UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 10 | Issue 1 Article 3

2006

Credit Union Conversions: Charter Choices and Controversy

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ARTICLES

CREDIT UNION CONVERSIONS: CHARTER CHOICES AND CONTROVERSY

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I. INTRODUCTION

Despite decades of banking industry consolidation, the variety and number of financial institutions in the United States remains without equal, and includes national and state banks, federal and state savings institutions, and federal and state credit unions.[2] These financial institution charters developed to meet similar yet distinct objectives, and each continues to offer its own unique advantages and historical benefits. While the distinctions in functions and powers have diminished over time, Congress and the states continue to permit different forms of ownership. Commercial banks are limited to stock ownership and credit unions are limited to the mutual form as membership institutions, while savings institutions may be mutual or stockholder owned institutions. This variety of financial institutions supports equally varied business models in diverse markets serving the ever expanding financial service needs of American consumers and businesses.

Over time, as businesses evolve, customer demands grow, and other circumstances change, many financial institutions have found it necessary to change their form of charter to one that more closely aligns with their business objectives and customer demands. Charter

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1. Member, The Florida Bar; Counsel to Gordon, Feinblatt, Rothman, Hoffberger & Hollander, LLC, Baltimore Maryland.

2. As of September 30, 2005, there were 8,854 institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). FDIC, http://www.fdic.gov/bank/statistical/stats/2005sep/industry.html (last visited Jan. 1, 2006). The 2005 Directory of Federally Insured Credit Unions includes more than 9,000 federal and state credit unions. NATIONAL CREDIT UNION ADMINISTRATION, 2005 DIRECTORY OF FEDERALLY INSURED CREDIT UNIONS, http://www.ncua.gov/data/directory/2005/2005CuDirectory.pdf.

conversions are contemplated and prescribed by statute and regulation.[3] There are a variety of reasons that might lead to a charter conversion decision, including new or different strategic initiatives and changing market demographics, as well as financial and regulatory considerations. One such charter conversion option that has generated a fair amount of interest and controversy recently involves the conversion of credit unions to mutual savings banks or mutual savings associations. Why have these conversions led to controversy or even litigation?

Interest in credit union conversions seems to result, in part, from the unique historical role credit unions have played in delivering financial services to American consumers[4] and, in part, from credit unions' strong competitive position.[5] Interest is strong despite the fact that credit unions in the aggregate comprise a relatively small portion of overall financial institution assets.[6] At the outset, it is worth an obvious note that no discussion involving credit unions occurs without some reference to the debate over credit unions' tax-exempt status. Nevertheless, consideration of issues surrounding the taxation of credit unions is beyond the scope of this article.[7]

Some regulators and credit union advocates see conversion of credit unions to mutual savings institutions and the possibility of future mutual-to-stock conversions as threats to member voting rights and the credit union charter itself. Others see credit union conversions as an appropriate business choice that all institutions should be free to make without undue interference. Supporters of "charter choice" believe existing statutes and regulations appropriately take into account member voting interests and ensure that all constituents in a conversion transaction are treated fairly. Those who have argued against recent

3. *See, e.g.*, 12 U.S.C. § 1785(b)(2) (2005) (permitting conversion of insured credit union to mutual savings banks or mutual savings association); 12 U.S.C. § 1464(i)(3) (2005) (permitting conversion of federal savings association to state-chartered savings bank); 12 U.S.C. § 214 et seq. (2005) (permitting conversion of national bank to state-chartered bank).

4. William R. Emmons & Frank A. Schmid, *Credit Unions Make Friends – But Not with Bankers*, THE REGIONAL ECONOMIST, Oct. 2003.

5. *See, e.g.*, Timothy Hannan, *The Impact of Credit Unions on the Rates Offered For Retail Deposits by Banks and Thrift Institutions*, (Board of Governors of the Federal Reserve System, Working Paper 2003-2006), *available at* http://www.federalreserve.gov/pubs/feds/2003/200306/200306pap.pdf.

6. FDIC *supra* note 2.

7. *See infra* notes 30-31 and accompanying text.

conversion efforts caution that additional credit union member protections are needed.

Although the level and tenor of the debate may have increased with news of recent conversions and attempts to convert, it is important to keep in mind that only a comparative handful of the thousands of credit unions in the United States have chosen to convert since legislative changes resulted in a more streamlined conversion process in 1998.[8] The vast majority of credit unions today serve their membership successfully, while enjoying strong consumer satisfaction and loyalty. In fact, credit unions consistently rank at the top among financial institutions in customer satisfaction surveys.[9]

II. UNIQUE ROLE AND STRUCTURE OF CREDIT UNIONS IN AMERICAN FINANCIAL SERVICES

A credit union is a cooperative financial institution owned by its members who are linked by a common bond.[10] Each credit union member is required to purchase shares in the institution.[11] The purchase of a share allows a member to become an owner with the right to vote, and to take advantage of the services offered by the credit union.[12] Regardless of the number of shares held, no credit union member has more than one vote.[13] Credit unions, like mutual savings banks and mutual savings institutions, do not operate to generate shareholder results. Credit unions redeploy net income and profits back into the organization's operations and services. Credit unions generally are governed by a voluntary board of directors.[14]

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8. National Association of Federal Credit Unions, *Credit Union Conversions–NAFCU Policy Recommendations* at App. A (Sep. 19, 2005), http://www.nafcu.org/Content/NavigationMenu/Legislation_Regulation/Studies/ConversionsWhitePaper.pdf.

9. Charles Keenan, *Customer Service Comeback Boosts Satisfaction Ratings,* AM. BANKER, Oct. 18, 2005, at 6A.

10. *See infra* notes 27-29 and accompanying text.

11. 12 U.S.C. § 1759(a) (2005).

12. National Credit Union Association, Interpretative Ruling and Policy Statement 03-01 (May 15, 2003), http://www.ncua.gov/RegulationsOpinionsLaws/charter_manual/2003ChateringandFOMManual.pdf (noting each state has specific laws and regulations governing the operations of its chartered credit unions). For discussion purposes, this article focuses on the applicable federal laws and regulations governing the chartering and operation of credit unions.

13. 12 U.S.C. § 1760 (2005).

14. *See* 12 U.S.C. § 1761a (2005).

Credit unions may be chartered at either the federal or state level.[15] Like banks and savings institutions, credit unions are regulated financial institutions.[16] Unlike other cooperative financial institutions, however, a credit union operates to serve a more narrowly defined membership. Credit unions work to encourage thrift among their members, create sources of credit at fair and reasonable rates of interest, and provide an opportunity for their members to "use and control their resources on a democratic basis in order to improve their economic and social condition."[17]

Today's credit unions trace their history to the nineteenth century when the first credit unions were formed in Europe to respond to the credit needs of farmers and others who were unable to obtain reasonable financing through traditional means.[18] The credit union concept crossed the Atlantic in 1900 when the first credit union in North America, La Caisse Populaire de Levis, was organized in Quebec.[19] In 1909, Massachusetts passed the first credit union law and the first credit union was established that same year in neighboring New Hampshire.[20]

Credit unions are not uniquely cooperative, however, nor were credit unions the first cooperative financial institutions in the United States. Nearly 100 years before the first credit union opened for business, the first mutual savings banks opened in 1816 when the Philadelphia Savings Fund Society began operations on a voluntary basis and the Provident Institution for Savings in Boston received its charter.[21] Credit unions and mutual savings institutions share common characteristics in that members control the institution and net earnings inure to the benefit of depositors or share account holders.[22]

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15. 12 U.S.C. §§ 1751-1775 (2005). A majority of states have credit union chartering acts; *see, e.g.*, MD. CODE ANN., FIN. INST. §§ 6-101 – 6-909 (LexisNexis 2005).

16. Credit unions are subject to most, but not all, of the same regulations that apply to other insured depository institutions. For example, credit unions are not subject to the requirements of the Community Reinvestment Act, 12 U.S.C. § 2902 (2005).

17. FLA. STAT. § 657.003 (2005).

18. National Credit Union Administration, *History of Credit Unions*, http://www.ncua.gov/AboutNCUA/historyCU.html (last visited Jan. 1, 2006).

19. *Id.*

20. *Id.*

21. FDIC, *History of the Eighties, Volume I, An Examination of the Banking Crises of the 1980s and early 1990s*, at 212 (Dec. 1997) (citations omitted) http://www.fdic.gov/bank/histoy/historical/211_234.pdf.

22. Brief for America's Community Bankers et al. as Amici Curiae Supporting

Originally, mutual savings banks were organized under state law to help the working and lower classes by providing a safe place where the small saver, at the time unwelcome by many commercial banks, could deposit modest amounts of money. Names such as Dime Savings and Salem Five Cents are reminders of these institutions' original marketing focus. Mutual savings banks were formed largely as a result of philanthropic support. Wealthy industrialists, concentrated in the Northeast and Mid-Atlantic, provided the start-up capital and served as bank management, overseeing operations without compensation.[23] Similar to a mutual savings bank, a federal mutual savings association is a non-stock, insured depository institution chartered by the Office of Thrift Supervision (OTS) under the Home Owners' Loan Act.[24] Federal mutual savings associations operate just like stock-owned federal thrifts, except that the depositors in a mutual savings association hold the ownership rights.[25]

Mutual savings institutions, like credit unions, developed around management strategies that are focused on the long-term success of the institution rather than on short-term shareholder results. Like other banking institutions, mutual institutions are governed by a board of directors that has a fiduciary responsibility to ensure that the institution is run in a safe and sound manner, and in compliance with all laws and regulations. Because mutual savings institutions also do not face quarterly earnings result pressures, most are deeply involved in philanthropic activities within their communities.[26]

To ensure that credit unions serve their intended select groups of individuals, federal and state chartering laws limit their fields of membership. Fields of membership include groups of individuals sharing a common bond. A common bond may be occupational (employees of the firm), associational (such as members of a religious

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Petitioners, Community Credit Union, v. National Credit Union Admin., et al., No. 4:05 CV 285 (E.D. Tex. Aug. 24, 2005) (dismissing with prejudice under terms of voluntary stipulation order on Sep. 08, 2005).

23. *History of the Eighties, supra*, note 21 at 212.

24. 12 U.S.C. § 1464(b) (2005).

25. *Id.*

26. *See, e.g., Hearing on GSE Reform Before Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises*, 109th Cong. 8-9 (2005) (testimony of Joseph F. Conners, Executive Vice President and Chief Financial Officer, Beneficial Savings Bank), *available at* http://financialservices.house.gov/media/pdf/030905jc.pdf.

or fraternal organization) or geographical.[27] Under the Federal Credit Union Act (FCUA), membership in any federal credit union is limited to one of the following categories:

1. One group that has a common bond of occupation or association;
2. More than one group –
    a. Each of which having a common bond of occupation or association (within the group); and
    b. The number of members of each such group not exceeding the applicable numerical limitation; or
3. Persons or organizations within a well-defined local community, neighborhood, or rural district.[28]

State credit union chartering acts include similar field of membership restrictions.[29]

Owing to their limited fields of membership and non-profit form of organization, credit unions enjoy tax-exempt status under federal and many state tax laws. The Internal Revenue Code exempts from federal income taxation federal and state credit unions "without capital stock organized and operated for mutual purposes and without profit."[30] The combination of tax-exempt status and membership orientation means that credit unions generally can, and do, offer higher rates of interest on savings deposits, or credit union share accounts, and lower rates of interest on loans.[31] Given this unique structure, and although credit union assets remain a small fraction of the total assets of FDIC-insured depository institutions, they are effective competitors in many markets.

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27. Emmons & Schmid, *supra* note 4, at 6.

28. 12 U.S.C. § 1759(b) (2005). Except as provided in the FCUA, multiple common-bond credit unions are limited to 3,000 members. *Id.*

29. *See, e.g.*, TEX. FIN. CODE ANN. § 122.051 (Vernon 2005).

30. 26 U.S.C. § 501(c)(14)(A) (2005). Prior to 1952, savings and loans and mutual savings banks also were tax-exempt because of similar non-profit strategic missions. In 1952, the tax exemption was repealed and these entities became subject to the regular corporate income tax. *See* America's Community Bankers, *Brief History of Taxation of Mutual Institutions*, http://www.acbankers.org/mutuals/mutualhistory.asp (last visited Jan. 1, 2006).

31. *See, e.g.*, National Association of Federal Credit Unions, *surpa* note 8, at 3.

While most credit unions are small, there are nearly 100 credit unions with assets in excess of $1 billion.[32]

III. CONVERTING TO A MUTUAL SAVINGS BANK OR MUTUAL SAVINGS ASSOCIATION CHARTER

In recent years, several credit unions have made the decision to convert to a mutual savings bank or mutual savings association charter. There are a variety of reasons underlying these conversions, but typically the reasons articulated include gaining the ability to raise capital for growth and expansion at a future date, either through the formation of a mutual holding company or the total conversion to a stock-owned institution, diversifying the institution's customer-member base, or entering new lines of business (or expanding existing business lines), which may be restricted under the institution's existing credit union charter.[33] Some have pointed to generally lower minimum capital requirements for FDIC-insured depository institutions as a competitive concern for credit unions that may lead to a conversion, although an obvious counterpoint is the financial impact of a credit union's tax-exempt status.[34]

Opponents of credit union conversions have cast doubt on the business reasons articulated in support of proposed conversions, and they argue that the converting institutions have failed to adequately inform their members regarding their potential loss of control over the institution. Many have expressed concerns that a credit union conversion is the first step toward a conversion to a stock form of ownership and question whether economic incentives for directors and senior management may be a driving factor in the decision to take the first conversion step from a credit union charter.[35]

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32. 2005 Directory of Federally Insured Credit Unions, *supra* note 2, at 170-171.

33. Tom Henderson, *Credit Union Files to Be Bank*, CRAINS DETROIT BUSINESS, Dec. 19, 2005, *available at* 2005 WL 20701632.

34. *See generally*, 12 C.F.R. §§ 565, 567, 702; *see also*, *Financial Services Regulatory Relief Act of 2005: Hearing on H.R. 3505 Before the Subcomm. on Financial Institutions and Consumer Credit*, 109th Cong. 6 (2005) (statement of Robert M. Fenner, General Counsel, National Credit Union Administration), *available at* http://www.ncua.gov/news/speeches/2005/Fenner/Fenner-09-22-2005.pdf.

35. *See* Henderson *supra* note 33.

Credit union conversions are subject to specific regulatory requirements regarding notice to the National Credit Union Administration (NCUA), the federal regulator of credit unions, notice of voting procedures, and limits on financial compensation to directors and senior management.[36] A converting credit union must apply for prior approval from the chartering agency to which jurisdiction the credit union seeks to convert.[37] If the converted mutual savings association subsequently elects to proceed to a second-step, mutual-to-stock conversion, extensive regulations govern these transactions.[38]

Prior to 1998, the FCUA required that a converting credit union obtain prior approval from the NCUA.[39] In 1998, Congress passed the Credit Union Membership Access Act ("CUMAA"),[40] which substantially reduced the NCUA's role in a credit union conversion transaction. Specifically, section 1785 was revised to eliminate the agency's substantive approval authority, and now provides that:

> [A]n insured credit union may convert to a mutual savings bank or savings association (if the savings association is mutual in form) . . . without the prior approval of the [NCUA] Board, subject to the requirements and procedures set forth in the laws and regulations governing mutual savings banks and savings associations.[41]

In amending the FCUA, Congress replaced the NCUA's transaction approval authority with a narrower authority to administer the process by which member votes are held to consider a conversion proposal.[42] The NCUA still must receive prior notice of the proposed conversion.[43] The CUMAA amendments to the FCUA were intended to

36. 12 U.S.C. § 1785(b)(2) (2005).
37. *See, e.g.*, 12 C.F.R. §§ 543.8–543.9 (2005).
38. 12 C.F.R. § 563b (2005).
39. 12 U.S.C. 1785(b)(1) (1994).
40. Pub. L. No. 105-219, 112 Stat. 913 (1998).
41. 12 U.S.C. § 1785(b)(2)(A) (2005).
42. *See id.* § 1785(b)(2)(G).
43. 12 C.F.R. § 708a.5 (2005).

make the NCUA's conversion regulations more consistent with those of the other federal financial institution regulators, including the OTS.[44]

Following enactment of the CUMAA, the NCUA adopted regulations to implement the requirements for administration and supervision of a converting credit union's voting process. Under the NCUA's revised regulations, a board of directors of a converting credit union must approve the transaction by a majority vote of those voting and set a date for a membership vote on the proposal.[45] In turn, the membership must approve the proposal by a majority vote of those members voting. [46] A credit union member may vote on the proposed conversion in person at a special meeting held on the date set by the board of directors or, alternatively, by written secret ballot.[47] Within ten calendar days after the vote is taken, the converting credit union's board of directors must certify the results of the vote to the NCUA's regional director, and must also certify that there have been no material changes to the written materials submitted in advance to the NCUA from those materials submitted to members, though prior submission to the NCUA is not required, or provide the revised materials along with an explanation of the changes.[48]

The credit union seeking to convert must provide three notices of the proposed transaction to its membership at intervals of ninety, sixty and thirty calendar days prior to the membership vote.[49] The member notice must "adequately describe the purpose and subject matter of the vote to be taken" and must include:

- A disclosure that the conversion from a credit union to a mutual savings bank could lead to members losing their ownership interests in the credit union if the mutual savings bank subsequently converts to a stock institution and the members do not become stockholders;

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44. 12 U.S.C. § 1785(b)(2)(G) (2005).
45. 12 C.F.R. § 708a.3 (2005).
46. 12 C.F.R. § 708a.4(a) (2005). Proxy voting is not permitted under the FCUA. 12 U.S.C. § 1760 (2005).
47. 12 C.F.R. § 708a.4(a) (2005).
48. 12 C.F.R. § 708a.6 (2005).
49. 12 C.F.R. § 708a.4(b) (2005).

- A disclosure of how the conversion from a credit union to a mutual savings bank will affect members' voting rights; and
- A disclosure of any conversion related economic benefits that a director or senior management official may receive, including receipt of, or an increase in, compensation and an explanation of any foreseeable stock related benefits associated with a subsequent conversion to a stock institution. Such an explanation must include a comparison of the opportunities to acquire stock that are available to officials and employees, as compared with those opportunities available to the general membership.[50]

In connection with the required notice to its members, the NCUA regulations also direct a converting credit union to include a 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 or other conversion related benefits, such as stock related benefits, to directors and senior management officials; or determine member voting rights based on account balances.[51]

In 2005, the NCUA further revised its regulations implementing section 1785's voting administration requirements. In particular, the NCUA added an additional, boxed disclosure requirement. Under revised regulation section 708a.4, all communications to members regarding the proposed conversion must include a disclosure, in substantially the form below:

The National Credit Union Administration, the federal government agency that supervises credit unions, requires [insert name of credit union] to provide the following disclosures.

1. OWNERSHIP AND CONTROL. In a credit union, every member has an equal vote in the election of directors and other matters concerning ownership and control. In a mutual savings bank,

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50. 12 C.F.R. § 708a.4(c)(d)(1) (2005).
51. 12 C.F.R. § 708a.4(d)(2) (2005).

ACCOUNT HOLDERS WITH LARGER BALANCES USUALLY HAVE MORE VOTES AND, THUS, GREATER CONTROL.

2. EXPENSES AND THEIR EFFECT ON RATES AND SERVICES. Most credit union directors and committee members serve on a volunteer basis. Directors of a mutual savings bank are compensated. Credit unions are exempt from federal tax and most state taxes. Mutual savings banks pay taxes, including federal income tax. If [insert name of credit union] converts to a mutual savings bank, these ADDITIONAL EXPENSES MAY CONTRIBUTE TO LOWER SAVINGS RATES, HIGHER LOAN RATES, OR ADDITIONAL FEES FOR SERVICES.

3. SUBSEQUENT CONVERSION TO STOCK INSTITUTION. Conversion to a mutual savings bank is often the first step in a two-step process to convert to a stock-issuing bank or holding company. In a typical conversion to the stock form of ownership, the EXECUTIVES OF THE INSTITUTION PROFIT BY OBTAINING STOCK FAR IN EXCESS OF THAT AVAILABLE TO THE INSTITUTION'S MEMBERS.

4. COSTS OF CONVERSION. The costs of converting a credit union to a mutual savings bank are paid from the credit union's current and accumulated earnings. Because accumulated earnings are capital and represent members' ownership interests in a credit union, the conversion costs reduce members' ownership interests. As of [insert date], [insert name of credit union] estimates THE CONVERSION WILL COST [INSERT DOLLAR AMOUNT] IN TOTAL. That total amount is further broken down as follows: [itemize the costs of all expenses related to the conversion including printing fees, postage fees, advertising, consulting and professional fees, legal fees, staff time, the cost of holding a special meeting, conducting the vote, and any other expenses incurred].[52]

In addition to being boxed, the additional disclosures must appear at least one font size larger than any other text (not including

52. 12 C.F.R. § 708a.4(e) (2005).

headings) used in the communications.[53] These additional disclosures were intended to address NCUA concerns that members of converting credit unions did not have a complete understanding of the full impact of their votes in a credit union conversion.[54]

Most converting credit unions have adopted a federal mutual savings association charter.[55] The OTS, as primary regulator of federal savings institutions, both stock and mutual, has adopted extensive conversion regulations and procedures.[56] Under OTS regulations, any "depository institution"[57] may convert to a federal mutual savings association, provided that:

- The depository institution will be FDIC-insured following its conversion;[58]
- The depository institution complies with all applicable state and federal statutes and OTS policies, and obtains all necessary regulatory and member approvals; and
- The resulting federal mutual savings association conforms, within the time prescribed by the OTS, to the requirements of section 5(c) of the Home Owners' Loan Act regarding permissible loans and investments.[59] Among the requirements to which a converting credit union must conform following its conversion is the Qualified Thrift Lender ("QTL") test, which requires an OTS-chartered institution to hold QTL investments equal to at least 65% of its portfolio assets or, alternatively, to qualify as a domestic building and loan association under the Internal Revenue

53. *Id.*

54. 70 *Fed. Reg.* 4005 (Jan. 28, 2005) (to be codified at 12 C.F.R. pt 708a).

55. Nat'l Assoc. of Fed. Credit Unions, *supra* note 8.

56. 12 C.F.R. §§ 543.8–9 (2005).

57. For purposes of the conversion rules, a "depository institution" means any commercial bank (including a private bank), a savings bank, a trust company, a savings and loan association, a building and loan association, a homestead association, a cooperative bank, an industrial bank or a credit union, chartered in the United States and having its principal office located in the United States. 12 C.F.R. § 552.13 (2005).

58. At the time a converting credit union files its application to convert, it also must submit an application to the FDIC for federal deposit insurance. *See* 12 U.S.C. § 1815 (2005).

59. 12 C.F.R. § 543.8(a)(3) (2005).

> Code.[60] While some converting credit unions might fail to meet the QTL test immediately upon conversion, the OTS can and does grant waivers to allow phased-in compliance in order to avoid unnecessary disruptions in an institution's operations or balance sheet, which could give rise to supervisory concerns.[61]

A converting credit union's board of directors must approve the transaction before application can be made to the OTS.[62] The application must include a conversion plan that specifies the home and branch office locations, and provides for adequate reserves and surplus, of the resulting institution.[63] In addition, the OTS requires that all applicants for an OTS charter make application for membership in the appropriate Federal Home Loan Bank.[64] Under NCUA regulations, meanwhile, the membership vote in favor of a conversion must be reviewed and verified by the regulatory agency that will have jurisdiction following the conversion.[65]

IV. CONVERSION CONTROVERSIES

Concerns and opposition over credit union conversions have recently centered on the potential for diminished voting rights following a conversion, a lack of sufficient member participation in conversion votes (i.e., too small a percentage of the total credit union membership making these critical decisions), and the potential economic windfall that credit union management could receive in the event of a subsequent conversion to a stock form of ownership.

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60. 12 U.S.C. § 1467a(m)(1) (2005). The Internal Revenue Code defines "domestic building and loan association" in I.R.C. § 7701(a)(19) (2005).

61. *See* 12 U.S.C. § 1467a(m)(2). The phased-in approach also helps avoid the negative tax consequences that could result from immediate changes in an institution's balance sheet.

62. 12 C.F.R. § 543.9(a)(1) (2005).

63. 12 C.F.R. § 543.9(b) (2005).

64. 12 C.F.R. § 543.9(c)(4) (2005).

65. 12 C.F.R. § 708a.8 (2005).

A. Diminished Voting Rights

Each credit union member has one vote to cast, including in a vote on conversion. When the NCUA adopted the boxed disclosure requirements in early 2005, the revisions reflected the NCUA's concerns that conversions were being approved by credit union members who were not fully informed and that disclosures under existing disclosure rules might be inaccurate or misleading.[66]

A federal mutual charter grants depositors one vote per $100 of deposits with an upward cap of 1,000 votes per member.[67] Alternatively, a federal mutual institution may provide that each of its members is entitled to a number of votes per member of between one and 1,000.[68] For its part, the OTS has expressed concerns that the revised NCUA boxed disclosures mandated by regulation section 708a.4(e) may themselves mislead rather than clarify.

In a decision certifying the conversion membership vote of Community Credit Union of Plano, Texas ("Community"), the OTS opined that

> The first required disclosure [under section 708a.4(e)] states that after a conversion to a mutual savings bank, account holders with larger balances usually will have greater control of the institution than members with smaller account balances. While it is true that the standard federal mutual charter provides for one vote for each $100 (or portion thereof) of deposits up to a maximum of 1,000 votes, it is extremely unlikely that even a depositor with 1000 votes will have any semblance of 'control' of the institution.[69]

The OTS also took issue with the third required disclosure under section 708a.4(e) that

66. 70 Fed Reg. 4005 (Jan. 28, 2005) (to be codified at 12 C.F.R. pt 708a).

67. 12 C.F.R. § 544.1 (2005).

68. 12 C.F.R. § 544.2(b)(4) (2005).

69. Off. Thrift Supervision. Order No. 2005-23,at 4 (Jun. 29, 2005), *available at* http://www.ots.treas.gov/docs/6/65023.pdf.

> implies that [credit union] members will have no subsequent vote with respect to any conversion of the institution to the stock form of ownership and that, if there is a conversion to the stock form of ownership, the Credit Union's executives will profit by obtaining stock far in excess of that available to the institution's members. In fact, even if the management of the credit union that converts to a mutual savings bank charter ultimately proposes to convert the institution to the stock form of ownership, the members must approve that conversion under a more rigorous vote requirement than that pertaining to the conversion to a federal mutual savings bank.[70]

The OTS went on to state that, because Community had included additional information with the section 708a.4(e) boxed disclosures, "it is unnecessary for OTS to determine whether the disclosures mandated by the NCUA's regulation would by themselves be so misleading that they would taint the vote of a credit union's members."[71]

B. Lack of Active Membership Voter Participation

Under the FCUA, an affirmative vote of a majority of the credit union's members voting is required to approve a proposed conversion.[72] The NCUA has expressed concerns that the simple majority rule now in place results in too few eligible voting members participating in the voting process to approve a transaction that has significant ramifications for the entire membership. This same concern was addressed in proposed Congressional legislation in 2005. As introduced, the Credit Union Regulatory Improvements Act of 2005 would require at least 20% participation by the eligible voting members in any vote on a proposed conversion.[73] The NCUA testified in support of this statutory

70. *Id.* at 3.
71. *Id.* at 3, n.2.
72. 12 U.S.C. § 1785(b)(2)(B) (2005).
73. H.R. 2317, 109th Cong. § 310 (2005).

amendment and credit union advocacy groups expressed their support as well.[74]

C. Conversion Compensation

Another often stated concern about conversions is that directors and senior management stand to gain financially in the event the converted credit union subsequently decides to convert to the stock form of ownership. In one recent media report, the chief executive of the Michigan Credit Union League was quoted in response to news that a large Detroit area credit union had filed for approval to convert to a bank as saying "it's well-documented that when credit unions convert to banks, insiders are enriched."[75]

When a credit union converts, the FCUA specifically limits the compensation a director or senior management official of an insured credit union may receive in connection with the conversion to director fees and compensation and other benefits paid to director or other senior management officials of the converted institution "in the ordinary course of business."[76] Once a credit union converts to a mutual savings institution, it may choose to complete a second-step conversion to a stock form of ownership. In that event, OTS regulations circumscribe the ownership stake that the institution's executives may acquire.[77]

Many mutual institutions do not take the next step to stock ownership, however, because they find it difficult to fully deploy the capital raised in any stock offering.[78] Other mutual institutions choose

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74. *See* JoAnn Johnson, Chairman, Nat'l Credit Union Admin., Financial Services Regulatory Relief: The Regulators [sic] Views (June 9, 2005), *available at* http://www.ncua.gov/news/speeches/2005/Johnson/RegReliefTestimonyJune2005.pdf.

75. *See* Henderson *supra* note 33 (quoting David Adams, president and CEO, Michigan Credit Union League).

76. 12 U.S.C. § 1785(b)(2)(F) (2005).

77. *See infra* notes 84-85 and accompanying text.

78. Alan Kline, *Why Mutual Holding Company Conversions May Be Cooling Off*, AM. BANKER, Jan. 4, 2006, at 1. Corporate governance responsibilities also has been raised as an impediment to moving to a stock form of ownership, although the federal banking regulators certainly have taken the position that the corporate governance standards applicable to companies with registered securities also should be implemented by non-stock companies, as appropriate.

to form a mutual holding company, which allows the organization to raise capital in a more deliberate and staged way.[79]

The benefits and likely success of any mutual-to-stock conversion are dependent on a number of market factors, including overall economic conditions and company valuations.[80] Certainly, the possibility exists that a credit union insider could benefit economically from the upside of a second-step conversion, although the restrictions on conversion compensation at the first stage, combined with the limits imposed in mutual-to-stock conversions, are intended to speak to this concern. Given these variable factors, certainly not all converted credit unions choose to take the next step and convert to a stock form of ownership. In fact, despite the economic motives many ascribe to credit union management seeking to convert, a very small percentage of credit unions actually have made this decision.[81]

If, and when, a converted credit union operating as a mutual savings institution makes the decision to pursue a second-step conversion and become stockholder owned, extensive conversion regulations govern every aspect of the transaction, including required pre-conversion meetings with the OTS, detailed requirements regarding the plan of conversion, member votes, proxy solicitations, restrictions and limitations in the offering and sale of the converting institution's stock, and post-conversion obligations.[82] A federal mutual savings bank that seeks to convert must submit its plan of conversion to the membership, which must approve the plan by a majority of the total outstanding votes, unless applicable state law requires a higher percentage vote.[83] OTS regulations strictly limit the amount of stock that any executive may purchase in a conversion.[84] In addition, in an OTS mutual-to-stock conversion transaction, the shares of stock must be offered for sale in a prescribed order to:

- Eligible account holders;
- Tax-qualified employee stock ownership plans;

79. *See* 12 U.S.C. § 1467a(o) (2005); 12 C.F.R. Part 575 (2005).
80. *See* Kline, *supra* note 78.
81. *See* Nat'l Assoc. of Fed. Credit Unions, *supra* note 8.
82. 12 C.F.R. § 563b.225 (2005).
83. *Id.*
84. 12 C.F.R. §§ 563b.355, 563b.360, 563b.385 (2005).

- Supplemental eligible account holders;
- Other voting members who have subscription rights; and
- The community and the general public.[85]

Taken together, OTS regulations are designed to help ensure the priority position of depositors when a converting mutual savings bank offers its stock for sale.

V. RECENT DEVELOPMENTS

A. Litigation Over Disclosures

In 2005, credit union conversion controversy led to both litigation and legislation. In September 2005, the NCUA and Community[86] settled a lawsuit involving Community's pre-conversion notices to its membership.[87] At issue in the litigation was whether Community's disclosures regarding a pending conversion membership vote had failed to comply with the boxed disclosure requirements of section 708a.4(e) of the NCUA's regulations. The boxed disclosures, which were placed on a separate sheet on the opposite side from a rebuttal that Community had prepared in response to concerns over the mandated language of the boxed disclosures, were mailed to some Community members in a method that might not result in the member opening and reviewing the boxed disclosures first. Community argued that the disclosures met all of the requirements of the regulation and that there was no regulatory requirement to fold the boxed disclosures in a certain way so that they would appear first when a member opened the envelope containing the conversion voting materials. Further, Community noted that the transaction was overwhelmingly approved by its members. As a result, the credit union argued that the NCUA had acted arbitrarily and capriciously in failing to certify the memberhip's approval of the conversion, and in violation of section 1785(b)(2)(G)(i)

85. 12 C.F.R. § 563b.320 (2005).

86. Omni Federal Credit Union, another converting Texas credit union, petitioned to intervene, and was joined as a plaintiff in the litigation.

87. *See generally* Report and Recommendation of U.S. Magistrate Judge, Community Credit Union v. National Credit Union Admin., No. 4:05 CV 285 (E.D. Tex. filed Aug. 24, 2005).

of the FCUA because the NCUA's actions were inconsistent with, and more restrictive than, rules enacted by other financial regulators.

For its part, the NCUA argued that the disclosures provided by the credit union failed to meet the requirements of NCUA regulations aimed at preventing the disclosure of inaccurate or misleading information to members considering a conversion proposal. In late August, the United District Court for the Eastern District of Texas issued a Report and Recommendation in which the magistrate judge agreed with Community that the NCUA had acted arbitrarily and capriciously in failing to certify the member vote, finding that, "once the vote is conducted in a fair and legal manner, the [NCUA] has no authority or discretion to disapprove of the methods or procedures used in the vote."[88] The parties quickly moved to settle the dispute and Community subsequently completed its conversion to become ViewPoint Bank, an OTS chartered mutual savings association, effective January 1, 2006.

B. Additional Legislative Action

The controversies surrounding credit union conversions have caught the attention of some members of Congress. In July 2005, Representative Patrick T. McHenry, a freshman Republican from North Carolina, introduced H.R. 3206, the Credit Union Charter Choice Act,[89] in response to complaints that the NCUA inappropriately was attempting to block conversions of credit unions that were authorized by statute and regulation. The bipartisan bill[90] resulted from the efforts of banking trade groups, including America's Community Bankers, that have been challenging the NCUA on its conversion rulemakings and decisions. The bill proposes the following amendments to credit union conversions under the FCUA:

- Eliminate the oversight role of NCUA with respect to member votes on conversion proposals;
- Revise and streamline the notice requirements governing

88. *Id.* at 14.

89. H.R. 3206, 109th Cong. (2005).

90. The bill was co-sponsored by Reps. Paul E. Gillmor (R-Ohio), Sam Johnson (R-Tex.), Peter T. King (R-N.Y.) and Edolphus Towns (D.-N.Y).

credit union notifications to the NCUA Board regarding planned conversions;

- Establish a NCUA Board approval process regarding materials submitted by converting credit unions in connection with such conversions;
- Require that member votes on proposed conversions be conducted by secret ballot, with an independent inspector of elections appointed by the converting credit union to receive and tally the votes;
- Continue to require that the board of directors of the converting credit union certify the vote results to the NCUA Board, but deny the NCUA Board any further review or approval authority over the conversion process, absent evidence that fraud or reckless disregard for fairness during the voting process had affected a vote outcome.[91]

The bill would also prohibit the NCUA from requiring a converting credit union to include in any required notice to members regarding a proposed conversion transaction any information or statements that:

(i) are speculative with respect to the future operations, governance, or form of organization of the financial institution that will result from the conversion, or may occur after the completion of the conversion;
(ii) are inaccurate with respect to a proposed conversion of the converting credit union or the application for a mutual savings bank or savings association charter filed in connection with the conversion;
(iii) conflict with regulations of other financial regulators, including the Director of the Office of Thrift Supervision, related to the subsequent conversion of the resulting financial institution from mutual to stock form;
(iv) distort the impact of conversion on the members of the credit union; or

91. H.R. 3206, 109th Cong. § 2 (2005).

(v) are attributable to the Board or state the Board's position on conversions.[92]

Opponents of efforts to limit the role of the NCUA in a credit union conversion argue that such initiatives undermine the need for transparency. Some credit union advocates argue that recent conversion activities may be inconsistent with the following principles:

- Credit union member-owners should exercise their democratic control of the institution;
- Conversion decisions should be based solely on member interests and not on economic opportunity;
- Full, plain language disclosures are essential to the conversion process;
- The NCUA and state credit union regulators should ensure that converting credit union members understand the conversion process and that the fiduciary obligations of credit union board members are fully enforced.[93]

VI. CONCLUSION

Credit unions are viable and powerful members of the financial services sector. They have proven to be formidable competitors in the fight for the American wallet. Mutual savings institutions have an equally long track record of customer service and community stewardship. These cooperative charters are important and complementary components of the American financial services marketplace. As their businesses evolve, some credit unions will continue to find merit in a mutual savings institution charter. When that happens, ideally, financial institution regulators will work together to ensure that thoughtful, legitimate conversion decisions are supported by regulations that are reasonable and consistent. Conversion regulations should address the important interests of all involved constituencies,

92. *Id.*

93. Credit Union Nat'l Ass'n, Principles Regarding Credit Union Conversions (June 16, 2005), http://www.cuna.org/gov_affairs/legislative/issues/2005/conversions_principles.html.

including members and those responsible for the safe and sound management and strategic direction of these valuable institutions.