinctions include but are not limited to:

- Rights of credit union members as opposed to privileges of depositors;
- FCU prohibition on the use of proxies;
- Considerable voting rights of credit union members;
- Bylaw differences;
- Extensive notice requirements for credit union meetings; and
- Ability of credit union members to approve a liquidation as an alternative to conversion.

However, it is certainly unclear whether, and to what extent, credit union members are provided sufficient disclosures to enable them to consider and appreciate what they lose when their credit union converts.

What Are Current NCUA Disclosure Requirements and Do They Protect Members?

Under NCUA's disclosure requirements for conversions, 12 CFR 708a, credit unions must provide written notices three months, two months and one month prior to the membership vote. The disclosures must:

- Adequately describe the purpose and subject of the vote;
- Notify members they can vote in person at a special meeting or by mail ballot;
- State the date, time and place of the meeting;
- Include the following disclosures (as of 1/2004):
    - ✓ The conversion could lead to members losing their ownership interests in the CU if the institution converts to a stock institution and the members are not stockholders.
    - ✓ How the conversion will affect members' voting rights.
    - ✓ Any conversion related economic benefit a director or other official may receive, including receipt of, or an increase in, compensation and an explanation of any foreseeable stock related benefit with a subsequent conversion to a stock institution. This would include a comparison of opportunity to buy stock for officials and employees compared to those of the membership.
    - ✓ An affirmative statement that at the time of conversion, the credit union does or does not intend to convert to a stock institution, provide any compensation to previously uncompensated directors or increase compensation, including stock benefit, to directors or other officials, and base voting rights on account balances.
- Notices must comply with the following additional requirements (as of 2/2005):
    - ✓ Disclosures must be offset by the use of a border and at least one font size larger than other text; certain disclosures must be bolded and capitalized.
    - ✓ Required information may be modified, only with consent of regional director or state agency.
    - ✓ Disclosures must state that every member has an equal vote, and in a mutual savings bank, account holders with larger balances usually have more votes and greater control (this disclosure is in bold, all caps and larger font).
    - ✓ Disclosures must state that CU directors and committee members are volunteers but directors of a MSB are compensated. CUs are exempt from Federal taxes but mutual savings banks are not and the conversion may contribute to lower savings and higher lending rate or additional fees (this last disclosure must be in bold, all caps and larger font).
    - ✓ Disclosures must state that the conversion is often the first step in a process to convert to a stock institution and in such a conversion, the executives

profit by obtaining stock far in excess of that available to the institution's members (this disclosure is in bold, all caps and larger font).

- ✓ Disclosures must state the costs of conversion in bold, all caps and large font. The disclosure must include an itemization of costs.

The disclosure requirements NCUA has adopted are extensive. Below is a brief review of recent disclosures that were approved by NCUA but are inaccurate, misleading or incomplete.

Examples of Problematic, Recent Credit Union Conversion Disclosures

- *"Savings Institution members will have ownership interests in the Savings Institution that are substantially similar to those they have as Credit Union members in the Credit Union, so long as the Savings Institution remains in mutual or mutual holding company form."*

Problem: As the discussion above reveals, the ownership interests of a credit union member materially differ from such interests of mutual savings bank depositors. Members are misled when the credit union is permitted to make an inaccurate statement regarding the nature of mutual savings banks ownership. As OTS documents clearly state, mutual savings banks are controlled by the directors and senior management, partly as a result of the use of proxy votes and partly because savings bank depositors do not have statutory rights provided to credit union members. Credit unions are owned and controlled by the membership. These are critical distinctions that must be disclosed in order for members to understand what is at risk when a conversion occurs.

- *"The Charter change will not affect the account balance, interest rate or dividends declared on any account or the terms of any loan."*

Problem: The veracity of this statement is questionable, particularly as it relates to future accounts balances, interest rates, or dividends.

- *The documents disclose that, after conversion, the savings institution plans to issue a minority stock offering of approximately $100 million to raise capital (p. A-1), but do not disclose that OTS regulatory policies permit the new mutual holding company to waive the receipt of any dividends on the majority stock interests held by that holding company.*

Problem: This is a very significant omission. That is because when a credit union converts and forms a mutual holding company, the former members of the credit union become members of the holding company. The waiver relating to holding company interests diverts the payment of dividends from the former credit union members to minority investors.

- *"Immediately after the Charter Change is consummated, the Savings Institution will continue to conduct its business substantially as it is now being conducted by the Credit Union. The Savings Institution will continue the loan and deposit products and services currently offered by the Credit Union, subject to changes as a result of market conditions…The Savings Institution has no intention of increasing the pricing on its loan products or service fees, or decreasing the deposit rates as a result of the Charter Change."*

Problem: This disclosure also omits material information. As discussed above, there are key differences in the way a credit union and a mutual savings bank conduct business that flow from the different rights and interests credit union members have compared to the interest of savings bank depositors.

Also, the disclosure does not reveal that the savings institution, unlike the credit union, will have to find a source of revenue to cover its tax liabilities. It also fails to point out the new institution will be expected to maximize its return on equity, even at the expense of member service, which is also vastly different from the

manner in which a credit union operates.

- ***"Loss of Tax Exemption:*** *…The Credit Union has factored these additional costs into its three-year business plan filed with the OTS. Based on the business plan, the expected increase in assets of the institution over the three year period, as well as the earnings on the additional capital expected to be raised, will more than offset the increased cost of paying* taxes."

Problem: Depositors of the savings bank and other members of the public do not have access to the business plan. Thus, it is extremely difficult for credit union members, as well as other community interests, to asses whether this statement is accurate or not.

- ***"Lending Powers:*** *…[For federal savings institutions, loans for other consumer purposes, such as automobile loans and finance leases, together with investments in commercial paper and corporate debt securities, are limited to 35% of assets; the Credit Union will request that the OTS allow the Savings Institution a six year period to meet this limit. The Credit Union anticipates meeting this requirement without reducing its consumer lending as a result of its increased lending limits stemming from leveraging the capital it intends to raise."*

Problem: This disclosure fails to state whether OTS has agreed to provide the waiver and what might occur if the waiver is denied. It also does not disclose what will occur if the savings institution is unable to raise all the capital it is seeking.

- ***"Qualified Thrift Lender Test:*** *…The Credit Union will request that the OTS allow the Savings Institution a three year period to meet this requirement. The Credit Union anticipates meeting this requirement by gradually adjusting its investments to meet QTL requirements."*

Problem: This disclosure also fails to address the disposition of the waiver and outcome if it is not granted, such as how the business model of a credit union must be dramatically changed to emphasize housing-related assets.

From the Standpoint of Protecting Members' Rights, Are There Concerns with the Current Process?

As this section demonstrates, the answer to that question must be a resounding "Yes!" The current process is flawed because of several factors, which include:

- Inadequate and misleading disclosures for members;
- Because of improper disclosures, members are unable to assess the nature of the differences between credit unions and mutual savings banks and how their rights will be diminished;
- Inadequate disclosures have been approved, which not only permitted credit unions to use such disclosures but also may be cited by credit unions in future disclosures if NCUA tries to require them to use better disclosures;
- There is little opportunity and support for opposing members to organize and share their views with members prior to the vote;
- OTS has abrogated its responsibilities to protect depositors that it should assume from the time an institution comes under its purview.

Actions to Protect Member Interests

To address those concerns, the following list outlines actions designed to improve the process to protect members' rights.

- Constructive NCUA Regulatory Actions (State regulators should establish similar authorities.)

  Note: These recommendations would not require new federal statutory authority.

  - Require public comment and/or a public hearing in the community prior to the vote on the conversion proposal.

  - Enable federal credit unions to adopt bylaw provisions that:

    - ✓ Guarantee that groups of dissenting members have an opportunity and the means to share their concerns about a conversion proposal with the membership.

    - ✓ Ensure members are informed of their right to and the option for apportionment of the equity prior to conversion.

    - ✓ Authorize full or partial distribution of equity to dissenting voters subsequent to a vote for conversion.

    - ✓ Require that only credit union members that do not have a conflict of interest may initiate a proposal to convert. The credit union may also set the threshold for the percent of member signatures required for a petition to convert.

  - Require additional disclosures to members that spell out:

    - ✓ The rights and economic value that the member is losing.

    - ✓ That the credit union's board must demonstrate to the membership how the conversion would be in their best interests.

    - ✓ How the ownership interests of a credit union member differ from the ownership interests of a mutual savings bank depositor.

    - ✓ That members may also file comments with OTS supporting or opposing the conversion.

    - ✓ How many credit unions that have become mutual savings banks have subsequently converted to stock form.

- ✓ The historical pricing practices of credit unions that have converted to a thrift charter.

- ✓ The duties of credit union management and directors to protect their rights, using specific language such as, “The directors and management of your credit union must act to protect the rights you have as one of the owners of the credit union. If you feel your ownership rights have not been or will not be protected in the proposed conversion, contact the National Credit Union Administration at ____.” (See later recommendation regarding establishment of Ombudsman at NCUA.)

- Require a credit union’s board to obtain an independent legal opinion regarding whether the conversion protects the ownership interests of the credit union’s members and provide the opinion to the membership prior to the vote.

- Require a credit union’s board to provide copy of its conversion plan to the membership.

- Require a “quiet” period prior to the membership vote in which information from the board cannot be provided to the membership about the conversion.

- Require the credit union to hold an informational meeting well in advance of the member vote.

- Clarify that credit union members have the right to continue their credit union, merge with another credit union, or approve liquidation in addition to supporting a conversion.

- Require credit union boards to demonstrate they have explored all possible options before converting, including liquidation, merger, and a pro rata apportionment of the equity prior to conversion.

- Adopt rules facilitating spin-offs of dissenting groups—along with their share of equity—into another credit union.

- Impose fees for NCUA’s costs of reviewing disclosures and processing conversions (so other credit unions don’t bear these costs).

- Remove unnecessary regulations to enhance the attractiveness of the credit union charter.

- Conceivable Judicial Actions

  - Current or former credit union members may sue the directors of the converting credit union -- or OTS—for breaching their fiduciary duties or violating the commitments established in a letter to the members prior to conversion.

  - Current or former credit union members may sue OTS for applying regulations arbitrarily and capriciously to highly capitalized credit unions, without safeguards for owner interests.

  - Current or former credit union members may sue directors and OTS on the theory of illegal conversion of members' property interests in their credit union.

- Constructive Legislative Actions to Protect Members' Interests

  - Broaden the statutory authority of NCUA and state regulators to review conversions.

  - In states where there is no law regarding conversions, provide the regulator with sufficient statutory authority to review conversions.

  - Prohibit current and former senior management and directors from obtaining any disproportionate, personal financial gain as a result of a conversion for ten years following the charter change.

  - Require apportionment of equity prior to conversion:

    - ✓ If converting to a stock institution, members will be issued stock in the new institution in the amount of their apportioned equity in the credit union.

    - ✓ If converting to a thrift, the net worth of the credit union must be frozen in a trust for the members. So long as the thrift remained mutual, the funds would remain part of the institution's net worth. If the thrift converted to stock, the funds in the trust would be distributed in the form of stock to the members of record at the time of the conversion.

  - Require that the conversion voting thresholds be at least as high as those for mutual savings banks.

  - Authorize credit union membership to set voting thresholds (via bylaw amendment) at levels higher than required by statute.

  - Prohibit OTS and the converting institutions it regulates from denying any depositors the right to a first priority to purchase stock.

- Prohibit credit unions that have converted to mutual holding companies from waiving dividends for ten years after the charter change in order to preserve members' economic interests.

➢ Credit Union System Actions

- Create a competing offer that the converting CU's Board would have a fiduciary duty to consider, such as a merger offer from another credit union.

- Create a pro-credit union website focusing on members' interests.

  ✓ If set up as a national resource, create sub-pages for developments in each state so that state regulatory issues can be addressed.

- Fully inform the credit union press and other credit union channels about the loss of member value that is involved in conversions.

- Participate in meetings/hearings with the OTS regarding conversions.

  ✓ Current OTS rules already provide for these.
  ✓ Local newspapers, where notices are published, could be monitored.

- Encourage state attorneys general to become interested in whether members are being adequately protected in conversions;

  ✓ Work through organizations like the National Association of Attorneys General.

- Commission a third party study on the loss of value to credit union members in a conversion.

➢ General

- Clarify the tax treatment regarding conversions.

  ✓ Tax implications are described in each set of disclosure documents.

- Encourage CUNA Mutual to conduct a separate risk assessment in determining whether to insure directors and officers for breaches of fiduciary duty relating to conversions.

ii. FIDUCIARY OBLIGATIONS OF CREDIT UNION BOARDS

FIDUCIARY DUTY IN THE CONTEXT OF CONVERSIONS – WHAT DUTIES ARE THERE, WHO OWES THEM AND HAVE THEY BEEN FULFILLED?

Introduction

Entities - individuals or organizations - that act in a legal capacity on behalf of others, particularly when there are monetary interests at stake, assume certain responsibilities for those for whom they act, as courts and statutes have made clear. Such obligations are known as "fiduciary duties" and present critical concerns in the consideration of conversion issues.

The fiduciary duties of boards of directors, both at credit unions and at mutual savings banks, flow from the ownership interests members and depositors have in their institutions. For credit unions, the ownership rights of members are considerable, while the interests of depositors in a mutual savings banks are less significant, as discussed in the last section. Because credit union members have greater ownership rights in their institutions than do depositors in a mutual saving bank, a greater standard of care is owed to credit union members by their board of directors than the directors of a mutual thrift owe their depositors.

Regarding conversions, there can be no question that the board of directors and management of a credit union have important obligations to the members and that the members are entitled to have such responsibilities fulfilled. Likewise, the board of directors of a mutual savings bank has duties to its depositors that are manifest in the conversion process.

There are other parties in the course of a conversion that have fiduciary duties but those obligations have been largely ignored in the legal process and unclaimed by members or depositors. They are the regulators, the National Credit Union Administration, the state regulators, and the Office of Thrift Supervision.

This section explores the nature of the duties owed to members and depositors by boards and management as well as by regulators and the extent to which such duties are recognized and executed – unrealized or abandoned. It discusses court cases as well as several statutes and other legal documents that impose or clarify the mantle of duty owed to members and depositors.

The section ends with important recommendations for clarifying fiduciary duties and for ensuring they are properly executed throughout the conversion process.
One cautionary note as this analysis is considered. It is apparent that comparisons of the fiduciary duties owed to credit union members with the duties owed to mutual savings depositors as well as with the shareholders of thrift stock associations are critical for an understanding of the conversion process and whether members receive adequate disclosures. Yet, legal questions regarding the differences among such duties have not been settled by courts and in some cases, have not been addressed at all

Nonetheless, relying on relevant case law and statutes, the analysis presents important considerations central to the issue of protecting the best interests of credit union members.

Discussion and Analysis

Fiduciary Duties/Mutual Savings Banks

The fiduciary duty owed to a depositor of a mutual savings bank is arguably a lesser responsibility than the directors of a credit union owe their members. This is a significant finding that must be reflected in disclosures to credit union members prior to a conversion, as yet another interest that will be jeopardized when a credit union converts.

Even so, the duties of mutual savings bank directors are considerable despite the efforts by OTS to minimize them or its negligence in enforcing them.

The fiduciary duties of mutual savings bank directors have evolved as the nature and control of mutual savings banks themselves have changed over time. When mutual savings banks were more firmly in the control of the depositors, older case law indicates a higher duty of care was recognized. Some current legal authorities hold that a lesser standard for directors is now sufficient.

In fact, the lack of consistent standards among federal and state statutes combined with different interpretations by courts indicates changing views today toward fiduciary duties that undermine depositors' interests.

Regrettably, whether and the extent to which such duties have diminished does not seem to have been a line of inquiry from the OTS or depositors. Nonetheless, it is appropriate to consider the level of obligation directors have to their mutual savings bank depositors.

Under federal law, mutual savings bank directors must perform their duties merely to avoid gross negligence (12 USC 1821(k)). At one time, federal case law determined such duties, but the Supreme Court voided those opinions. The federal standard of gross negligence is now the floor for determining the duty of care as courts have recognized the authority of states to set standards for the savings bank directors that operate within their jurisdictions.

This principle was addressed in *Atherton v. FDIC*, 519 U.S. 213, 226-27(1997), in which the court considered whether state or federal law determined federal mutual thrift directors' duties of care in a receivership case. The court held that state law prevailed and that 12 U.S.C. § 1821(k) was only applicable when state law did not dictate a higher standard (*Atherton,* 519 U.S. at 225-27).

This decision in the Atherton case may be highly significant in the evolution toward a lower standard of care for mutual savings bank directors. It has opened the door for a hodge-podge of state standards, some of which may even conflict with the federal statute.

For example, in *Lanz v. Resolution Trust Corp.*, 764 F. Supp. 176,179 (S.D. Fla. 1991), the court held that state law in Florida did not recognize **any** fiduciary relationship between a mutual thrift and its depositors.

In fact, the issue of whether a duty is owned to the depositors or to the association is a related but separate issue that has significance as well.

In older cases in states where mutual savings banks first organized, such as Massachusetts courts often recognized a high duty of care to depositors. For example, in *Cosmopolitan Trust Co. v. Mitchell*, 242 Mass. 95,118-19 (1922), the court, reflecting on the duty to the depositors, stated:

> Directors in financial institutions are summoned to the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs.

In *Hun v. Gary*, 82 N.Y. 75, the court said that the standard owed to depositors is one of the "ordinary care, duty, judgment, and skill of a provident owner," which is a duty of care that cannot be ignored. This case also represents the New York common law standard for mutual thrift directors' fiduciary duties to their depositors today. Interestingly, when New York later codified this standard, it directed that the statutory duty is owed to the institution, not to the depositors.

> Trustees and officers [of savings banks] shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which prudent men would exercise under similar circumstances in like position. (N.Y. C.L.S. Bank § 398-b.)

More recent cases have recognized a standard of "reasonable" care and some contemporary state case law has recognized that a duty is owned to depositors, not just to the association *(In re Concerned Corporators* of the Portsmouth Savings Bank, 129 N.H. 183, 205 (1987)/; *Selective Builders, Inc. v. Hudson City Savings Bank*, 137 N.J. Super. 500, 509, 349 A.2d 564, 569 (N.J. Super. Ct. Ch. Div. 1975). However, where state codes have addressed fiduciary duty of mutual savings bank directors, and not all have, the trend has been to reference such responsibilities in terms of what is owed to the association, not to the depositors.

The Maryland statute exemplifies this development. In that state, directors of thrift associations must perform their duties in the best interests of the association, "in good faith, and with the care that an ordinarily prudent person in a like position would use under similar circumstances." (Md. Code Ann., Corps. & Assns., § 2-405.1 (a))

Such duties are not always guaranteed, however and the statutes of at least two states, Florida and Maine, do not address the fiduciary duty of a mutual thrift's directors. However, the federal standard to avoid gross negligence would apply, under 12 U.S.C. § 1821 (k) and the *Atherton* decision.

Thus far, this analysis has focused on a discussion of the duties owed to mutual savings bank depositors, compared to the care owed to credit union members. However, it is also useful to consider the fiduciary duties that stock associations owe their shareholders.

While some courts have viewed the fiduciary duties of the directors of mutual savings associations as similar to those of the directors of stock associations, other courts have recognized a higher degree of care is owed to the shareholders, due to their ownership stake in their institutions. This is analogous to the care that members of a credit union are owed, which is discussed below. That is, because they, like shareholders, have a greater ownership interest in their institution than do mutual savings bank depositors.

For example, California's provisions were reviewed in *McSweeney v. FDIC,* 976 F.2d 532, 538 (9TH Cir. 1992). There, the court held that a stock savings bank's directors owed a fiduciary duty of reasonable care to their stockholders under California law.

Thus, as this review indicates, the directors or a mutual thrift have a duty of care that is owed to their association, if not to their depositors. While defined minimally at the federal level, the standards for fiduciary duty have been augmented by a number of states in both their statutes and case law. As discussed below, this level of duty is not the same standard of care owed to credit union members. Nonetheless, it is important and should not be ignored or eroded further, either by neglect or through overt actions on the part of OTS.

Whether OTS has been a good steward to date in supervising the execution of directors' duties to depositors is examined next.

OTS Role in Supervising the Execution of Fiduciary Duties and Protecting Depositors

OTS's record as it relates to the supervision of fiduciary duties demonstrates that the agency views itself as a force for safety and soundness, rather than the protector of depositors' interests. Yet, while it is appropriate for the Federal Deposit Insurance Corporation, as the federal insurer of thrift deposits, to focus on the safety and soundness of an institution. it is only when the interests of depositors and the objectives of safety and soundness intersect that FDIC can act.

OTS, as the regulator, has its own responsibilities to ensure directors implement their fiduciary duties and protect depositors. However, OTS does not always act in the best interests of depositors, as examples discussed below illustrate.

Examples of OTS's Actions That May Harm or Render Depositors Vulnerable

The OTS's *Regulatory Handbook* contains a limited discussion of the "rights" of depositors and the agency states it will take into account the interests of savings account holders in considering a conversion. Nonetheless, time and time again the agency has acted in derogation of such interests.

- **OTS Permits Proxy Voting**

  This was discussed in the previous section and is a prime example of how the agency ignores or willfully disregards the interests of depositors. The agency is not required to permit proxy voting. Its decision to do so supports management and directors of a savings banks and allows depositors to relinquish any semblance of control or participation in the decisions of the institution.

  While the OTS and the FDIC prohibit the use of running proxies in conversions, it has not been demonstrated that depositors understand what they are relinquishing when they sign over their voting rights.

- **OTS Does Not Require A Local Depositor Preference**

  While at various times the OTS has considered the issue of whether depositors within an institution's "local community" should receive preference over other depositors with regard to the right to purchase the institution's stock, this is not a current requirement.

  The rationale for such a requirement is to prevent abuse from "professional" depositors, who make deposits in thrifts all over the country in anticipation of a conversion, in which they will then have priority over non-depositors and others to purchase the stock. Local depositor preference requirements are also designed to promote local community participation by long-term depositors, as well as ensure that these long-term depositors have the opportunity to fully participate in the stock offering.

  Evidence that such requirements would protect depositors is that in 1994, the FDIC considered imposing such requirements to give preference to depositors in the local community. The FDIC decided to defer to the judgment of the board of directors and any applicable state law that addresses this issue, but its policy is to encourage institutions to provide such preferences.

- **OTS Has Permitted MHCs To Waive Dividends**

  Mutual-to-stock conversions often lead to the reorganization of the thrift into a mutual holding company structure and a most recent credit union conversion attempt would result in direct transformation to a mutual holding company.

  One issue with regard to these types of transactions is that OTS permits a MHC to waive its rights to dividends that would otherwise by paid to it by the subsidiary stock institution. Such a decision harms the former credit union's members that become the owners of the mutual holding company.

  Retaining the dividends at the insured institution level that would otherwise go to the mutual holding company increases the ownership interests of the minority

owners of the institution (the mutual holding company generally owns a majority of the stock of the institution).

Conversely, the owners of the holding company, which includes the depositors of the converted credit union or thrift, lose an interest in the dividends that would otherwise be paid to them. This leads to a conflict-of-interest in a situation in which the directors of the holding company who request the waiver are also the minority shareholders of the subsidiary institution that is receiving the benefit of the waiver.

The OTS rules allow these dividends to be waived if no insider or employee stock benefit plan of the mutual holding company holds stock in the institution. The mutual holding company can also request OTS's permission by demonstrating that the waiver would not adversely affect the safety and soundness of the institution and that the waiver is consistent with the directors' fiduciary duty to the mutual holding company. The FDIC requires that such waived dividends not be available for distribution to the minority shareholders.

- **OTS Requires A Liquidation Account That Is Meaningless for Depositors**

The liquidation account is designed to represent the interests of eligible account holders in the institution's net worth at the time of the conversion. (It does not affect actual net worth.) Under OTS regulations, a liquidation account, which is a sub-account, purporting to reflect the interest of each account holder, must be maintained.

It is required because, only in the event of a complete liquidation, each account holder who has a savings account from the time of the conversion until liquidation must receive a distribution in the amount of his or her sub-account. Eligible account holders do not retain any voting rights based on their liquidation sub-accounts.

If a mutual thrift converts to a stock form, it must include in its new charter a directive that it establish and maintain a liquidation account for the benefit of its savings account holders. However, as noted by outside counsel to CUNA, this account "is a complete legal fiction" and has no value to the account holder for purposes of the conversion transaction.

In addition to regulatory actions that undermine the rights of depositors in favor of directors and management, the OTS has participated in a number of legal actions that have challenged and ultimately undermine the legal rights of depositors in savings banks.

It is clear that although the OTS has the authority and even the duty to protect the privileges of savings bank depositors in the conversion process, it has not acted to further their best interests. Rather, OTS has adopted policies and undertaken court action that benefit directors at the expense of the interests of depositors.

Having reviewed the fiduciary duty of directors to depositors and OTS's ineffectual supervision or deliberate actions to circumvent such duties, this section will review the level of care owed to credit union members and the extent to which such care has been preserved by credit union regulators.

Fiduciary Duty Owed to Credit Union Members

As is the case for mutual savings banks, court decisions and state statues define the standards for the fiduciary duties of credit union directors. In many states, although not all, legal authorities have recognized a relatively high degree of duty that directors are obliged to fulfill on behalf credit union members and/or their institutions.

Under the Federal Credit Union Act, credit union directors' fiduciary duties are expressly addressed only in the instance of their credit unions' insolvency, in which case they may be sued by the NCUA Board for breaching their duty to avoid gross negligence (12 U.S.C. 1751-96k).

A New York case, *Gully v. NCUA Board*, 341 F.3d 155, 165 (2nd Cir. 2003) is the most recent court pronouncement on this issue and provides a good summary of the fiduciary duties owed to members. This case is significant for two reasons. The court upheld NCUA's expanded view of fiduciary duties for credit union officials and the New York statute in question is similar to other state statutes, improving the chances that this decision could be relied upon by other jurisdictions for guidance.

In this case, NCUA had defined an official's fiduciary duty as "a duty to act in the best interest of the institution, its shareholders, and its depositors." The court compared NCUA's definition with standards established under New York case law and statutes, which provide:

> …[A] corporate officer shall perform his duties in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. N.Y. C.L.S. Bus. Corp. §715(h); Gully, 341 F.3d at 165.

Upon review, the court determined that the standard of what is in the best interests of the institution as well as the members as applied by NCUA was proper and consistent with New York law (*Gully*, 341 F.3d at 165)[1].

While directly applicable to cases in the Second Circuit only, *Gully* as a contemporary case, could be very useful in future legal action pressing for the rights of members to receive a high duty of care from their credit union's officials.

[1] The Court in *Gully* applied the section of the New York Code defining the duties of the corporate officers rather than the section defining the duties of credit union officers and directors. This should not detract from the precedential value of *Gully* as the definitions of fiduciary duty in the two sections of the New York Code are virtually identical. (N.Y. C.L.S. Bus. Corp. § 715(h); N.Y. C.L.S. Bank § 471(1). Also, *Gully* involved a credit union officer rather than a director, but such individuals are held to the same level of care in executing their duties.

However, as with mutual saving banks, there are states that do not permit a legal cause of action for the breach of a high level of fiduciary duty as recognized by New York. In Florida, for example, the rights of credit union members are limited by law and recovery is clearly barred for any breach of fiduciary duty unless the director has committed an "egregious wrong" (Fla. Stat. § 657.0265). Thus, the gross negligence standard that applies to mutual savings bank directors would likely apply to credit union directors as well.

Nonetheless, a number of states have adopted statutory provisions regarding the fiduciary duty of corporate directors that are similar to those of New York. This fact, combined with the important decision in *Gully,* presents a clear picture of the high degree of fiduciary duty that is owed to credit union members in many states.

Arguably, the duty of care owed to credit union members is higher than the duty owed to mutual savings bank depositors. While this issue has not been addressed in court, a number of factors provide a strong foundation for pressing such a claim successfully.

Those factors include:

- Credit union members' voting rights are distributed equally, as each member has one vote. Thus, a small group of individuals with large deposits cannot dominate the affairs of their institutions. Mutual savings banks, however, generally apportion votes based on the deposits that individuals have in their accounts.

- It is clear from the Federal Credit Union Act, as discussed in the previous section, that credit union members are encouraged to participate in important decisions of their institutions. By contrast, mutual savings banks depositors are encouraged to forego participation, through proxy voting.

- While as discussed below NCUA must be more vigilant in protecting member's rights and implementing directors' duties, OTS over the years has taken several actions that have demonstrably eroded depositors' interests. A number of court decisions have also weakened the ability of depositors to challenge director decisions, while strengthening directors' autocratic rule of mutual savings banks.

Thus, a number of states recognize that credit union directors owe a high duty of care to their credit unions and members. While the issue is untested, there are forceful arguments that support the premise that the duty to credit union members exceeds the duties owed to mutual savings banks directors.

The role of NCUA in protecting members' rights and ensuring directors fully meet their obligations is critical. Yet, as discussed below, there are strong arguments that such differences have not been sufficiently protected or properly disclosed in the conversion process.

What is the Role Of NCUA To Protect Members by Enforcing Directors' Fiduciary Duties?

There is ample legal authority that evidences NCUA has a significant role in defining and supervising the execution of directors' fiduciary duties on behalf of members, including within the conversion process. For example, within the FCU Act, it is clear that NCUA regulates and is entitled to supervise the statutory requirements imposed on credit unions.

As recent court cases, such as *Gully,* have demonstrated, there is a fiduciary duty directors owe members that NCUA may enforce in a court of law. Such authority is derived from the FCU Act. If NCUA is authorized to enforce such authority in court, the view that the agency has similar authority to regulate such activities can also be supported.

Further, just as the OTS is distinctly positioned to protect mutual saving bank depositors' interests, NCUA has a unique role in ensuring credit union members rights are fully protected.

However, even though NCUA has a highly significant function to protect members' rights and interests, the agency could more fully assert this role, as it relates to conversions.

Examples of agency actions, or the failure to act, that potentially impact members' rights include:

- The need for more stringent review of disclosures, including very recent ones that do not adequately inform members about the differences between credit unions and mutual savings banks.

- The need for stronger enforcement of bylaw provisions that require directors to refrain from taking any action in the name of the credit union that would benefit them personally.

- The need for more rigorous exercise of its authority to review business plans in all conversion applications.

- The need to require credit unions to demonstrate how a conversion would be in the best interests of members.

Actions to Protect Member Interests

Improving the Conversion Process and Ensuring Directors' Fulfill Their Fiduciary Responsibilities

There is no question that credit union members and mutual savings bank depositors alike are owed some degree of fiduciary duty from their institutions' directors -- even though the degree of such duty varies. Yet, it is an unavoidable conclusion that the regulators have not taken sufficient action to protect the best interests of members or depositors in the context of conversions. This result is apparent, even though NCUA in the last two years has been more proactive in considering changes to disclosures and other aspects of the conversion process within its regulatory purview.

Nonetheless, the conversion process is in need of significant, if not bold changes, if the interests of credit union members are to be protected to the fullest extent permissible under controlling legal authority. Some of the recommendations in the previous section would also apply to this section. Other recommendations to shield members from director/management abuses that were not included there or deserve additional attention in this section include:

- Develop a comprehensive regulation on the fiduciary duties of credit union directors. Such a rule would include the following requirements:

  - ✓ Prior to the member vote, directors must attest that the conversion is in their members' best interests.

  - ✓ Directors and management involved in a conversion must attest to NCUA how they are complying with the standard federal bylaw that prohibits directors and officers from participating, in any manner, directly or indirectly in the deliberation of any question affecting their personal interest.

  - ✓ Directors must execute a letter to the members that they will not seek or accept any disproportionate benefit relative to what other members receive in the event of a conversion, or recuse themselves from any decision of the board regarding a conversion.

  - ✓ NCUA should prescribe the elements and require submission of the business plan of a converting credit union and review it for its validity in the context of disclosures to the members.

- Require that member meetings to consider conversion must follow Robert's Rules of Order.

- Prohibit inducements (raffles and prizes) designed to encourage members to vote for a conversion.

- NCUA should consider replicating the following OTS rules:

  - ✓ A bylaw provision that facilitates members' communications with each other regarding a conversion.

  - ✓ The right of dissenting members and others to submit comments for the public record.

- Establish a new office in its headquarters, Ombudsman to Protect Members' Rights. Such an office would:

  - ✓ Be a repository for information for members about the differences between credit unions and mutual savings banks.

  - ✓ Provide resources on what the conversion process means for them as members.

  - ✓ Inform members of how they can support or contest an upcoming conversion.

  - ✓ Review conversion issues raised by members and determine if the directors have properly protected their interests.

  - ✓ Review conversion issues in which there is a disagreement between NCUA and the directors.

iii. CURRENT ("vested") ECONOMIC INTEREST OF MEMBERS

Analysis and Discussion

The unique relationships that credit union members have with their credit unions were described in the Treasury Department's 2001 report Comparing Credit Unions with Other Depository Institutions. Pertinent to the issue of member interests and charter conversions are the following characteristics of credit unions mentioned in the Treasury report:

1. Credit unions are member owned.
2. Each member is entitled to one vote.
3. Credit unions do not issue capital stock.
4. Credit unions generally rely on volunteer, unpaid boards of directors whom the members elect from the ranks of membership.
5. Credit unions operate as not-for-profit institutions.

Treasury points out that thrifts may share some of these characteristics, but only credit unions exhibit all of them together. It is this unique combination of characteristics of a financial cooperative that generate the enormous economic benefits that members enjoy.

As of the end of 2004, the total net worth of the nation's credit unions was $72.5 billion. That net worth represents the sum of all the net income of all credit unions since their organization. At the same time, there were 86.2 million members with $572.4 billion in shares. Since the only owners of a credit union are its members, it is the members who own the $72.5 billion in net worth. However, under current rules, the only way members can "cash out" their ownership in their credit union is in the event of its liquidation. If members decided to take that option, and if all assets were sold at book value[2], the national average payout per member would be $840. The most practical method for distribution in the event of liquidation would be based on member shares, since it is shares that evidence a member's ownership interest in the credit union.[3] The average payout rate for US credit unions would be 12.7% of shares. In other words, if members decided to liquidate, they would receive on average a liquidating dividend of 12.7% of shares. At the recent average rate paid on overall credit union shares, this would amount to about 8 years worth of dividends. (If shares and loans were combined, the average payout would be 7.2%)

[2] Given sufficient time for an orderly sale, it is quite likely that a healthy credit union's assets would on average sell for as much as or more than book value. Although some assets might require a discount, evidence from credit card portfolio sales for example suggests some assets could be sold at a premium.

[3] Distribution could be based on shares at time of liquidation or averaged over some time prior to liquidation. A credit union could decide to use loan balances (again as of the liquidation averaged over a prior period) in addition to share balances. Finally, a case could be made that the amount that a member has paid in fees to the credit union over some time period should also play a role, but this would be difficult to quantify.

Largely because they cannot withdraw their portion of the net worth at will, members are typically unaware of both the fact that they are the direct owners of the credit union and the magnitude of that ownership. Were members made aware of the fact and amount of their ownership rights, the knowledge would likely have an effect on how they voted in conversion issues. Therefore, it is crucial that in any conversion decision, members are fully and effectively informed about their real stakes in their credit unions.

Immediately after conversion from a credit union to a mutual thrift, some have argued that the members have not given up any ownership interest because the thrift remains a mutual institution. This might appear to be the case, but case law has found that thrift depositors' ownership rights are merely a technicality. Evidence that the rules and regulations governing thrifts do not take seriously the depositors' ownership interest is abundantly clear in the way that ownership interest fails to be protected in the case of conversion from mutual to stock-owned thrifts.

It is upon the subsequent conversion of a mutual thrift (previously a credit union) to a stock institution that the former credit union members' ownership rights are totally severed. In such conversions, the members' loss is the gain of those who are granted or purchase stock in the new institution. After the stock issuance, the old net worth of the credit union falls into the hands of the stock purchasers. They stock they buy is worth not only what they paid for it, but also a pro rata share of the previous retained earnings of the credit union. This is the source of the "first day pop" in initial stock offerings. If all members were as fully informed about and assisted in the purchase of stock as the insiders typically are, virtually all of them would buy stock. Buying stock in such a transaction is indeed a way to cash out of a credit union. The mere fact that most members pass on the initial stock offering is proof they are not informed of the process. Because there are typically just a few people who are informed about the benefits of stock purchases, the potential gain for individuals can be enormous. This creates a huge incentive for individuals with influence in a credit union, its board and senior management, to begin a conversion.

Actions to Protect Member Interests

- Ensure that members are more informed about their direct, ownership interest in their credit unions. This can be achieved both by requiring disclosures in conversions to fully explain these interests, and by taking steps to see that members are informed of their ownership outside the formal disclosure process.

- There are a number of a legislative or regulatory changes that would ensure that members' ownership interests in their credit union could be further protected. CUNA and the leagues should seek one or more of these changes at the federal and/or state level.

  The specific recommendations to achieve these are outlined in the previous sections of this report. Put simply, the net worth of a credit union really does belong to the members of the credit union. It is difficult to imagine any circumstances under which a

scheme to transfer that ownership from all the members to a small subset of the members plus a few outsiders without compensation can be considered to be in the best interests of the members.

iv. FUTURE ("Unvested") ECONOMIC INTERESTS OF MEMBERS

Analysis and Discussion

Year after year, credit union members enjoy substantial benefits as a result of doing their business with a credit union rather than some other financial institution. These benefits are both tangible and intangible. On the intangible side is the sense of belonging and control many members have with a credit union. Even more widespread is the strong advantage credit unions have in member or customer satisfaction compared to banks and thrifts. For nineteen years running, credit unions have recorded higher member/customer satisfaction scores than both banks and thrifts. The cooperative structure really does translate into a completely different way that members are dealt with compared to customers at banks and thrifts.

CUNA's Research and Policy staff has quantified the amount by which credit union members benefit by using a credit union rather than a for-profit bank or thrift.[4] Because of more favorable pricing on loans, savings and transactions services, credit union members benefited by over $6 billion in 2002. That amounts to about $75 per member per year, or $160 per member household per year. This is in effect the annual dividend on membership that is relinquished when a credit union converts to a thrift charter.

There are a number of sources of this substantial benefit to members. The largest is the absence of a need to pay stock dividends in a credit union compared to a bank. Next comes the effect of the tax exemption. Third is greater operating efficiency, in part provided by the near absence of directors' fees. Although a post-conversion thrift or bank can cover the greater costs from the point of view of the institution, the members will have lost these benefits completely.

Proponents of conversions have argued that as a mutual thrift a former credit union can operate in exactly the same manner that it did before the conversion, so that the members lose no future benefits. However, that is just not the case. Savings institutions have limits on the amount of consumer lending they can do. Consumer borrowers are likely to see a less willing lender after a conversion. Also, a thrift is regulated by agencies more used to dealing with for- profit firms, where the interest of the customer is placed behind that of the institution itself. Finally, the only real way a thrift can make up for the effect of the tax exemption is to charge its customers higher loan rates and fees and pay lower dividend rates than it did as a credit union. Again, the institution may not suffer after a conversion, but its customers (former members) will.

CUNA is conducting research with preliminary results showing that after conversion from a credit union to a thrift and subsequently to a stock owned institution, the pricing behavior of converted institutions resembles that of banks rather than credit unions. Members do lose the benefit of credit union membership.

[4] See "The Benefits of Credit Union Membership", CUNA Research and Policy Department, at http://advice.cuna.org/econ/member/download/whpaper_mmbrshp.pdf

The annual benefits that credit union members now receive from their credit unions compared to using banks are akin to an annual dividend on their ownership in their credit union. If they lose their ownership, they of course lose access to the dividends.

Actions to Protect Member Interests

- Ensure that members are more informed about the ongoing financial benefits they receive as a result of belonging to their credit union. This can be achieved both by requiring disclosures in conversions to fully explain these stakes, and by taking steps to see that members are informed of their ownership outside the formal disclosure process. Once the information on past conversions is developed, require that the actual pricing practices of other post-conversion thrifts be disclosed to members.

v. UNJUST ENRICHMENT ISSUES

Introduction

One of the primary concerns with conversions of a nonprofit organization to a for-profit, publicly held company are the opportunities for insiders, namely boards of directors and senior management, as well as savvy outside investors, to take advantage of the unwariness and lack of sophistication of the original owners of the institution -- the former members of the credit union -- for their own unfair personal gain.

Similar concerns have been raised about credit union conversions, including issues about how insiders and others are able to "game" the system to further their own financial interests. Since 1998, when Congress relaxed requirements for credit unions converting to mutual savings banks, 22 credit unions have converted – 16 of those transactions were ultimately to stock banks. Currently, at lest one credit union is attempting to convert directly to a mutual holding company, which may be the corporate model of choice for any future conversions because of the advantages the Office of Thrift Supervision has afforded to MHCs, to the detriment of the former credit union's members.

To address these issues, this section looks at the process for converting to publicly held banks or MHCs and the opportunities those processes present for unworthy recipients to reap ill-gotten gains. It focuses on the disadvantageous position that credit union members have in the conversion process, which regrettably is permitted under OTS regulations. It also discusses recent actions taken by the Securities and Exchange Commission to stop illegal purchases of stock in a bank conversion as well as concerns raised recently by the Federal Deposit Insurance Corporation and the SEC regarding such transactions.

Recommendations to improve the process and limit opportunities for abuses at the expense of former credit union members are provided at the conclusion of this section.

Analysis and Discussion

HOW BANK AND SAVINGS ASSOCIATION MUTUAL-TO-STOCK CONVERSIONS WORK

A conversion from a credit union to stock form requires that the credit union first convert to a mutual savings bank and then to a stock institution. Such conversions to stock form can provide great opportunities for officers and directors of the former credit union to benefit unjustly.

In a standard conversion to stock form, a stock savings bank is formed along with a stock holding company. All of the bank's stock is issued to the stock holding company and 100% of the stock of the stock holding company is offered to customers, employees and other members of the community in a subscription offering. Directors of the former

mutual institution become directors of the stock bank and stock holding company. Proceeds of the stock sale may be retained by the bank to expand operations or be retained at the holding company level and used for dividends or stock repurchases in an effort to exert more control over the organization. Officers and directors can purchase up to 21% of the voting stock, either directly or through stock benefit plans.

As described in the OTS section on mutual holding companies in the "Holding Companies Handbook," (January 2003, Section 920), a mutual holding company is another form of corporate structure that may be employed when converting to a stock form. As OTS states, "In all cases, the thrift becomes a stock institution. Some structures will include a mid-tier stock holding company between the stock thrift and the MHC. Other structures will include only the stock thrift that is directly owned by the MHC."

Much attention has been focused on the multi-tiered MHC. In this arrangement, a majority of the stock is owned by the new MHC, and voting is controlled by the new board of directors, which can be the same board from the time the institution was a credit union. The rest of the stock is sold in a subscription to depositors, insiders and the community. The main advantages of this corporate form are that they permit capital to be raised through the sale of the stock, but the MHC controls a majority of the shares, and its directors will continue to set the course for the institution.

HOW DIRECTORS AND MANAGEMENT CAN ABUSE THE SYSTEM

The officials of a converted credit union have several opportunities to benefit unfairly, essentially diverting equity from the former credit union's members in the process.

One of the avenues for abuse concerns the sale and purchase of the stock of a credit union that converts directly or ultimately to a stock organization. (While credit union converting to a stock bank or bank holding company must first convert to a mutual savings bank, a recent conversion attempt involved a planned conversion from a credit union to a mutual holding company.)

One of the most significant events in a mutual-savings-bank- to-stock conversion is the initial public offering (or "IPO") in which shares of stock in the institution are offered for purchase.

According to the Securities and Exchange Commission, historically, it has not been easy for individual investors to purchase shares in an IPO. However, OTS wants to encourage conversions to stock form, under its regulations, individuals investors have what SEC terms "a rare opportunity" as eligible depositors in the converting institution to exercise the first priority to make stock purchases.

Prior to the sale of the shares, the size of the offering is based on an independent appraisal and the value, or "subscription price", of the shares is set by the institution. Eligible depositors are able to purchase a set amount of shares at that subscription price, before the stock is available to the public. The stock that a converting institution offers is

attractive to depositors because of the potential for the stock price to increase or "pop" on the first day of the sale.

If more shares are purchased by those who have a priority than the institution plans to offer, the general public is not given a chance to participate in the initial IPO, although the public may be able to participate in future stock sales.

Under OTS regulations, the directors and management can purchase up to 5% of the stock. The directors and management may also select or form a charitable foundation and issue up to 8% of the stock to that organization.

In addition, the holding company may establish stock benefit plans under which an Employee Stock Ownership Plan (ESOP) may purchase up to 8% of the initial offering. Six to 12 months after the initial offering, the stock holding company may implement a restricted stock plan valued at up to 4% of the initial offering and a stock option plan of up to 10% of the initial offering. Officers and employees may participate in all three of these benefit plans while directors may participate in restricted stock and stock option plans.

Unfortunately, converting financial institutions, consistent with OTS rules, usually require depositors who want to purchase stock in an IPO to pay for their shares in full at the time their order is submitted. Such sums are often enormous for an individual purchaser and preclude them from participating in the stock offering.

Thus, OTS's rule unfairly favor directors and officers, allowing such insiders to control up to 21% of the voting stock of the holding company. It is clear that under OTS's approach to conversions, management and directors benefit disproportionately from the agency's rules, including the ability to purchase stock that generally increases in value after it is offered to the public.

Interestingly and typical of OTS's consistent actions to disadvantage depositors, in the Supplementary Information to its final rule in 1998 on mutual holding companies, the OTS stated that it may grant individual MHC's the ability to withhold a first priority in stock purchases from the members of the former institution that has converted. As stated by the agency:

> OTS generally will continue to require that mutual members be granted a first priority subscription interest for stock issued by savings associations and SHCs. OTS notes, however, that Section 575.7(d)(6) currently provides that OTS may permit a non-conforming stock issuance where the applicant demonstrates that it would be more beneficial to the issuing savings association. Under this provision, the OTS believes that properly structured merger transactions that do not grant priority subscription rights may qualify for approval and OTS is willing to consider and approve such transactions on a case-by-case basis. (63 *Fed. Reg*. 45, 11361]

Under this scenario, a credit union could be merged into a newly formed holding company under OTS' purview and the former credit union's members would not have to receive any priority rights to purchase stock.

A final abuse addressed in this section that is permitted by OTS is the waiver of dividends otherwise owed to the owner of the mutual holding company. As a result of this flagrant abuse sanctioned by OTS, the owners of the holding company, which would include the former members of a converted credit union, are denied an interest in the dividends that would otherwise be paid to them.

This is particularly egregious as the directors of the holding company who request the waiver are the very same shareholders of the subsidiary institution that benefits from the waiver.

It is clear that the conversion process does not sufficiently protect the rights of credit union members. However, the role that some directors play in potential abuses may result from a lack of awareness or understanding of the conversion process and how senior management can manipulate the process for their own ends. In such cases, credit union directors are abrogating their fiduciary duties, as discussed in the previous section, and should be held legally liable to their members as well as by NCUA or the state regulator for failing to uphold their responsibilities to their credit union's member/owners.

While the conversion process is ripe for abuses that result from actions of directors and management, there are also opportunities for abuses at the hands of outside investors.

A complaint filed by the SEC June 29, 2005, involving the illegal purchase of stock in an IPO of a bank holding company in Connecticut illustrates the vulnerability that OTS's regulations and its lax supervision of the conversion process have created.

In that action, SEC alleges that five defendants secretly funded seven depositors' stock purchases totaling $4.9 billion in violation of state and federal laws *(SEC v. Robert R. Ross et all,* US District Court, District of CT). The stock purchase rights of depositors are nontransferable.

As a result of this and other actions, the SEC and FDIC have published an alert issued June 28, 2005 warning unwary depositor/investors seeking to purchase stock in an IPO that they must know the rule and read the disclosures carefully lest they be taken in by fraudulent arrangements.

Actions to Protect Member Interests

It is critical that a course of action be established that will protect the interests of credit union members in a conversion and prevent insiders, as well as unscrupulous outside investors, who seek to prey on unwary members from securing unjust enrichment. Listed below are actions designed to shield credit union members from such abuses, some of which were included in previous sections.

- Prohibit current and former senior management and directors from obtaining any disproportionate, personal financial gain as a result of a conversion for ten years following the charter change.

- Require apportionment of equity prior to conversion.

    a. If converting to a stock institution, members will be issued stock in the new institution in the amount of their apportioned equity in the credit union.

    b. If converting to a thrift, the net worth of the credit union must be frozen in a trust for the members. So long as the thrift remained mutual, the funds would remain part of the institution's net worth. If the thrift converted to stock, the funds in the trust would be distributed in the form of stock to the members of record at the time of the conversion.

- Prohibit OTS and the converting institutions it regulates from denying any depositors the right to a first priority to purchase stock.

- Prohibit credit unions that have converted to mutual holding companies from waiving dividends for ten years after the charter change in order to preserve members' economic interests.

B. Identification and Prioritization of Charter Enhancements

This section of the report addresses the second area of focus addressed by the Task Force:

- *Identification and prioritization of charter enhancements critical to the long-term viability of the credit union charter…*

Discussion and Analysis

In a number of areas, credit unions currently face greater statutory and regulatory constraints than banks and thrifts. Of course, there are other areas in which credit unions have advantages compared to other institutions, chiefly exemptions from federal income taxes and the Community Reinvestment Act. Although AACUL believes that on balance the credit union charter is far superior from the point of view of members, the Association is committed to further enhancing the credit union charter by working to remove or reduce restrictions on credit union operations. The following are the primary areas that CUNA and the leagues are working to enhance the credit union charter:

- Capital requirements. Credit unions are currently subjected to net worth requirements that are higher than those that pertain to banks. Credit unions also lack access to alternative sources of capital. Any move to rationalize credit union capital requirements, such as relating these requirements more to financial risk, and/or provide credit union access to secondary capital, would address this concern.
- Field of membership. Any citizen in America can do business with any of the nation's roughly 8,000 banking institutions. Despite substantial improvements during the past two decades, there are some citizens that are effectively not eligible to be served by any of the nation's almost 9,000 credit unions. From the point of view of individual credit unions, enforcing rules about who can join, and to whom the credit union can market is an unnecessary burden. Because credit unions offer such great benefits to members, AACUL seeks changes in laws and regulations that would make credit unions more accessible to American households.
- Business lending. Credit unions are encountering increasing demands for members to provide member business loans. Over the past decade, state and federal supervisory authorities have come a long way in understanding and accepting the value of business lending in a credit union's portfolio. However, more needs to be done to spread this understanding throughout the ranks of the supervisory authorities. In addition, the 12.25% of assets limit on business lending portfolio holdings needs to be raised. Although there are ways to meet member business loan demands by taking loans off balance sheet, the business lending cap places an unnecessary burden on credit union member business lending, to the detriment of America's important small business sector.
- Investments. There are a number of safe, high quality investments that credit unions do no have access to. Making more investment alternatives available to

credit unions would allow them to more effectively manage surplus funds on behalf of members.

- Others. There are a number of other items that should be pursued to increase the flexibility of the credit union charter, at both the state and federal level. Many of these are included in the Credit Union Regulatory Improvements Act (CURIA), such as extending permissible loan maturities, increasing CUSO investment authority, granting credit unions the same treatment as banks under securities laws, etc. In addition, improvements can always be made in how credit union regulatory agencies respond to credit union activities.

In addition to making improvements to the credit union charter – both state and federal - wherever possible, it is of course paramount that the centerpiece of credit union advocacy be the preservation of the tax exemption. There are good public policy reasons for the tax exemption, and it provides substantial benefits to credit union members. AACUL believes that, with sufficient vigilance a unified credit union movement will always be able to convince legislators that the tax exemption should be maintained.

C. Identification of Range of Options for Leagues

This section of the report addresses the third area of focus addressed by the Task Force:

- *Identification of a range of options for leagues to implement during all stages of a conversion process.*

Discussion

Until very recently most leagues have not been faced with decisions and actions that must be agreed upon with respect to credit union conversions. However, since this issue has become a major topic of discussion in the credit union community, it has become apparent that each state association's leadership should have a plan of action for addressing conversions.

There are various stages of a conversion process that call for different levels and types of activities. In looking at these stages, the task force identified three areas where input and activities by the league are critical.

Before conversion(s) arise – This is the position that most state leagues find themselves in at the present time. In this period, there have been no conversions, and no outward discussion of particular credit unions seeking to convert. Now is the time to act. As recent examples have shown, it is much more difficult to make policy decisions and take actions when a specific credit union or individual is associated with the conversion proposal.

Focusing on education of credit union management and volunteers, ensuring the state has appropriate laws, regulations, and procedures associated with conversions, and development of league policies are critical during this stage.

Conversion Exploration - This is the period in which a credit union's management and board are actively exploring the potential of a charter conversion. This exploration can happen in two ways. The first is what would be termed an "open exploration", where the credit union makes the league and/or others aware that the thrift/bank option is being discussed. In this scenario, the league may have the opportunity to meet with management and the board to provide information, education and to influence the process.

The second way a conversion exploration can occur is in a "closed" environment. That is a case where the credit union has been very guarded in its deliberations and the credit union community – including the league – find out about the proposed conversion via a public announcement, or just prior. Obviously, there is no ability to influence the decision making process in this event.

Post Board Conversion Vote - This is the time period between when a credit union board of directors votes to propose a charter conversion to the credit union membership and

when the membership actually votes on the measure. Because of the public nature of this period, league actions during this stage would typically be much more high profile, and be the areas of potential concern for some in the credit union community.

At this juncture, providing fact-based information regarding issues of conversions to the media, working to provide alternative structural models to members (merger, liquidation, distribution of equity prior to conversion), and arming members opposed to the conversion with information and resource options are the primary initiatives leagues might undertake.

Actions to Protect Members' Interests

Before conversion(s) arise

- Elevate attention to governance, ethics and fiduciary duty issues for credit union boards by integrating the responsibilities into all levels of education programs. This would include volunteer conferences, certificate programs, director liability education from CMG, etc…

- Leagues should adopt a formal position on conversions. (See Model Position – Exhibit B.)

- Leagues should review their state's laws and regulations governing charter conversions and recommend changes as appropriate to ensure full disclosures and a fair and open voting process. Consideration should be given to voting thresholds and alternatives such as dissenters' right to a special dividend alternative. (See Model CU Act Provisions – Exhibit C.)

- Make available sample bylaw language for credit unions that wish to adopt a provision prohibiting unjust personal gain for board and management.

Conversion Exploration

- League should propose meeting with board and management to provide perspective on the need for conversion and the protection of members' interests.

- If steps outlined in the "before" section have not taken place, those items should be initiated at this time.

Post Board Conversion Vote

- Create, or link to, a web-based central repository for credit union members, the media and the general public with information regarding conversions and their impact on credit union members.

- Develop and institute a fact-based, media initiative regarding the importance of full disclosure of the ownership interests of members, an open and fair voting process, and the avoidance of unjust insider enrichment.

- Ensure that members opposing a conversion have access to assistance that could include…

  - ✓ Provision of materials relating to the potential loss of their membership interest in the credit union.
  - ✓ Provision of information regarding alternative structural models such as liquidation, merger, dividend prior to conversion, etc…
  - ✓ Potential funding resources.

D. Development of Library of Information for Leagues

The fourth area of focus the Task Force addressed is:

- *Development of a library of information and tools for leagues to use in addressing all aspects of conversions.*

One of the primary reasons AACUL appointed a group to work on the conversion issue was to ensure that leagues have access to as many resources as possible to assist them in developing policies and actions in their respective states.

This report, along with all the supporting research, background materials, appropriate federal and state regulatory and legal information as well as sample information from leagues has been collected and organized. Effective October 2005, this information will be available to leagues through www.aacul.org, or the "league only" section of the cuna.org website.

In addition, part of the undertaking of the Task Force has been to work with a third party such as Consumer Federation of America (CFA) to encourage presentment of a consumer website that highlights and promotes the interests of credit union members. This effort is underway, and as CFA makes further progress on this initiative, leagues will be provided this link as a resource as well.

EXHIBITS

Exhibit A

Summary of Actions to Protect Member Interests

- Constructive NCUA Regulatory Actions (State regulators should establish similar authorities.)

Note: These recommendations would not require new federal statutory authority.

- Require public comment and/or a public hearing in the community prior to the vote on the conversion proposal.

- Enable federal credit unions to adopt bylaw provisions that:

  - ✓ Guarantee that groups of dissenting members have an opportunity and the means to share their concerns about a conversion proposal with the membership.

  - ✓ Ensure members are informed of their right to and the option for apportionment of the equity prior to conversion.

  - ✓ Authorize full or partial distribution of equity to dissenting voters subsequent to a vote for conversion.

  - ✓ Require that only credit union members that do not have a conflict of interest may initiate a proposal to convert. The credit union may also set the threshold for the percent of member signatures required for a petition to convert.

- Require additional disclosures to members that spell out:

  - ✓ The rights and economic value that the member is losing.

  - ✓ That the credit union's board must demonstrate to the membership how the conversion would be in their best interests.

  - ✓ How the ownership interests of a credit union member differ from the ownership interests of a mutual savings bank depositor.

  - ✓ That members may also file comments with OTS supporting or opposing the conversion.

  - ✓ How many credit unions that have become mutual savings banks have subsequently converted to stock form.

- ✓ The historical pricing practices of credit unions that have converted to a thrift charter.

- ✓ The duties of credit union management and directors to protect their rights, using specific language such as, “The directors and management of your credit union must act to protect the rights you have as one of the owners of the credit union. If you feel your ownership rights have not been or will not be protected in the proposed conversion, contact the National Credit Union Administration at ____.” (See later recommendation regarding establishment of Ombudsman at NCUA.)

- Require a credit union’s board to obtain an independent legal opinion regarding whether the conversion protects the ownership interests of the credit union’s members and provide the opinion to the membership prior to the vote.

- Require a credit union’s board to provide a copy of the conversion plan to the membership.

- Require a “quiet” period prior to the membership vote in which information from the board cannot be provided to the membership about the conversion.

- Require the credit union to hold an informational meeting well in advance of the member vote.

- Clarify that credit union members have the right to continue their credit union, merge with another credit union, or approve liquidation in addition to supporting a conversion.

- Require credit union boards to demonstrate they have explored all possible options before converting, including liquidation, merger, and a pro rata apportionment of the equity prior to conversion.

- Adopt rules facilitating spin-offs of dissenting groups—along with their share of equity—into another credit union.

- Impose fees for NCUA’s costs of reviewing disclosures and processing conversions (so other credit unions don’t bear these costs).

- Remove unnecessary regulations to enhance the attractiveness of the credit union charter.

- Develop a comprehensive regulation on the fiduciary duties of credit union directors. Such a rule would include the following requirements:

- ✓ Prior to the member vote, directors must attest that the conversion is in their members' best interests.

- ✓ Directors and management involved in a conversion must attest to NCUA how they are complying with the standard federal bylaw that prohibits directors and officers from participating, in any manner, directly or indirectly in the deliberation of any question affecting their personal interest.

- ✓ Directors must execute a letter to the members that they will not seek or accept any disproportionate benefit relative to what other members receive in the event of a conversion, or recuse themselves from any decision of the board regarding a conversion.

- ✓ NCUA should prescribe the elements and require submission of the business plan of a converting credit union and review it for its validity in the context of disclosures to the members.

- Require that member meetings to consider conversion follow Robert's Rules of Order.

- Prohibit inducements (raffles and prizes) designed to encourage members to vote for a conversion.

- NCUA should consider replicating the following OTS rules:

  - ✓ A bylaw provision that facilitates members' communications with each other regarding a conversion.

  - ✓ The right of dissenting members and others to submit comments for the public record.

- Establish a new office in its headquarters, Ombudsman to Protect Members' Rights. Such an office would:

  - ✓ Be a repository for information for members about the differences between credit unions and mutual savings banks.

  - ✓ Provide resources on what the conversion process means for them as members.

  - ✓ Inform members of how they can support or contest an upcoming conversion.

  - ✓ Review conversion issues raised by members and determine if the directors have properly protected their interests.

  - ✓ Review conversion issues in which there is a disagreement between NCUA and the directors.

- Conceivable Judicial Actions

  - Current or former credit union members may sue the directors of the converting credit union -- or OTS—for breaching their fiduciary duties or violating the commitments established in a letter to the members prior to conversion.

  - Current or former credit union members may sue OTS for applying regulations arbitrarily and capriciously to highly capitalized credit unions, without safeguards for owner interests.

  - Current or former credit union members may sue directors and OTS on the theory of illegal conversion of members' property interests in their credit union.

- Constructive Legislative Actions to Protect Members' Interests

  - Broaden statutory authority of NCUA and state regulators to review conversions.

  - In states where there is no law regarding conversions, provide the regulator with sufficient statutory authority to review conversions.

  - Prohibit current and former senior management and directors from obtaining any disproportionate, personal financial gain as a result of a conversion for ten years following the charter change.

  - Require apportionment of equity prior to conversion.

    a) If converting to a stock institution, members will be issued stock in the new institution in the amount of their apportioned equity in the credit union.

    b) If converting to a thrift, the net worth of the credit union must be frozen in a trust for the members. So long as the thrift remained mutual, the funds would remain part of the institution's net worth. If the thrift converted to stock, the funds in the trust would be returned to the members of record at the time of the conversion.

  - Require that the conversion voting thresholds be at least as high as those for mutual savings banks.

  - Authorize credit union membership to set voting thresholds (via bylaw amendment) at levels higher than required by statute.

  - Prohibit OTS and the converting institutions it regulates from denying any depositors the right to a first priority to purchase stock.

- Prohibit credit unions that have converted to mutual holding companies from waiving dividends for ten years after the charter change in order to preserve members' economic interests.

➢ Credit Union System Actions

- Create a competing offer that the converting CU's Board would have a fiduciary duty to consider, such as a merger offer from another credit union.

- Create a pro-credit union website focusing on members' interests.

  ✓ If set up as a national resource, create sub-pages for developments in each state so that state regulatory issues can be addressed.

- Fully inform the credit union press and other credit union channels should be fully informed about the loss of member value that is involved in conversions.

- Participate in meetings/hearings with the OTS regarding conversions.

  ✓ Current OTS rules already provide for these.
  ✓ Local newspapers, where notices are published, could be monitored.

- Encourage state attorneys general to become interested in whether members are being adequately protected in conversions;

  ✓ Work through organizations like the National Association of Attorneys General.

- Commission a third party study on the loss of value to credit union members in a conversion.

➢ General

- Clarify the tax treatment regarding conversions.

  ✓ Tax implications are described in each set of disclosure documents.

- Encourage CUNA Mutual to conduct a separate risk assessment in determining whether to insure directors and officers for breaches of fiduciary duty relating to conversions.

➢ Additional Focus For Leagues

Before conversion(s) arise

- Elevate attention to governance, ethics and fiduciary duty issues for credit union boards by integrating the responsibilities into all levels of education programs. This would include volunteer conferences, certificate programs, director liability education from CMG, etc…

- Adopt a formal position on conversions. (See Model Position - Exhibit B.)

- Review their state's laws and regulations governing charter conversions and recommend changes as appropriate to ensure full disclosures and a fair and open voting process. Consideration should be given to voting thresholds and alternatives such as dissenters' right to a special dividend alternative. (See Model CU Act Provisions – Exhibit C.)

- Make available sample bylaw language for credit unions that wish to adopt a provision prohibiting unjust personal gain for board and management.

<u>Conversion Exploration</u>

- Propose meeting with board and management to provide perspective on the need for conversion and the protection of members' interests.

- If steps outlined in the "before" section have not taken place, those items should be initiated at this time.

<u>Post Board Conversion Vote</u>

- Create, or link to, a web-based central repository for credit union members, the media and the general public with information regarding conversions and their impact on credit union members.

- Develop and institute a fact-based, media initiative regarding the importance of full disclosure of the ownership interests of members, an open and fair voting process, and the avoidance of unjust insider enrichment.

- Ensure that members opposing a conversion have access to assistance that could include…

  - ✓ Provision of materials relating to the potential loss of their membership interest in the credit union.
  - ✓ Provision of information regarding alternative structural models such as liquidation, merger, dividend prior to conversion, etc…
  - ✓ Potential funding resources.

Exhibit B

AACUL Model Position Statement on CU Charter Conversions

July 2005

The _____Credit Union League strongly believes that the member-owned, not-for-profit credit union charter is the charter of choice for providing the public with consumer-friendly financial products and services.

We also strongly believe that the issue of credit union charter conversions should be approached from the point of view of the **members** of the credit union, since they are the owners of the institution.

We understand that under current laws and regulations, credit unions face more restrictions on their operations than do mutual savings banks or commercial banks. In particular, credit unions lack access to alternate sources of capital, face higher net worth requirements, are more restricted in business lending, and can serve only a defined field of membership. We are dedicated to lessening or removing these restrictions on credit union operations through legislative or regulatory means.

However, research has confirmed that even with these greater restrictions, the credit union charter provides by far the best deal for credit union **members**. The primary driver of this greater benefit is the not-for-profit cooperative structure upon which is based the credit union tax exemption. Credit unions are able to offer a far better economic return to their members than would be possible for a stock owned bank or a mutual thrift.

In addition, substantial case law suggests that depositor ownership of a mutual thrift is merely a technicality, so that the fiduciary responsibility of a thrift board of directors is to serve the institution. As the US Treasury Department has pointed out, credit unions are owned by their members. Therefore, the fiduciary responsibility of a credit union's board of directors is to the owners – the members. There are indeed real differences between a mutual thrift and a credit union, and these differences serve the members of credit unions.

In other words, we cannot conceive of any circumstance under current law and regulation that **members** would be better off after a conversion to either form of bank charter. Although there may be operational advantages to the management of a credit union to have a bank charter, because the credit union exists for the benefit of the members, it is the responsibility of credit union management to preserve that benefit for the members.

However, we fully appreciate that in the future the relative member benefit of a credit union compared to a bank charter could change. It is possible that the restrictions on credit unions' capital, lending or fields of membership could become so onerous that the balance would tip in favor of a bank charter. Or, it is conceivable that the tax exemption

could be lost without an immediate relaxation of legal/regulatory charter disadvantages. Although we think the likelihood of either of these changes is extremely low, the mere possibility of such changes in the future requires the continued existence of the alternative of a charter conversion for credit unions.

The problem is that the existence of a "safety valve" for a charter conversion - to be maintained for future emergency - can be misused by current credit union management. There can be significant personal financial incentives for this to happen. This inappropriate use of charter conversions is facilitated by the fact that many members do not fully understand their ownership interest in their credit union, and how the cooperative structure benefits them. This lack of understanding in no way diminishes these ownership rights. We believe that credit union members have the full right to decide the future of their credit union. We are also confident that a fully informed membership would be incredibly unlikely to vote for a conversion under current laws and regulations.

In order to protect the interests of credit union members, the _____ Credit Union League will:

- Continue to seek legislative and regulatory changes (state and federal) that will make the advantages of the credit union charter even stronger.

- Provide credit union officials with information and persuasion prior to any decision to convert.

- Pursue state and federal regulatory changes to strengthen conversion disclosure requirements to ensure that members are more fully informed about their ownership interests and the consequences to them of a conversion.

- Work with state and federal regulators to address guidelines that ensure an open and fair voting process.

- Illuminate credit union directors' fiduciary responsibility to protect the members' interests by advocating for

  - ✓ Disclosures of personal conflicts of interest.

  - ✓ Providing alternative structural mutations which might include merger, liquidation, dividend prior to conversion, etc…

- Seek ways to eliminate any unjust enrichment of insiders in credit union conversions or in subsequent conversions of the thrifts to stock ownership.

- Express fact-based opinions to the media regarding the importance of complete, fair and balanced disclosures, the avoidance of undue enrichment on the part of any credit union official, and the need for a fair voting and conversion process in order to protect the interests of all members.

- Direct members, the media, and the general public to a central repository of information regarding conversions and their impact on credit union members.

- Direct members opposing a conversion to information and funding resources.

Exhibit C

CREDIT UNION CONVERSION TO MUTUAL BANK MODEL PROVISIONS

Appendix C of Model CU Act

(CUNA's Legislative Advisory Panel – June 2005)

Currently, the Model Credit Union Act does not provide for the conversion of a credit union to a non-credit union structure. Concerns have been raised in national discussions that a small number of credit union members could eventually benefit financially from a credit union-to-mutual savings bank conversion, while the large majority of the credit union members lose their equity capital when the credit union ceases to exist.

While these issues continue to be debated, the credit union-to-mutual savings bank provisions will be in the Appendix to CUNA's Model Credit Union Act.

If the circumstances in your state require that the credit union league develop language that would allow a credit union to convert to a non-credit union structure, the Task Force recommends the following provisions be considered:

Model Provisions:

Section 10.43. Credit Union Conversion to Mutual Savings Bank or Mutual Savings Association

(1) Not withstanding any other provision in this chapter, with the approval of the commissioner and upon the affirmative vote of 2/3 of the members who vote on the proposal, a credit union organized under this act may convert, subject to this section and, if a holding company is to be formed in connection with the conversion, the regulations of the federal reserve board of governors or of the office of thrift supervision applicable to holding companies, into a mutual savings bank or mutual savings association.

(2) The converted credit union must retain at least 50 percent of the net conversion proceeds.

(3) The board of directors, by an affirmative vote of 2/3 of the entire board, shall approve any plan of conversion under subsection (1) before submitting the plan to the commissioner for preliminary review.

A state credit union league may choose to pick one or more of the following alternative provisions:

DISCLOSURE ALTERNATIVE

(4) At least 30 days before voting on the plan, the board of directors shall give notice to the credit union's members that it is considering a conversion. The notice shall be mailed to the credit union's membership and shall not be included with other mailings sent to the credit union's membership. The notice shall include all of the following:

(a) In clear and conspicuous print, a brief statement as to why the board is considering the conversion.

(b) In clear and conspicuous print, a brief statement of the major positive and negative effects of the proposed conversion.

(c)In clear and conspicuous print, a request for members' written comments on the proposed conversion.

(5) The commissioner shall review the contents of and member comments on the conversion plan and grant preliminary approval before the credit union board presents the conversion plan to the members for a vote. The commissioner shall grant preliminary approval of the contents of the conversion plan only if the commissioner is satisfied of all of the following:

(a) The conversion plan discloses to the members, in clear and conspicuous print, information concerning the advantages and disadvantages of the proposed conversion and contains a statement indicating any material differences in powers.

(b) The conversion plan must include a comprehensive business plan reflecting the board's intended plans for the proposed conversion proceeds. At a minimum, the business plan must address:

(1) The converting credit union's projected operations and activities for four years following the conversion.
(2) Four years of projected financial statements;
(3) The board's plan for deploying conversion proceeds to meet credit and lending needs in the proposed market areas;
(4) The risks associated with the board's plan for deployment of conversion proceeds, and the effect of this plan on management resources, staffing, and facilities.
(5) The expertise of the management and board of directors, or that is planned for adequate staffing and controls to prudently manage the growth, expansion, new investment, and OTHER OPERATIONS and activities proposed in the business plan.

(c)The conversion would not be made to circumvent a pending supervisory action that is initiated by the commissioner or other regulatory agency because of a concern over the safety and soundness of the credit union.

(d) The conversion plan does not provide any official of the credit union with any remuneration or other economic benefit in connection with the conversion of the credit union.

(e)The converted organization is likely to be economically viable.

(6) Upon preliminary approval of the contents of the conversion plan by the commissioner, the credit union shall do the following:

(a) Call a special meeting of the members to vote on the conversion plan. The special meeting must be held in a reasonable manner conducive to accommodating members that wish to attend.

(b) Mail to each member of the credit union, at least ninety (90) days but no more than 120 days before the special meeting of the members, a Notice of the Meeting and a written copy of the proposed conversion. The Notice of the Meeting shall include:

(i) In clear and conspicuous print, a statement of the positive and negative effects of the proposed conversion.

(ii) In clear and conspicuous print, a statement whether the directors of the converted organization will receive compensation and that interested persons may obtain more detailed information from the credit union at its offices or by other methods having the prior approval of the commissioner.

(iii) In clear and conspicuous print, a statement describing the total equity of the credit union as of the last reporting date and an explanation of the member’s partial ownership of this equity amount.

(iv) In clear and conspicuous print, a statement that the proposed plan of conversion may be substantively amended by the board of directors as a result of comments from regulatory authorities or otherwise before the meeting, and that the proposed plan may be terminated by the board of directors.

(v) In clear and conspicuous print, directions for obtaining copies of the conversion plan.

(vi) In clear and conspicuous print, the date of the special meeting and a statement that the vote on the conversion will close on that date.

(vii) Other information as required by the commissioner.

(c) Credit union members opposing the proposed conversion may submit an Opposition Statement to the board of directors. Credit union members supporting the proposed conversion may submit a Support Statement to the board of directors.

(d) All Opposition and Support Statements must be received at least sixty (60) days prior to the annual meeting date. The board shall review all Opposition and Support Statements and prepare a Consolidated Opposition and/or Support Statement which reflects the opinions of those credit unions which submitted statements.

(e) At least thirty (30) days prior to the annual meeting date, the board shall mail a ballot, Purpose Statement and Consolidated Opposition and/or Support Statements and a Meeting Notice to all member credit unions entitled to vote.

(7) The 30-day notice required under subsection (4)(b) shall include the date, time, and place of the special member meeting, a ballot and postage-paid return envelope and the methods permitted for casting votes.

(8) The vote on the conversion proposal must be by secret ballot and conducted by an outside, independent, certified public accounting firm. The outside, independent, certified public accounting firm must be a company with experience in conducting corporate elections. No official or senior manager of the credit union, or the immediate family members of any official or senior manager, may have any ownership interest in, or be employed by, the certified public accounting firm. The certified public accounting firm may not be hired by the credit union as a conversion consultant or be an affiliate of the conversion consultant.

(9) If the plan of conversion is substantively amended by the board of directors, at least 30 days before the vote of the members on the proposal the credit union shall provide members with notice containing the information required by subparagraphs (i) to (vi) of subsection (4)(b) that accurately describes the amended plan of conversion.

(10) In addition to accepting member votes at the special meeting and by mail, with the prior approval of the commissioner, a credit union may also accept member votes on the conversion by an alternative method that is reasonably calculated to ensure each member has an opportunity to vote. The credit union shall file with the commissioner all of the following:

(a) Certified copies of records of all proceedings held by the board of directors and members of the credit union.

(b) Copies of member comments submitted to the credit union under subsection (2)(c).

(c) A certified copy of consent or approval of the federal regulatory authority or the regulatory authority of the applicable state, territory, or protectorate of the United States if the consent or approval is required by the laws of the applicable jurisdiction.

(d) Evidence that the converted organization is eligible for federal insurance of deposits.

(11) If all of the conditions required by this section have been met and the commissioner determines that notices to members were accurate, timely, and not misleading, and that conduct of the vote on the conversion plan was fair and lawful, the commissioner shall approve the conversion and the conversion shall become effective.

(12) Except as otherwise required by the commissioner, this section does not apply to a credit union that submitted to the commissioner a plan of conversion into a mutual savings bank or mutual savings association before the effective date of the amendatory act that added this section.

[Editor's Note: The following provision is still in the drafting process]

DISSENTERS' RIGHT TO SPECIAL DIVIDEND ALTERNATIVE

(13) If at anytime the credit union members vote to convert the credit union to a non-credit union structure, credit union members who oppose the conversion may withdraw their ownership equity shares along with their regular credit union accounts to join another credit union.

Ownership equity shares will be calculated by subtracting the percentage of capital required for a mutual savings bank to be "adequately capitalized" as required by federal regulations, from the total assets of the credit union. This amount will then be divided on a pro rata basis among all of the credit union members based on the amount of interest and fees paid and earned at the credit union by the members over the past 24 months.

[Editor's Note: Additional provisions still to come:

- *Alternative that restricts MSB conversions by credit unions to state chartered MSBs to allow effective member protections to be added to other parts of the state code.*
- *Investigate adding member equity protections to the IRS rules, because the IRS governs all corporate structures from non-profits to mutuals to stock corps. Whatever protections are put in the regs can be applied no matter what the final corporate structure of the credit union.*