FEDERAL HOME LOAN BANK BOARD

C O N F I D E N T I A L   INTER-OFFICE COMMUNICATION

From Office of the General Counsel

Date August 15, 1973

To: Chairman Bomar
Board Member Kamp
Board Member Perry

Subject Board Policy on Mutual to Stock Conversions

I. INTRODUCTION

On September 22, 1972 the Board adopted Resolution No. 72-1112 deciding that the moratorium on mutual to stock conversions which it imposed on December 5, 1963 is terminated effective upon the final adoption of new conversion regulations and directing the staff to draft such regulations. That resolution is attached at Tab A.

On January 3, 1973 the Board, by Resolution Nos. 73-25 and 73-26, proposed to revoke its existing regulations on mutual to stock conversions. The proposed regulations had a comment period until March 12 and are attached at Tab B.

On March 9, 1973, the Board extended the comment period until March 19 and announced that the Board intended to issue revised proposed regulations. On March 12 and 13, 1973, two days of public hearings were held on the proposed regulations. The 800 page transcript of those hearings and a summary thereof have been previously submitted to you. Several hundred letters of comment have been received on the proposed conversion regulations.

On May 31, 1973 then Acting Chairman Kamp testified on the subject of conversions before the Subcommittee on Bank Supervision and Insurance of the House Banking and Currency Committee. Attached to that testimony was a major legal memorandum of this Office dated May 17, 1973 and dealing with the subject of the ownership of mutual savings and loan associations, particularly in the context of mutual to stock conversions. A copy of that memorandum is attached at Tab C.

At the initial meeting on June 18 of the weekly Monday morning meetings to establish and review agency objectives and projects, this Office was requested to prepare a policy paper on the subject of conversions. This memorandum is written in response to that request. It is somewhat delayed due to the diversion of staff personnel to work on rate control, the Prudential litigation, the Presidential Message regarding the Hunt Commission and other priority intervening events.

In very general terms, the proposed conversion regulations can be divided into two parts: the "formula" part (section 5 of new Part 563b) and the "non-formula" part. The non-formula part would embrace such matters as filings, notice, disclosure, approvals, solicitation of proxies, voting, appraisal, pricing and the like. Portions of the non-formula part would be necessary under any scheme of conversion; other portions are dependent upon, and determined by, the formula part. Hence, the division between a formula part and a non-formula part is not completely clean, but it is sufficient and valuable for analytical purposes.

Many of the comments (by which I mean both the letter comments and the testimony at the public hearings) dealt with the non-formula portion. This memorandum makes no effort to discuss this aspect of the comments; it deals solely with the comments on the formula portion. Once the Board has reached a decision on the formula portion, the non-formula portion should fall into line without too much difficulty.

II. ALTERNATIVE FORMULAS

When reduced to its essentials, the formula in the proposed conversion regulations (hereinafter "the Board formula") can be described as a free and time-weighted distribution of stock or cash to accountholders on a past record date. The free aspect of the distribution was based on the view that this was a necessary aspect of the ownership interest of the accountholders. The time-weighted aspect was based on the view that some fairly severe disincentives to shifts of funds was necessary to limit or control such shifts and other undesirable side effects of the free distribution.

The comments on the Board formula can be considered to fall into four categories:

A. Suggested improvements of the Board formula
B. Distribution to public bodies
C. Selling the stock
D. The Dual Net Worth concept

These categories will be examined below in the order stated.

III. SUGGESTED IMPROVEMENTS ON THE BOARD'S FORMULA

I do not consider it necessary to give a detailed description and evaluation of the suggested improvements of the Board formula. Many of these comments accepted the essential features of the Board formula and then attempted to make mechanical improvements of it so that it would be less of an administrative burden. Such comments are quite subsidiary to the Board's present concerns and can be returned to at a later date if the Board's decision is to proceed with a formula not essentially different from that proposed in January.

A number of the comments questioned the Board's authority to require an averaging formula because of its relatively adverse impact on recent depositors. I am of the view that such impact does not provide a valid ground of legal objection. On p. 21 of the opinion of this Office attached at Tab C, I state, in connection with the question of the constitutionality of modifications of the historical ownership interest of mutual accountholders in a conversion, that "any modification must be the minimum modification necessary to control the side effects which led to the modification." Time-weighting causes a modification of the historical ownership interest of mutual accountholders in a conversion to the stock form. In my judgment, however, any lesser modification would clearly not be sufficiently effective to control shifts of funds. Hence, I continue to believe that the Board has the authority to require time-weighting. More frequently the comments questioned the Board's authority to regulate conversions involving solely state-chartered insured institutions and/or the Board's authority to require an averaging formula to be applied to such institutions. In my view, the question of the existence of such authority turns on certain factual determinations. If the financial stability of insured institutions would be impaired (as I believe it would) should conversions not be conducted according to reasonably uniform national standards involving an effective disincentive to shifts of funds, then the Board has the questioned authority, in my opinion.

A major criticism of the Board formula raised by the comments was that the cash-out provisions in the formula would very likely cause the association to fail to meet the 50% continuity of interest test necessary to make the conversion a tax-free reorganization. While this criticism may be accurate, I believe the Board formula can be modified to meet it.

From the standpoint of the major conversion policy questions now before the Board, the most relevant comments were those questioning the effectiveness of time-averaging to adequately control shifts of funds. Some of those comments suggested solving the problem by making the discounting more severe. Such comments are, I believe, misdirected. While more severe discounting would control shift of funds more effectively, it would do so principally by making conversion a far more difficult and costly administrative process. In other words, it might work but it would work by affecting the wrong variable.

Other comments said, in effect, that a time-averaging formula simply would not be effective to adequately control shifts of funds, if the formula operated at a tolerable level of administrative difficulty. This type of comment obviously goes to the heart of the problem. Unfortunately, it is a conclusory statement and acceptance or rejection of it can only proceed from an instinctive judgment. Since the Board's formula has never been tested in operation, one cannot know in advance whether it will work. The Board is very much in the position of the experimenter who is deciding whether to run an important test which might well have the predicted and valuable results and which also might well blow up, taking a good deal of expensive equipment with it.

At this point in this memorandum, let me do what the hypothetical experimenter would surely do and that is to consider his alternatives.

IV. DISTRIBUTION TO PUBLIC BODIES

The comments made two basic suggestions regarding distribution to public bodies. The first was to transfer the value of the converting mutual to a public trust fund for housing and the second was to transfer such value to the FSLIC. (The comments spoke of transferring the net worth of the converting mutual but, after questioning, those making the comments realized that to prevent a windfall, which was their goal, the full market value would have to be transferred.)

The primary, and in my judgment unsuperable, difficulty with proposals regarding distribution to public bodies is a legal difficulty stemming from the principle of minimum modification mentioned above. Proposals of this type result in the accountholder receiving absolutely nothing; the historical ownership rights of the mutual accountholder are totally abrogated. These proposals operate, in effect, on a principle of maximum modification.

In recognition of this fact, two variations were proposed on the basic scheme of making distributions to public bodies. The first, which came from Catholic University, suggests distributing some percentage of the stock (say one-third to one-half) to the accountholders and the remainder to a public body (a housing trust fund, the FSLIC or whatever). The theory behind this proposal is that it reduces the windfall and that the portion going to the public body is like an escheat of lost property. The escheat analogy is considered justified because many of the accountholders who have built up the value of the association over time and their respective interests are unlocatable or indeterminable.

The second variation (which has been presented in various forms) proceeds along the following lines. The accountholders would receive a distribution of stock and the association would issue a debenture (or some debt security) to the FSLIC. Under differing debenture schemes, the debenture would be in the amount of the market value of the association, or in the amount of the net worth of the association, and would bear a greater or lesser or no rate of interest. The term of the debenture would be quite long, perhaps 30 years. There would be an annual sinking fund requirement. As the association grew in value and as the indebtedness was reduced the stock would rise in value. Regardless of the exact mechanics, the desired result under the various forms of the debenture variation is to "sterilize" for a temporary but extended period the income of the association by creating an obligation to allocate it to the FSLIC, and to place the FSLIC in a debt relationship to the association rather than an equity relationship. A further possibility which has been suggested in this connection is that the FSLIC would eventually pay back the funds over an additional 30 year period.

These proposals present the following difficulties:

A. There would continue to be a windfall even though it would be reduced. Under the Catholic University proposal the windfall would be cut in half at most. Under the debenture proposal, the market would probably place some current value on the stock, especially if the debenture were issued for less than the full market value of the association. On the other hand, if the stock were drastically reduced in value, it would be a cheap, penny stock which is itself an undesirable result.

B. Both proposals neglect the fact that the historical rights of accountholders in a conversion are in the current accountholders. The Catholic University proposal proceeds on the erroneous assumption that past accountholders have some entitlement which can be made the subject of escheat. The debenture proposal on the other hand would grant the maximum benefit to future accountholders in the sense that current accountholders would receive something of little present value. Full value would be obtained by future transferees or by current accountholders who held on to the stock for a long time.

C. Assuming the public body involved were the FSLIC, both proposals would have the effect of giving the FSLIC a substantial direct financial stake in converted associations. Under the Catholic University plan the "stake" would be at least a 50% direct equity position. Assuming the FSLIC held the voting rights normally attached to the stock, the result would be nothing less than nationalization. The situation would not be much improved if the FSLIC stock were considered to be non-voting stock, and the situation might well be worsened if the voting rights were held by persons other than the FSLIC. Under the debenture proposal, the "stake" of the FSLIC in the association would have to be a real, binding and substantial position if the market were not to ignore it and thereby create the windfall which it is desired to avoid. Thus, the proposal does not eliminate the basic difficulty of the insurer having a major financial position in the insured. Further, it seems to me that the problems described in this paragraph would be exacerbated if the public body were one other than the FSLIC.

D. Under the debenture proposal, there is a serious question of whether the required payments would not seriously impair or cripple the financial position of the association. Proponents have argued that this problem could be cured by selling additional stock. This assumes, however, that the stock could be sold at a reasonable price, which is extremely doubtful. Financially, the debenture plan is like half killing a man and then hoping against hope that the medicine will be available to cure him.

E. It must be recognized that all proposals for distribution to public bodies represent extremely radical departures from the existing law governing conversions. In my judgment the Board could not implement any of these proposals without statutory change.

V. SELLING THE STOCK

This type of plan (which might be called the pure selling-the-stock-plan) assumes that the converting mutual association will simply sell stock in itself on the public market. The only right that the account-holder would have is a preferential right to subscribe for the stock. A simplified example of the operation of this plan is as follows: *

XYZ Savings and Loan Association
(000 omitted)

Savings Deposits	90,000
Other Liabilities	5,500
Net Worth	4,500
Total Liabilities	100,000
Gross Income (@7.1%)	7,100
Expenses (@1.2%)	1,200
Net Income Before Interest on Savings and Taxes	5,900
Less: Interest on Savings (@5.382%)	4,844
Net Income Before Taxes	1,056
Taxes (Federal and State @28%)	296
Net Income	760
FIR Allocation	300
Surplus Addition	460
Market Value of Stock (@PE Ratio = 10)	7,600

Thus, the association under this type of plan would sell $7,600,000 of stock and assuming the entire amount were added to net worth, the

* This example is also simplified in that it gives no effect to the additional earnings that would be generated from the addition of $7,600,000 in capital. The over-capitalization problem described below would be far worse if this effect were taken into account.

association would have $12,100,000 in net worth following conversion.

This type of plan is to be distinguished from the "Dual Net Worth" concept or "Walker Plan" discussed in the next section. Under the Walker Plan the new capital raised in the conversion would be segregated into a new net worth category called "stockholders net worth" and the existing net worth would be segregated into a category called depositors net worth.

In accordance with the Board's request, certain OGC staff members conducted a detailed examination of the Walker Plan and the pure selling-the-stock plan described in this section. For convenience of reference with respect to this section and later sections, I should like to introduce at this point a number of additional attachments which were considered and generated as a part of that staff review.

Tab D--The Walker Plan
Tab E--May 15 Memorandum of Mr. Bomar
Tab F--June 26 Memorandum of Mr. Bomar
Tab G--Memorandum of Kenneth Thygerson
Tab H--Memorandum of James Hollensteiner
Tab I--July 10 Memorandum of Robert Chaut
Tab J--July 12 Memorandum of Robert Chaut
Tab K--Letter of July 12 by Eric Stattin
Tab L--July 23 Memorandum of Robert Chaut
Tab M--July 26 Letter of Palmer Sessal
Tab N--December 5, 1972 Memorandum of Mr. Donahoe

The difficulties inherent in the pure selling-the-stock type of plan appear to be as follows:

A. It will necessarily result in the gross over-capitalization of the association. In the hypothetical example of XYZ Association given above (which is the basic example used by Mr. Walker in his materials at Tab D). The association is earning a 16.88% return on net worth prior to conversion ($\frac{.76}{4.50}$). After conversion it would be earning a 6.28% return on net worth ($\frac{.76}{12.10}$). Note that Mr. Chaut on page 1 of his July 10 memorandum states that this type of plan will result in "the necessary overcapitalization of converting associations, thus reducing their ability to earn a fair return on net worth." (Mr. Chaut's reference to this type o^c plan as the "Judy" plan is intended as humorous.) Note also that Mr. Hollensteiner on pages 2 and 3 of his memorandum at Tab H draws the same conclusion with respect to the Walker Plan, which is designed to decrease the possibility of overcapitalization.

It is also important to note that the hypothetical example given above corrects an error in the Walker materials which causes the amount of the overcapitalization to be understated in those materials.

The XYZ Association already has reserves equal to 5% of savings; thus there is no requirement to make the $300,000 FIR allocation. This point is made on page 4 of Mr. Hollensteiner's memorandum. In any event, one does not apply the PE ratio only to the surplus addition ($460,000) as Mr. Walker's materials do. It is applied to the total of the surplus addition and the FIR allocation ($760,000).

B. Mr. Chaut, Mr. Weiant of Blyth, Eastman Dillon & Company, and Palmer Sessel of Dean Witter & Co., Inc. (whom the staff consulted in connection with its review of this matter) were strongly of the view that this type of plan would cause almost impossible marketing problems. These marketing problems fell under several headings:

1. The capacity of the market to absorb the issuances. At the time of its conversion Citizens Federal had total assets of about $560 million. Under this type of plan Citizens would have issued around $60 to $65 million in stock. While an issuance of that size is not particularly large when one is dealing with debt securities, it is an enormous issue when one is dealing with capital stock. Citizens of course was only one conversion. If the associations which we presently know are seriously pursuing conversion (Prudential, First Federal of Phoenix, First Federal of Tucson, American Savings and Loan, West Federal and Buckeye Federal) were to convert under this type of plan, the total common stock issuances would amount to several hundred million dollars. The underwriting personnel listed above were strongly of the view that the market simply could not absorb issuances of this magnitude.

2. The distribution problems. Common stock issuances of the size mentioned in the previous paragraph could be marketed only by very large underwriting groups. The issuances could not be absorbed locally but would have to be marketed over a wide geographical area if they are to be absorbed at all. In the view of the underwriters we consulted, successful wide geographic marketing presumes either an issuer with a good existing national reputation or an issuer with clearly superior financial and managerial prospects. In their terminology, you must have "a great reputation or a great story to trade off of". Effectively, this might limit the conversion of larger associations to only the very best associations.

3. The small association problem. In the view of the underwriters we consulted, the problems described above would be compounded in the case of smaller associations. They believe that a plan of this type, more than any other type of plan discussed, has the effect of requiring smaller associations to engage in public underwritings. They did not believe that smaller associations could do so except at prohibitive expense. This view is expressed on page 1 of Robert Chaut's memorandum of July 10 at Tab I.

4. Mr. Weiant believes that the pure selling-the-stock plan raises a major problem which he described as "macroeconomic" and

almost philosophical". He believes that it is a responsibility of the investment banking industry and of the Board as a government agency not to take any actions inconsistent with the optimally efficient employment of the limited supply of the total available capital in the Nation. Because of the low rate of return on the additional capital that would be raised under this type of plan, he doubts that the market would supply the capital in the first place. But, even if it were supplied, he is of the view that it ought not to be supplied, or more precisely, that the Board ought not take steps which would facilitate its being supplied. This view is based on the proposition that capital ought always to be allocated to those uses in which it can be most productively employed.

One might make the counter-argument that housing needs all the funds it can get and that encouraging a massive influx of capital to housing is hardly irresponsible on the Board's part. His reply, which I think conclusive, is that capital flows to where it can earn the highest return and that the capital necessary to make the selling-the-stock plan work would simply not be supplied.

C. From the legal point of view, this type of plan raises considerable difficulties because the mutual accountholders' rights are reduced to a bare priority right to purchase. As will be noted from the hypothetical example given above, the existing net worth of the association would become part of the stockholders' equity of the new stockholders.

D. A further difficulty with the pure selling-the-stock plan is that it may well result in the conversion not being a tax free reorganization under the Internal Revenue Code on the corporate level. Based on our preliminary conversations with the IRS staff, in order for the transaction to be tax free, a basic requirement that may have to be met is a 50 percent continuity of interest test. Under this test approximately 50 percent or more of the stock apportioned to accountholders must be accepted by the accountholders to whom it is apportioned. The stock purchased by one accountholder from another accountholder does not count toward meeting this test. In view of the magnitude of the offerings under this type of plan it is extremely unlikely that accountholders would have the financial resources to exercise on the average a sufficient amount of their pro rata assignment of rights to purchase.

There is a further variation on the selling-the-stock plan which I should like to discuss at this point. This variation is discussed in detail in Mr. Donahoe's memorandum of December 5, 1972 which is attached at Tab N. Basically, this variation envisages that all of the stock would be issued to a ten year trust which would then sell all of the stock in a single offering and disburse the cash proceeds over the life of the trust to the accountholders. Another form of this variation involves the trust selling off the stock gradually over the life of the trust. It appears to me that all of the foregoing difficulties apply with at least equal force to either form of this variation.

VI. THE DUAL NET WORTH CONCEPT

The dual net worth concept (also referred to as the "Walker Plan" or "DNW") is designed to avoid all of the difficulties described in the previous sections. The basic features of the Dual Net Worth plan are that the existing net worth of the association will be designated as depositors net worth; that future additions to FIR will be allocated to this account; that stock in the conversion will be sold publicly with the existing depositors having a priority right to purchase; that the stock sold will represent the present capitalized value of the associations future income stream net of the required allocation to depositors' net worth; and that the depositors net worth will be distributed pro rata to the then existing accountholders in the event of a solvent liquidation. This plan is intended to avoid the difficulties described in the previous section in the following ways:

A. The pure selling-the-stock plan results in overcapitalization because it capitalizes the entire future income stream of the association. Under DNW, only a portion of the future income stream is capitalized; the remainder is "sterilized" by allocating it to depositors net worth. Thus, it is thought that the overcapitalization problem is eliminated or at least quite substantially reduced.

B. The impact on the rights of mutual accountholders is considered to be far smaller than it would be under the other plans discussed above. The accountholder would receive a priority right to purchase, he would retain an interest in a net worth account to be distributed in the event of a solvent liquidation, and that net worth account would be increased by a required allocation of a portion of the future income stream to it. Of course, he would retain his interest in the net worth account only as long as he remained an accountholder and his interest would be diluted by any net increase in deposits by new accountholders. But, these two effects are present under the mutual form and cannot be considered as adversely affecting his interests.

C. As is apparent from the Walker materials attached at Tab D, the windfall aspect of the Board formula is considered either an evil in itself or the proximate cause of a variety of other evils. A principal object of the DNW plan is to eliminate the windfall.

D. Since the amount of stock to be distributed under the DNW plan is considerably less than the amount to be distributed in the pure selling-the-stock plan, it is thought that the distribution and market absorbtion problems described above would be eliminated or substantially reduced.

Set forth below under the headings indicated are a number of considerations which developed in the course of our review of the DNW plan:

A. Allocation of Income. A basic feature of the DNW plan is that the future income stream of the association be allocated between depositors net worth and stockholders net worth, with allocation to the depositors net worth being the required additions to FIR and the allocation to stockholders net worth being the remainder. However, as Mr. Walker notes on page 4 of his letter to Mr. Bomar (Tab D), this particular method of allocation is not an essential feature; in fact on the same page he lists alternative methods of allocation.

It was the unanimous view of the review group (including Mr. Walker) that, while an allocation based on FIR is easy to calculate, it could not be applied generally and indeed would be applicable to a given association only by happenstance. This agreement is noted in the last paragraph of page 1 of the July 10 Chaut memorandum (Tab I). The reasons for this agreement are basically those described on page 4 of the Hollensteiner memorandum (Tab H). The Hollensteiner memorandum notes: "More importantly, the FIR requirement can vary considerably among various institutions. ----As a result, it would be possible for all of the earnings of [an] association to be channeled to stockholders' net worth with nothing going to depositors net worth. A similar situation would result in the event of a conversion of an association which has high reserves. It is conceivable that this institution would not have to make any allocations to depositor net worth for an extended period of time. This, thus, results in a major windfall to the stockholders."

Mr. Chaut's July 10 memorandum (Tab I) constitutes his effort to devise a fair and workable alternative method of allocating the future income stream. Mr. Chaut's memorandum does not lend itself to easy summarization, and as he noted therein, the nature of his argument is made clearer by going through it step by step. I would recommend that it be carefully read at this point. Attached at Tab J is a further memorandum from Mr. Chaut, dated July 12, in which he explores the ramifications of his alternative method in the case of cash dividend payouts. I would recommend that it be read at this point as well.

This Office does not have the expertise to evaluate definitively Mr. Chaut's alternative method. I am, however, able to formulate the following impressions which I find disturbing. First, it appears that the exact percentage allocation would vary from association to association depending on whether the conversion occurred in a favorable or unfavorable market (that is, whether at the time of conversion savings and loan stocks were trading at higher or lower multiples). Secondly, the exact percentage allocation would vary from association to association, even under identical market conditions, depending on the reserve positions of the associations prior to conversion. Third, the exact percentage allocation would vary from association to association, even under identical market conditions and even with identical reserve positions, depending on the amount of new capital which the associations thought they could employ with acceptable profitability. Fourth, in order for Mr. Chaut to make his alternative method work, he finds it necessary to introduce a third net worth account which he calls "permanent reserves". Although I cannot assert this point with a great deal of confidence, this new account has all the earmarks of a "fudge factor". In any event, this new account, as Mr. Chaut recognizes, raises a number of difficult questions regarding the rights of the accountholders and stockholders with respect to it.

Attached at Tab L is a third memorandum from Mr. Chaut, dated July 23, 1973, in which he suggests another possible method of handling the allocation problem. While this method is a refinement of his previous suggestions, it does not appear to be essentially different than those previous suggestions and therefore appears to be open to all the objections to those previous suggestions. Indeed, this method appears to be more likely to result in overcapitalization.

B. Hybrid Association. It should be noted that, unlike the other plans discussed above, the DNW plan does not result in a true or normal stock association. A DNW association is a hybrid association, part mutual and part stock. Contrary to the suggestion in the Walker materials a DNW association would be quite a different thing than the stock associations found in some parts of the country in which the accountholders and/or the borrowing members have some voting rights. The hybrid nature of the DNW association raises a number of questions respecting voting rights, state law, and mergers and acquisitions which are discussed under separate headings below.

C. Voting Rights. The DNW plan assumes that both stockholders and accountholders will have voting rights. The accountholders will have voting rights both because they continue to be "owners" and because it is desired to maintain after conversion as many of the rights they had prior to conversion. The stockholders will have voting rights because that is a normal incident of an equity position in a corporation. The existence of the two groups of voters creates this dilemma: The greater the voting strength of the accountholders, the greater the probability of management dominance and the less attractive the investment to stockholders; on the other hand, the greater the voting strength of the stockholders, the greater the impairment of the ownership rights of the accountholders.

In addition, the interests of the accountholders and the interests of the stockholders are made quite antithetical. The accountholders would want a higher rate of return on savings and the stockholders would want a lower return. The accountholders would want a conservatively managed association with lower dividends and a more aggressive profit oriented association. Thus, Mr. Leibold suggests, the DNW plan causes an internal division of interest which is likely to cause future contention in DNW associations.

I am not pursuaded by this line of reasoning. A basic function of the board of directors in any corporation is one of striking a balance between the competing benefits of alternative courses of action. Undoubtedly, in a DNW association the directors would adopt an equimarginal strategy designed to produce the optimum interest rate and dividend rate. The stockholders would not want too low an interest rate since it would cause the association not to attract funds which could be loaned out profitably. The accountholders would not want too high an interest rate since it would decrease the soundesss of the association and imperil their position. A similar analysis would obtain with respect to dividends.

D. State Law. The Walker materials assert that the hybrid DNW association is a type of association "not in opposition to any substantial body of state law". By this it is meant that, in those states allowing stock associations, the hybrid DNW association could be chartered de novo and that state law would regard as legal and fair the conversion mechanics which would result in the hybrid DNW association. It would take extensive research, which time has not permitted, to validate this assertion in any definitive way. I am inclined to think, however, that a DNW association is such a novel concept and state laws are often so vaguely or badly drafted that the assertion could not be so validated. Nevertheless, I am also inclined to think that, if the State supervisors were convinced that the DNW plan was workable and would solve the conversion problem, the very vagueness of the laws they administer would enable them to conclude that it falls within those laws.

In any event, if the Board comes to the conclusion that some form of the DNW plan is the only safe and sound way to solve the conversion problem, the Board would have to take the position that conversions could not occur in states having contrary laws. Hence, while the DNW plan raises problems under the laws of the various states, I do not think those problems should be determinative in the Board's evaluation of the DNW plan.

E. Mergers and Acquisitions. On page 6 of the Walker presentation of the DNW plan (Tab D) a number of statements are made as to the treatment of DNW associations in the event of merger with differing types of associations. These statements were the subject of considerable discussion during our review of this matter and Mr. Walker does not now stand by them. Chairman Bomar also had reservations on this point (see page 3 of Tab F). Our review did not produce any definitive conclusions except that the existence of DNW associations would require an additional and highly complex body of new merger law. Mr. Chaut has promised a memorandum on this point but it has not been received as of this writing. At this point a list of questions which explore the dimensions of the problem may be all that is required.

1. DNW into DNW. The merger of two DNW associations would not be a simple balance sheet merger as in the case of two mutuals. Nor would the primary determinant be the calculation of an appropriate exchange ratio for their stock, as in the case of many mergers between stock associations. The two DNW associations would have differing percentages for income allocation, as voted above. Hence, some equitable method of arriving at a new percentage allocation for the resulting association would have to be devised. This might not be too difficult. It could, for example, be based on the relative ownership percentages in the surviving association.

2. Mutual into DNW. In the case of a merger of a mutual association into a DNW association, it would appear, as the Walker materials suggest, that all that is necessary is for the net worth of the mutual to be added to the depositors net worth of the dual net worth association. This however would increase the earnings base of the new association and would result in a disproportionate and inequitable benefit to the stockholders of the DNW association unless a reallocation of the income stream were made. In the absence of such a reallocation, transactions of this type would be so unfair that they would certainly not occur in the first place. The basic question here is how the new percentage is determined. The new percentage would, of course, be different in each case depending on the relative sizes and reserve positions of the merger partners.

3. DNW into Mutual. In the case of a merger of a DNW association into mutual association, the Walker materials state that "the Dual Net Worth association's outstanding stock would be repurchased or retired, either by the Dual Net Worth association or by the acquiring entity, as part of the transaction". In this transaction the stockholder of the DNW association would immediately receive cash or its equivalent, such as an account in the mutual association. The basic problem encountered here is a valuation problem. What is the stock in the DNW association worth?

4. Stock into DNW. In the case of the merger of a stock association into a DNW association, the Walker materials state that "the depositors in the stock association would be given voting rights and the net worth of the stock association would be apportioned between depositors net worth and stockholders net worth". Such a procedure would appear to create a disproportionate benefit to the accountholders of the stock association.

5. DNW into Stock. In the case of the merger of a DNW association into a stock association, the Walker materials state that "the depositors of the Dual Net Worth association would receive stock for their proprietary interests in the depositors net worth account." Such a procedure, however, is exactly the windfall distribution of stock

the Walker plan is designed to avoid. Thus, on this count at least, the DNW plan seems ineffective in the accomplishment of its principal goal.

F. Elimination of Windfall. A fundamental consideration in reviewing the DNW plan is whether in fact it would operate to eliminate a windfall. Alternatively stated, the question is whether the creation of the depositors net worth account and the allocation of some percentage of the earnings to such account actually operates to "sterilize" such earnings or whether these procedures are simply accounting entries which the market will largely ignore. Attached at Tab K is a letter from Eric Stattin in which he expresses initial views on this subject among others. Mr. Judy has spent some time with Mr. Stattin obtaining a more complete explanation of his views.

Mr. Stattin expresses his views by way of an analogy to the present accounting treatment of S&L bad debt reserves. When an S&L liquidates, its accumulated bad debt reserves are taken directly into income. Theoretically, Mr. Stattin states, S&L's should set up a deferred tax liability account and add to this account annually so that upon a liquidation the funds in this account would be sufficient to discharge the tax liability created by taking the bad debt reserve into income. In fact, S&L's do not do this because the accounting profession recognizes that S&L's do not plan to liquidate. The association is viewed as going concern. Significantly the market takes the same view and regards the bad debt provisions solely as a matter affecting the tax rate on the association's current and projected income.

Mr. Stattin suggests that in much the same way the market would ignore the intended effect of depositors net worth and allocations thereto. He suggests that net worth constitutes an earnings base for the stockholders (no matter how it's classified) and that allocations to depositors net worth would increase that earnings base for the benefit of the stockholders.

As in the case of many of Mr. Chaut's suggestions, this Office does not have the expertise to evaluate Mr. Stattin's views with complete certainty. Again, however, I am able to form certain impressions. It appears to me to overstate the case to say that the market would totally ignore the establishment of a depositors net worth account and the allocation of earnings thereto. Rather, Mr. Stattin's point might be better expressed by saying that the market would regard a DNW association as a stock association with a legally-mandated conservative policy regarding allocations to reserves. That is, the market would view the association very much like certain old line insurance companies which have always allocated very large percentages of their earnings to reserves and paid dividends only out of the remainder.

I am inclined to agree with Mr. Stattin's view as so stated. Significantly, under such a view, windfalls would not be eliminated. Rather, they would simply be reduced because of the conversative manner in which the market would price the association's stock. In addition, the foregoing factors would make the pricing of the stock in a DNW conversion a very tricky piece of business. The extreme difficulty of pricing the stock in a DNW conversion was a major point made by our underwriting consultants, and at least as Mr. Judy understood them, the view expressed by Mr. Stattin was one of the reasons for their making this point. They also expressed the view that this extreme difficulty in pricing would cause sophisticated and expensive appraisal services to be necessary in all DNW conversions.

G. Unsubscribed For Shares. The Walker materials contemplate that the account holders' right to purchase stock would not be transferable. This proscription is based on a concern that manipulation might result and, far more importantly, on the view (which is correct) that a windfall would be obtained by the seller if the rights were transferable. This proscription results in a requirement that the plan contain a mechanism which assures that all shares will be sold, because the shares could not be accurately priced in the absence of such an assurance. Since it is highly unlikely that the account holders will buy all the shares, it will be necessary in all cases to have an underwriter, management synidcate, or some similar group standing by the purchase at an agreed upon price following the period during which the accountholders can exercise their rights. An underwriter would be necessary except in the case of relatively small associations where a management synidcate could be assembled. In view of the number of shares and the period of the committment, an underwriter would charge a very substantial fee for this service.

Moreover, the question is raised as to what happens when the accountholder does not have the money to exercise his right to purchase or is unwilling to do so even if he has the money. Mr. Walker's answer is that the accountholder will always have the money because the balance in his savings account will always exceed the purchase price of the stock allocated to him. This is true, but it is also true that many accountholders will not be willing to convert their highly liquid insured savings account into a quite illiquid, uninsured equity position. They have a savings account because it is safe and can be turned into cash immediately. Under the DNW plan, such a person gets absolutely nothing. His right to purchase is simply extinguished. In terms of the DNW plan, this result is quite logical, since there would be a windfall if such an accountholder received something of value for his right. The result raises, however, severe problems of equity,.especially if it is considered that this result would normally obtain in the case of the smaller accountholders.

H. Legality. The basic legal case in favor of the legality of the DNW plan is presented in the memorandum of law from Mr. Walker's attorneys at Tab D. In this connection several points need to be separately articulated:

1. Regardless of the conclusions expressed in that memorandum, many of the arguments therein are either incorrect or are policy arguments rather than legal arguments. For example, it is simply incorrect to argue that the DNW plan is legal because corporations have the power to issue more than one class of stock. A corporation can issue more than one class of stock only if it is already a stock corporation or is being chartered as such. In addition the arguments regarding simplicity, public acceptability and raising of new capital are policy arguments.

2. It should be understood that the basic proposition being argued in the memorandum of Mr. Walker's attorneys is that the rights of mutual accountholders under the DNW plan is all they ever had and that the previous conversion plans approved by the Board and the courts erroneously granted them more than they were entitled to. I continue to regard this type of proposition to be erroneous.

3. In my view the basic legal questions are whether there are sufficiently changes circumstances to justify specific modification of the rights of mutual accountholders and whether the Board has the authority to make those modifications without seeking legislative amendments. By changed circumstances I mean the advent of mass communications, greatly expanded savings and lending areas, increased mobility of funds, increasingly sophisticated and informed savers, and other factors which make the conversion of 50 years ago an entirely different event than it would be today. As noted earlier, time-weighting is such as modification and I believe that this modification is justified by changed circumstances and is within the Board's authority.

It must be recognized that there is an enormous difference between the modification accomplished by time weighting and the modifications accomplished under the Walker plan. I am not prepared to say that modifications as extensive as those contemplated under the Walker plan could not be justified. Possibly conversions could be made to work on a national level only with such extensive modifications. That is almost entirely a factual rather than a legal conclusion.

It is clear to me, however, that the legal justification presented in the Walker materials is too weak and misdirected and contains too many errors for it to serve as a justification for the Board to adopt the DNW plan.

I. General Evaluation of the DNW Plan. In this Part I have evaluated the DNW Plan to the extent and depth possible within the time and expertise available to this Office. With more time and greater external expert advice, a better evaluation could be produced. Several things appear so clearly to me, however, that I think more time and more expert advice would serve only to more fully document them.

1. The legality of the DNW plan is so highly questionable that the Board should not decide to adopt final regulations based on it without statutory change (or Congressional ratification at a bare minimum).

2. I have the gravest reservations about the feasibility of the DNW plan. In order for the plan to work, a system of income allocation no less complex than the ingenious system devised by Mr. Chaut is necessary. It seems to me that any such system must be a highly artificial, ad hoc, and contrived system. When that is combined with the hybrid type of association that is produced, with the extensive and complicated new merger law that would be necessary, with the pricing problems that would be encountered, and with the problems of voting rights and unsubscribed for shares that would arise, I see a conversion process of the most questionable feasibility.

Moreover, even if the process could be formulated in a manner that would be satisfactory on the theoretical level, it seems to me that it would be so complex that it probably could not be efficiently administered on the practical level. This latter point is one which I think should be stressed and on which the Board should focus carefully. It is critical that any conversion formula be one that can be understood and administered fairly readily by most associations and by the existing personnel at the Banks and at the Board's staff. A system of conversion that can be understood and administered only by the most highly trained and specialized personnel cannot be acceptable even if it should turn out to be otherwise feasible and fair. On this score alone, I have the most serious doubts about the DNW plan.

3. In the final analysis, it seems to me that the situation described in this Part is the result of Mr. Walker's attempting the impossible. On the one hand, he stresses that mutual accountholders have valuable ownership rights and he desires to recognize those rights. On the other hand, he desires to eliminate a windfall to the accountholders, but <u>this can be done only by somehow derogating those ownership rights</u>. It is worth considering carefully why this underlined sentence is true. The accountholder in a mutual association has a present ownership interest in it. However, that ownership interest is basically valueless as long as the association remains in existence as a mutual. The interest becomes valuable only if certain events were to occur in the future. Thus, the right is described as an "inchoate" right (by lawyers anyway). By way of analogy, the term "inchoate" is used to describe the rights of dower and curtesy which, in States that still recognize those rights, are the rights that wives and husbands have in certain of each others' properties during their lifetimes. These are rights that exist at the present, have no value at the present, but that become valuable in the future upon being triggered by the death of either spouse.

Put in more general terms, a right--any right--has value only when and to the extent that it can be exercised. A right has financial value only when and to the extent that it can be exercised in some financial way, such as by sale or pledge. Thus, an inchoate right differs from the ordinary ownership right (say in a house) only by the remoteness in time and probability of the events that can trigger its exercise.

Mr. Walker recognizes that the mutual accountholders' ownership interest is an inchoate right and his basic aim is to keep it that way. If this could be done, the right would have no present value both before and after conversion and no windfall would result. The essential problem is that the very act of conversion triggers the inchoate right and causes it to have present value. The owner of a share in a stock corporation has an ownership interest that has present value because he can exercise his right now by selling the share and obtaining money for it. The act of conversion is the act of making the inchoate ownership interest in the mutual association into the presently valuable ownership interest in the successor stock association. Somebody must end up with the presently valuable ownership interest in the stock association. If that somebody is the accountholders, then they obtain the "windfall" that results from the triggering of their inchoate interest; if that somebody is third parties, then the "windfall" goes to them. All the law described in my May 17, 1973 legal memorandum at Tab C is based on the idea that, as between the accountholders and third parties, the windfall ought to go to the accountholders since it is their inchoate right which is being triggered. Thus, the conclusion in the underlined sentence above seems inescapable: if it is desired to eliminate a windfall to the mutual accountholders, their inchoate ownership rights must be derogated.

I realize that the foregoing may seem excessively abstract and philosophical. But, I believe that much of the confusion in this area results from a failure to analyze with careful precision the nature of the ownership interest in mutual associations and the nature of value. I cannot stress too strongly that the very act of conversion triggers the inchoate rights of mutual accountholders and gives those rights present value which must go to somebody. The pure selling-the-stock scheme candidly sells those rights mainly to third parties; the distribution to public bodies plans give those rights to the public bodies; the DNW plan attempts to simultaneously and impossibly recognize and deny those rights in the accountholders.

VII. GENERAL EVALUATION AND RECOMMENDATIONS

For the reasons given in Part V above, I believe that the pure selling-the-stock plan is unworkable and should not be further considered. Because of its unworkability, there is no question of seeking statutory change to gain the authority to implement it.

As stated in Part IV (D), in my judgment, the Board does not have the authority to implement any form of plan involving distribution to public bodies without statutory change. For all of the reasons reviewed in Part IV, it would be my view that plans involving distribution to public bodies are the least attractive alternatives to the essential Board formula.

For the reasons stated in Part VI above, I believe that the Board should not decide to make the DNW plan the basis of its revised proposed conversion regulations.

Assuming the Board shares my views, as expressed in the previous three paragraphs, the only remaining option is improvements to essential features of the Board formula. Set forth below is a plan which builds upon the Board formula and which I hope will constitute the core of a solution to the conversion problem. In constructing this plan I have endeavored to add provisions directed toward further controlling shifts of funds (which I take to be the root of the Board's concern) and, at the same time, to cause the minimum modification of the rights of mutual accountholders.

A. I would generally retain the avéraging provisions in the proposed regulations but would make two revisions designed to decrease their administrative costs and complexity. First, I would provide that the association's calculations shall be final and determinative unless the accountholder provides contrary evidence within a relatively brief period. I would provide that the association need consider an account (whether passbook or certificate) as a predecessor account only if the interests in it were identical to those in the account open on the distribution record date (assuming the requisite continuity were present). To illustrate the simplicity which would be achieved by this change, the association could trace all predecessor accounts by making a computer run on taxpayer identification numbers or social security numbers over the averaging period. It should be noted that an additional effect of the latter change will generally be to steepen the discounting caused by the averaging provisions. Fewer persons would have accounts outstanding for the earlier periods in the averaging provisions but the percentage of the stock allocable to those periods would remain the same.

B. I would require that the eligible accountholders pay a certain amount of money in order to receive the stock allocated to them on the basis of their account balances during the averaging period. This requirement is similar to, but essentially different from, the pure selling-the-stock scheme. Under this plan the account holder would be making a mandatory capital contribution, but the amount would be less than the amount of capital necessary to "purchase" the full income stream of the association. (The payment by the accountholder would not be a capital contribution in the usual sense of the word, nor would it be a true purchase of the stock by the accountholder. I have used the term "capital contribution" because that is the practical and important effect of the payment.)

The amount of the capital contribution would vary from association to association and would be discretionary in the association subject to

Board approval. The amount would have to be high enough to constitute an effective disincentive to shifts of funds when taken in combination with the averaging provisions. On the other hand, it would have to be low enough to prevent excessive capitalization and to prevent the association from failing to meet the 50% continuity of interest test which might be applicable in this case to accomplish a tax free reorganization.

A requirement for mandatory capital contributions would not, of course, eliminate windfalls, since the stock received would always have a greater value in the market than the amount of the capital contribution. However, the windfall would be reduced and the necessity to put up cash immediately would cause a significant disincentive to shifts of funds.

The basic mechanism to be employed in the implementation of this plan would be a rights offering. Accountholders would be issued warrants evidencing their right to purchase the shares allocated to them. As noted above, since the purchase price (capital contribution) for the allocated shares would be less than the fair market value of those shares, the rights to purchase would have value. The rights could be made transferrable if there were assurances that a market would exist for the rights. In any event, the association would need to make arrangements for the sale of the rights to purchase the unsubscribed allocated shares at the end of the subscription period.

C. Account holders who do not elect to make a capital contribution and receive their allocated shares would be "cashed out" under a deferred payment mechanism. The deferred payment mechanism could operate in the following way. The cash payment would be put in a long term certificate of deposit in the accountholder's name in the association. The term of the certificate could be set by the association within minimum and maximum limits set by the Board. I have in mind a minimum of not less than 6 years and a maximum of not more than 12 years. Interest would be payable in accordance with the association's normal schedule on other certificates. Principal could not be withdrawn during some initial period of about 2 years. Thereafter principal could be withdrawn in equal annual installments such that the entire certificate could be liquidated by the end of its term. The association would be free, of course, to encourage accountholders to redeposit the funds in passbook accounts and ordinary certificate accounts. I would also suggest that no long term certificate account be set up if the accountholder would be entitled to $100 or less.

Alternatively, the deferred payment mechanism could be modeled on the trust fund idea suggested by Mr. Donahoe at Tab N. All cash payments of more than $100 could be placed in a trust fund with a life of between 6 and 12 years and the association would gradually liquidate the corpus of the trust by making payments to accountholders. Following conversion the account holders who were beneficiaries of the trust would receive non-transferrable trust receipts. This alternative mechanism may be administratively simpler for the association and a trust fund may have a public relations benefit in selling this new plan to the industry.

D. In connection with this new plan I should like to raise with the Board the possibility of reducing the minimum averaging period. The proposed regulations provide for a minimum averaging period of 5 years; the association could decide on a longer period with Board approval. The revised proposed regulations could provide, for example, for a 3 year minimum averaging period with percentages of 40%, 35% and 25% or perhaps 50%, 30% and 20%. I raise this question because the Board might want to allow an association to have the flexibility to adopt a plan providing for a shorter averaging period and a higher capital contribution on the one hand, or on the other hand, a longer averaging period and a lower capital contribution.

E. I have not attempted in the foregoing paragraphs to develop this new plan fully, and a number of its aspects raise questions which will have to be carefully explored. My main purpose has been to describe the outlines of the plan in sufficient detail for the Board to be able to determine whether it wishes to proceed along these lines. Some of the principal questions involved concern tax matters. For example, there is a question whether the cash payments would be taxed at capital gains rates or ordinary income rates. There is a question whether the cash payments would be taxable to the accountholder at the time they are put in the certificate or whether tax on such payments would be deferred until principal payments were actually received. (The latter case would obviously be preferable and would constitute a strong selling point for this plan.) Based on our preliminary conversations with the IRS staff, there are questions on the corporate level as to the applicability of a 50% continuity of interest test and the manner in which such test might be satisfied. A basic problem in the tax area is that the tax laws were not drafted with mutual to stock conversions in mind and that any proposed conversion plan presents a series of novel questions that can be answered only by very loose analogies to normal practice. Very close liaison with IRS will be necessary to resolve these questions. At some point personal contact between the Chairman and the Commissioner of the Internal Revenue may be necessary. In addition, the possibility of special tax legislation should not be ruled out.

I would appreciate the opportunity to discuss this memorandum and its attachments with you at your earliest convenience. I suggest that Messrs. Carrington, Sprague and Judy also attend.

Charles E. Allen

Charles E. Allen
General Counsel

Attachments

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cc: Messrs. Carrington, Sprague, Judy

8

OUTLINE OF FEDERAL HOME LOAN BANK BOARD

FINAL REGULATIONS GOVERNING MUTUAL-TO-STOCK CONVERSIONS OF INSURED INSTITUTIONS

Board Resolutions dated 2/28/74; publication in Federal Register on 3/7/74; effective on 4/8/74.

Principal Provisions of New Regulations (apply to conversions of FSLIC-insured mutual savings and loan associations, both Federally chartered and State-chartered, to the State-chartered stock form of organization)

A. Findings of the Board

a. Equitability factor relates not only to individual conversion but also to entire system of thrift institutions
b. A conversion involving a "windfall" distribution would create strong incentives for significant shifts of savings funds
c. Such shifts would threaten financial stability of thrift institutions
d. A "windfall" distribution would tend to force mutual institutions to convert
e. An equitable conversion must virtually eliminate such "windfall" distributions
f. Methods of conversion other than that in the regulation do not virtually eliminate such "windfall" distributions
g. Substantial uniformity on a national scale needed
h. New regulations preserve rights of account holders while virtually eliminating "windfall" aspect
i. Important determinant in Board's findings is Office of Economic Research Study; study will be available to public soon after final editing and printing

B. Sale of capital stock by converting institution

1. Required provisions relating to plan of conversion

a. Sale of all shares at total price equal to estimated pro forma market value
b. Priority nontransferable subscription rights for eligible account holders up to 100 "entitlement shares" or if greater an amount equal to savings account balances on eligibility record date
c. Eligibility record date not less than 90 days prior to adoption of plan by board of directors
d. Subscription rights for eligible account holders for shares in addition to "entitlement shares"
e. Public or other offering of all unsubscribed shares at end of subscription period
f. Underwriting discounts or commissions only on unsubscribed shares
g. Exclusive voting rights to shareholders of converted institution
h. Minimum one year restriction on sale for any shares purchased by directors or officers

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2. Optional provisions in plan of conversion

    a. Up to 10% discount on subscription price to eligible account holders, with a six months restriction on sale
    b. Subscription rights for up to 100 shares for other account holders and/or borrowing members, with same discount and restriction on sale; with additional shares for purchase without discount and restriction on sale
    c. If any remaining unsubscribed shares after other priorities, subscription rights to certain shares to directors, officers, and employees, with same discount but two-year restriction on sale
    d. Minimum subscription 25 shares (but not exceeding $500)
    e. Sale of units of securities comprised of shares and long-term warrants or other equity securities

C. <u>Liquidation account for benefit of eligible account holders in the event of complete liquidation subsequent to conversion</u>

1. Equal to net worth of converting institution
2. Pro rata ("subaccount") interests of eligible account holders based on savings account balances on eligibility record date
3. Priority on liquidation over any distribution to shareholders, otherwise available except for payment of cash dividends or repurchase of shares
4. Downward adjustment to reflect savings account withdrawals
5. Survival of rights in merger or consolidation

D. <u>Savings accounts; Borrowers</u>

1. Savings accounts to be identical in amount and terms
2. Continued FSLIC insurance of accounts
3. Borrowers' loans unaffected by conversion

E. <u>Votes</u> - plan to be approved by at least two-thirds of directors and by majority of total outstanding votes of members

F. <u>Cash dividends and stock repurchase restrictions</u> - annual cash payouts limited to not more than two-thirds of net income

G. <u>Anti-Takeover Provisions</u>

1. Provisions preventing takeovers of newly converted institutions by companies "significantly engaged" in business activities not permitted for multiple savings and loan holding companies
2. Required agreement with FSLIC
3. Optional charter provision, with full enforcement thereof a condition of approval

H. <u>Notice; proxy statement; offering circulars</u>

1. Approval of Board required prior to use of proxy material or offering circulars
2. New proxies required for conversion voting
3. Disclosure requirements correspond to those of SEC

OUTLINE ON CONVERSIONS

I. *Why Conversions*

A. *Need for Equity Capital*

1. *Support savings growth and expanded services*
2. *Need not met by subordinated debentures*

B. *Efficient Allocation of Housing Capital - Surplus to Deficit Areas*

C. *Improve Competitive Structure*

1. *Facilitate appropriate mergers; attract and compensate management*

D. *Supervisory Effect*

1. *Increase net worth and ability to absorb losses*
2. *Clearer and more explicit responsibility*
3. *Management stake in sound and proper performance*

E. *Business Freedom*

1. *Law permits and action is safe*
2. *Government should not restrict safe and legal action*

II. *Historical Background*

A. *The Administrative Moratorium - Dec. 1963-April 1974 (10 years, 4 months)*

1. *Three studies on conversions*
2. *"Test case" conversion of Citizens Federal - 2/72*
3. *Five "study" applications - 7/26/72 to 9/22/72*
4. *Proposals of January 3, 1973*
   a. *Weighted distribution of stock to accountholders without payment*
   b. *Public hearings - 3/12-/3/73*

B. *The Statutory Moratoria - Public Law 93-100 - August 16, 1973*

1. *Moratorium until 12/31/73 for five "study applications"*
2. *Moratorium until 6/30/74 for other applications*

C. *Final Regulations*

1. *Announcement of policy change on 8/27/73*
2. *Proposal of revised new regulations on 11/29/73*
3. *Final adoption on 2/28/74; effective 4/8/74*

D. *Current Filings*

1. *35 on file; 25 from Federals; 10 from State-chartered*
2. *Florida (10); Texas (5); California (4); Arizona, New Jersey and Wisconsin (2); Colorado, Illinois, Kansas, Maryland, Michigan, New Mexico, Ohio, Tennessee, Utah and Washington (1).*

III. *Section 105(d) of Senate Version of H.R. 11221*

A. *New moratorium until 6/30/76*

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B. *Continued explicit exception for supervisory cases*

C. *Expand exce[illegible]on for certain pre-May 22, 197[illegible] applications*

1. *Add 3 named associations on a free distribution basis*

D. *Exception for 23 test cases*

E. *Exception for States enacting new stock laws ("Williams Amendment")*

F. *Federal associations may retain Federal charters*

G. *Federal associations may convert only in States chartering stock association*

IV. *Problems With Section 105(d)*

A. *Specific Numerical Limits*

1. *Can cause arbitrary selection and rejection of meritorious applications*
2. *Capital markets set natural limits on number of conversions*
3. *Expansion of "grandfather" exception for those on file*

B. *Special interest free distribution exceptions for 3 named associations*

1. *Not warranted under the facts (Bomar letter in Senate Report)*
2. *Creates dangerous precedent for shifts of funds and forced conversions*
3. *Creates legal confusion* Litigation

C. *Need for appropriate judicial review provision* from Bank Merger Act

D. *Need for clarifying provisions removing doubt as to proper approach*

E. *No necessity for State law restriction in States where:*

1. *All associations are Federals (e.g., Puerto Rico, Alaska)*
2. *Exclusive Federal regulation (District of Columbia)*

F. *Allow for States in which stock associations are "grandfathered"*

G. *Drafts No. 1 and No. 2 in letter of 8/15/74*

V. *Basic Provisions of Final Board Regulations on Conversions*

A. *Sale of all shares at price equal to estimated pro forma market value*

B. *Full priority offering to eligible accountholders as of past record date*

C. *Public or other offering to assure complete sale*

D. *Liquidation account for benefit of eligible accountholders in the event of complete liquidation subsequent to conversion*

E. *Approval by 2/3 of directors and majority of accountholders' votes*

F. *Anti-Takeover provisions*

G. *Board approval of notice, proxy statements and offering circulars*

H. *Expert appraisal and Board review of pricing*

FEDERAL HOME LOAN BANK BOARD

INTER-OFFICE COMMUNICATION

From *Office of the General Counsel* *Date* May 17, 1973

To: The Federal Home Loan Bank Board *Subject* Ownership Interests in Mutual Associations

This is in response to your request for a memorandum concerning the question of the ownership of mutual savings and loan associations, particularly in the context of conversions from mutual to stock form.

This memorandum is divided into seven parts. The first part outlines the method of distribution embodied in the Board's proposed conversion regulations and in two alternative proposals. The second part traces the history of the mutual savings and loan association. The third part reviews the relevant case law. The fourth part describes recent legislation affecting the relationship between the association and its members. The fifth part compares the attributes of membership in a mutual association with the rights of stockholders in a stock corporation. The sixth part discusses the charter requirements concerning the distribution of assets and reviews the Board's prior regulations and practice regarding conversions. The seventh part outlines the conclusions reached in this analysis.

I should like to preface this memorandum with a caveat. Much of the difficulty in formulating a clear discussion of the questions dealt with in this memorandum is caused by terminological or semantic problems. The courts and other sources in this area sometimes use the word "surplus" to refer to a true surplus and sometimes to refer to the market value of the association. Sometimes the word "depositor" is used to refer to a person who has established a true debtor/creditor relationship with an institution and sometimes to refer to a person who holds a share account. A share in a modern mutual association is a different thing from a share in older types of mutual associations, and both of these shares are similar to, but quite different from, a share of stock in a stock corporation. The concept of "mutuality" has altered over the years, but retains certain essential notions. Hence, it is important in reading this memorandum to consider each of these terms in the various contexts in which they are used.

I. Proposals

A. Proposed Conversion Regulations

The Federal Home Loan Bank Board has proposed regulations for the conversion of a mutual savings and loan association into the stock form of association pursuant to the third unnumbered paragraph of Section 5(i) of the Home Owners' Loan Act of 1933, as amended,[1/] and Title IV of the National Housing Act, as amended.[2/] Section 5(i) provides, among other things, for the conversion of Federal mutual associations to the stock form upon an equitable basis. In general terms, the proposed regulations provide for the pro rata distribution of stock or cash representing the ownership interest in the mutual association to its accountholders as of a certain record date prior to the adoption of the plan of conversion by the association. The reason for limiting the distribution to accountholders as of a prior date is to substantially reduce the shift of funds by speculators to take advantage of the distribution. In addition, the proposed regulations provide for distribution in accordance with a time-weighted formula which allocates proportionately more of the stock or cash to accountholders whose accounts have been outstanding for longer periods of time.

B. Other Proposals

There are other proposals for the distribution or allocation of the ownership interest in a converting mutual association. The value of established mutuals has been built up over the years by persons other than current accountholders. Examples of such persons are past accountholders, past and current borrowers, and past and current directors, officers and employees of the association. The Federal government and the general public have also contributed to the value of mutual associations by giving them tax subsidies,[3/] protecting them from excessive competition,[4/] and allowing them to open for business with relatively small amounts of initial capital.[5/] Consequently, it is argued that it amounts to an unjust enrichment to distribute the value generated over the years to savers whose only claim to the distribution is that they were fortunate enough to be accountholders on the conversion record date. Instead, it has been proposed that a converting mutual should transfer a sum equal to its current market value to the Federal Savings and Loan Insurance Corporation (FSLIC) or to a Board supervised trust fund to be used to aid housing and to promote homeownership.[6/]

Another proposal suggests that, since the value of the association has been accumulated over time and since all of the contributors thereto cannot be located, the share of such unlocated depositors, which is some portion of the total amount, should be turned over the the FSLIC or to a public trust to be managed for the promotion of housing and home-ownership.[7]

Numerous variations on these proposals have been suggested or can be imagined. The unifying idea behind proposals of this nature is that the value of the mutual association should be distributed in whole or in part to persons other than the current accountholders. The basic issue to be dealt with in this memorandum is the legality of these alternative methods of distribution.

II. History of the Mutual Building and Loan Association

The first mutual building and loan association in the United States was organized at Frankford (later part of Philadelphia) in 1831 and was called the Oxford Provident Building Association. The association's purpose was to enable members, most of whom were workers in the textile trade, to build or purchase dwelling houses. The par value of shares was set at $500 each and members were required to make an initial or membership payment of $5.00 and then pay $3.00 per month on each share until the full $500 par value had been paid. No one could own more than five shares. Money received was offered as loans to the highest bidder among members who were entitled to borrow an amount equal to $500 for each share held. Members desiring to withdraw had to give a month's notice and were charged a penalty of 5% of the amount paid in at the time of withdrawal. Fines were levied for nonpayment of the monthly dues. No loans were to be made for building houses at a greater distance than five miles from Frankford.

The Oxford arrangement was a Terminating plan, which provided for the issuance of one series of shares as of the same date and amount and with a fixed date of expiration. A member joining the association after the original subscription had to make all the back payments so that his holding would equal that of an original subscriber.

The arrangement was shortlived because of its nature and because it was very difficult to expand the membership after the first several years. The successor plan was called the Serial plan or Pennsylvania plan. In the Serial plan, instead of issuing only one series of stock, several series were issued at stated intervals. This arrangement allowed for the expansion of the association because new members could subscribe to the most recently issued series and pay back dues only to the beginning of that series.

In the 1880's the Permanent plan became popular. The distinguishing feature of the permanent plan was that it permitted shares to be issued at any time, with the accounts of the individual members being kept separately; that is, each account started and matured individually, without reference to the other members' accounts. A sophistication of the permanent plan was the Dayton plan. Under the Dayton plan, members subscribed for shares upon which payments of dues could be made at any time and in any amount. The shares were generally withdrawable for the full amount of dues paid in and dividends credited. The plan also provided for the issuance of paid up shares on which dividends were paid in cash after each periodic distribution of earnings. In addition, the Dayton plan abolished the use of premium charges in connection with loans. Instead, the borrower was required to pay a fixed minimum sum per share per week or month, out of which interest or other charges were deducted and the balance applied as dues toward the maturity of the share.[8]

In 1933, Congress enacted the Home Owners' Loan Act, authorizing the chartering of Federal mutual savings and loan associations. The initial capitalization of a Federal association is in the form of pledged accounts established by the organizers. The original Federal associations were issued a charter in the form of Charter E, which had many of the characteristics of the Dayton plan. Since that time the Board has issued increasingly flexible charters denominated as Charters K, N and K (revised). Modern Federal associations may now raise capital in the form of savings deposits, shares or other accounts for fixed, minimum or indefinite periods of time as authorized by its charter or by regulations of the Board and may issue passbooks, time certificates of deposit, or other evidence of savings accounts as authorized. Savings accountholders and borrowers are the members of an association under each of the Federal charters.[9]

It is difficult to imagine a mutual association more clearly owned by its members than the original Terminating plan association. It will be noted, however, that subsequent developments in mutual associations were not of the type that would alter the ownership rights of the members. Rather, the developments were designed to give the associations increasing permanency and greater flexibility in their assets and liabilities, and thereby to provide better and more continuous service to their members. The ownership interest in the mutual became more easily acquired, more easily lost, and of greater use when it was held. But, it was not eliminated in its essential aspect.

III. Case Law Concerning Distribution of Surplus in Mutual Savings Associations

A. Ownership of the Surplus of a Mutual Savings Institution

In Huntington v. Savings Bank, 96 U.S. 388, 24 L. Ed. 777 (1877), a suit brought by a depositor of a mutual savings bank to compel distribution of profits, the Supreme Court recognized the ownership rights of depositors (as opposed to incorporators' rights) in such profits in its exploration of the nature of a mutual savings institution:

> "It is like many other savings institutions incorporated in England and in this country during the last sixty years intended only for provident investment, in which the management and supervision are entirely out of the hands of the parties whose money is at stake, and which are quasi benevolent and most useful, because they hold out no encouragement to speculative dealing or commercial trading. This was the original idea of savings banks [citations omitted] . . . where it is said the bank derives no benefit whatever from any deposit, or the produce thereof. Indeed, until recently, the primary idea of a savings-bank has been, that it is an institution in the hands of disinterested persons, the profits of which, after deducting the necessary expenses of conducting the business, inure wholly to the benefit of the depositors, in dividends or in a reserved surplus for their greater security." (24 L. Ed. at 779.)

Some thirteen years after the Huntington case, a Rhode Island court in Mechanics' Savings Bank v. Granger, 17 R.I. 77, 20 Atl. 202 (1890), also came to the conclusion that the reserved profits of a savings bank belong to its depositors. The suit was brought by a mutual savings bank to recover a tax assessment on reserved profits on the ground that, under its charter, the reserved profits belonged to (and were taxable at time of distribution to) the depositors and not to the bank. The court reasoned that:

> "[T]he reserved profits are a part of the earnings of the depositors, reserved for the purpose of facilitating the management of the bank's affairs, and of imparting greater steadiness and security to its operations in

> periods of financial depression and disaster. There is no way in which the ownership of them can pass from the depositors to the bank under its charter by reason of such reservation. It is true that the depositor, when he withdraws his deposits, cannot draw upon the reserve for his part, but he gets the benefit of it in the safety of his deposit, in an increase of dividends, and in freedom from fluctuations in the receipt of them. That he cannot withdraw any part of the reserve, when he withdraws his deposit, is owing to the terms under which, by force of the charter and by-laws, his deposits are given and received."
> (20 Atl. at 203.)

However, the court also recognized the importance, for purposes of its analysis, of what was in effect a liquidation clause in the institution's charter which would allow a pro rata distribution of all property to the depositors upon a majority vote of the board of trustees:

> "The board of trustees may however, as we have seen, vote to divide the whole property among the depositors in proportion to their respective interests therein. In case of such a vote, the then depositors would get their proportionate shares of the reserve, if any there were, after repayment of their deposits in full, and neither the bank nor trustee could retain a cent. This provision in itself shows conclusively that, in contemplation of law, the reserved profits belong to the depositors, not to the bank."
> (20 Atl. at 203.)

Liquidation clauses providing for pro rata distribution of surplus are found in most charters of mutual savings associations, assuring the continuing vitality of the above reasoning.

I have been unable to find any case which holds against the proposition that the depositors of a mutual savings institution have an ownership interest in the surplus; instead, it is the accepted first premise of the line of cases in the next section, which seek to establish the principles upon which distribution of surplus to depositors may be made.

B. Depositor Eligibility for Distribution of Surplus

Morristown Institution for Savings v. Roberts, 42 N.J. Eq. 496, 8 Atl. 315 (1887), involved a petition brought by the trustees of a mutual savings bank to obtain judicial instruction with regard to the disposition of surplus as a result of a voluntary liquidation. Among the defendants were current depositors and those who had withdrawn their deposits before liquidation proceedings had been instituted. The institution's charter provided that depositors should receive as interest their ratable proportion of net profits (reserving a portion for surplus), but it did not specify how surplus funds should be distributed upon liquidation. The court held that the surplus was to be distributed only to those who had current deposits at the commencement of liquidation proceedings, basing its decision on the protective purpose of the creation and maintenance of the reserved surplus and the present contractual interest in the assets which resides only in current depositor-members:

> "The surplus was created and maintained for the protection of the depositors from loss by reason of the depreciation of securities, etc., -- to protect them against the casualties and contingencies to which the funds of the institution were liable, and which might impair their deposits. It stood as such indemnity for the depositors who were such for the time being. So long as a person continued to be a depositor, so long it stood for his protection, and when, by withdrawing his funds, he ceased to be a depositor, his interest was at an end. He thus relinquished his interest in it, and as he would not be liable to contribute to any loss to which the remaining depositors might be subjected, so, on the other hand, he would not be entitled to any participation in the surplus . . .
>
> [Current] depositors, being the only persons interested in the assets of the corporation at the time of winding up, are entitled to a ratable distribution among themselves, according to the amount of their respective deposits, of those assets . . ." (8 Atl. at 317.)

The holding in the Morristown case was reluctantly followed in a later New Jersey case, Barrett v. Bloomfield Savings Institution, 64 N.J. Eq. 425, 54 Atl. 543 (1903), in which the Court of Chancery of New Jersey had before it the question whether a current depositor had standing to maintain an action to enjoin a presumptively inequitable voluntary dissolution, even though she would recover her deposit plus interest and a share in the surplus. The court conceded that "[T]here is indeed no known mode of dividing a surplus of a savings bank, when such division becomes necessary, except among the bona fide depositors at the time of the dissolution." Although it was able to hold that the injury a current depositor may sustain, by reason of the extinction of the savings institution as custodian and investor of her funds, was sufficient to give her the right to bring the action, the court felt obliged to express as an obiter dictum its dissatisfaction with the rule of surplus distribution to current depositors only. The rule was characterized as "a rule of convenience and necessity, not of equity." The full text of this portion of the court's decision is as follows:

> "There is indeed no known mode of dividing a surplus of a savings bank, when such division becomes necessary, except among the bona fide depositors at the time of the dissolution. But it does not follow that such division is just and equitable. It is a rule of convenience and necessity, not of equity. Consider, in that connection, the temptation of eleventh-hour people to come in as depositors in anticipation of dissolution. In fact, I am confirmed in the view I stated at the argument, that the attempt to make an equitable division of the surplus of a savings institution, such as we have to deal with here, presents an insoluble problem. That surplus is the result of the surplus earnings of all the money that has been deposited by all the depositors from the beginning of the bank. It is well known that many of those have already withdrawn and thereby, as it has been well said, have abandoned their share in the surplus; but it by no means follows that the equitable rights of those who remain are any greater by such abandonment than they would have been without it. Then, of those who remain at the end some have been depositors for a longer time than the others. The present case presents an example of that. In my opinion, the true status of a surplus is that it is held by the institution in trust for the benefit of the immediate community in assisting to maintain and perpetuate the existence of the institution."
> (64 N.J. Eq. at 435.)

A more recent case which holds that only current depositors may share in the surplus is In re Cleveland Savings Society, 192 N.E. 2d 518 (Ohio 1961). In this action, a plan for dissolution of a mutual savings bank, the assets of which were to be converted into a national bank, provided for the issuance of voting trust certificates and scrip only to those depositors who had account balances on the date of dissolution. The objections to the plan were from former depositors who had withdrawn their accounts prior to the cut-off date. Some of the funds had been deposited in the savings bank for 20 years and had been withdrawn just prior to the cut-off date. The court rejected as without legal basis the claim that former depositors who contributed to the surplus should share in its distribution, and quoted extensively from Morristown, Mechanics' and a tax assessment case before the Supreme Court, Society for Savings in the City of Cleveland v. Bowers, 349 U.S. 143, 75 S. Ct. 607, 99 L. Ed. 950 (1955):

> "The asserted interest of the depositors is in the surplus of the bank which is primarily a reserve against losses and secondarily a repository of undivided earnings. So long as the bank remains solvent, depositors receive a return on this fund only as an element of the interest paid on their deposits. To maintain their intangible ownership interest, they must maintain their deposits. If a depositor withdraws from the bank, he receives only his deposits and interest."
> (349 U.S. at 150.)

Accord: In re Springfield Savings Society of Clark County, 12 Ohio Misc. 51, 73, 230 N.E.2d 139 (1965).

The cases noted above dealt with the protested exclusion of former depositors. In Federal Home Loan Bank Board v. Elliott, 386 F.2d 42 (9th Cir. 1967), the court was faced with a conversion/merger plan which excluded the most recent current depositors. The Board approved a plan of merger which provided for distribution of the stock of the surviving stock association to the accountholders of record of the merged mutual in 1960 as their share of the surplus upon dissolution. Between 1960 and 1964, a great deal of speculative money had been deposited in the mutual, apparently to take advantage of the impending distribution of surplus. The Board believed that, under the circumstances, a pro rata distribution would be unfair to the long-standing accountholders of the mutual. The District Court disallowed the Board's restrictive distribution plan, holding that the distribution had to be pro rata to all accountholders of record just prior to the merger in 1964.

The Court of Appeals held that (1) the District Court had no authority to remedy what it regarded as an invalid distribution program by designating a revised plan and imposing it upon the parties without the requisite approval of accountholders and administrative agencies, and (2) the plaintiffs were barred under the doctrine of laches because they deliberately waited until after consummation of the merger to contest the distribution plan. The court did not reach the question of whether the provision for an early cut-off date was invalid. For the two reasons given above, the Court of Appeals reversed the judgments and remanded with directions to dismiss the actions and return the impounded stock for distribution in accordance with the provisions of the Board approved plan.

In an earlier Ohio case, In re Springfield Savings Society of Clark County, supra, the court squarely faced the question and upheld a provision in a distribution plan which provided for an earlier cut-off date applicable only to depositors who had inside knowledge of the possibility of dissolution. Under the provision, the court disallowed the claims of a number of speculators for a share in the surplus.

C. Distinctions Among Current Depositors

Several cases have further distinguished among the eligible group of depositors. In the Cleveland Savings Society case, 192 N.E.2d at 534, the court found that persons owning, or having an interest in, Christmas Club accounts, escrow accounts, employees' United States Savings Bond deposits, funds held for borrowers, borrowers construction loan funds, hypothecated deposits on installment loans, outstanding certified checks and official checks did not meet the requirements necessary to create an intangible ownership interest and evidenced only the creation of a creditor-debtor relationship. Contracts with such persons were special contracts which distinguished them from regular savings depositors. They had no savings passbooks in Society, received interest (or no return) rather than dividends from Society and their right, if any, to demand payment of such fund was to be determined in accordance with their special contracts or general law and not governed by the regulations and rules relating to regular savings deposits. With regard to the deposit of public funds, these too were found to be made pursuant to special contract and fully collateralized as required by state law, and therefore of a distinctive nature as contrasted to the "regular" depositors who were to share in the distribution.

In In re Springfield Savings Society of Clark County, on remand, 230 N.E.2d 139 (1967), the court was requested by trustees of the merged savings bank to determine whether public depositors, inter alia, should share with all other current depositors in the distribution of surplus of the merging bank. As in the Cleveland Savings Society case, the court noted that governmental deposits were of a different quality than regular accounts. Government accounts were backed by collateral for the full amount of the deposit which exceeded the Federal insurance maximum, the accounts received a fixed rate of interest, the funds could be withdrawn on short notice and the accounts were not subject to the regulations and rules governing passbook holders. Because of the "privileged position with respect to their deposits", the court held that the governmental deposits were not entitled to share pro rata with regular accountholders in the distribution of surplus.

D. Summary of Cases

A summary of the principles established by the cases is as follows:

1. The depositors have a right to share in the distribution of the surplus of a mutual association upon termination.

2. The depositor in a mutual association obtains an intangible pro rata interest in the surplus of the association upon the opening of an account and loses his interest upon withdrawal.

3. Upon termination of the mutual association, the surplus is to be distributed to the depositors at that time. This conclusion is based on the second principle indicated above, on the purpose served by the surplus, namely, protection of current depositors, and the fact that there is a contractual relationship only between the association and its current depositors. One case, the Bloomfield Savings Institution case, agrees with this conclusion on grounds of convenience and necessity rather than on grounds of equity.

4. The depositors receiving the surplus need not be the depositors on the date of termination. The right to share in the distribution is in the most current depositors to whom it is feasible to make a distribution. The rights of depositors may be modified or conditioned in order to avoid free riding, shifts of funds and other problems.

5. Not all current depositors are entitled to a distribution. It is necessary to examine separately the exact nature of the contractual relationship involved in each type of account.

IV. Recent Legislation Bearing on Depositors Claim of Ownership

Since the organization of the original mutual associations as described in Part II and since the time that some of the controlling legal precedents of the case law described in Part III have been established, certain legislative developments have occurred affecting the arrangement between a mutual savings and loan association and its accountholders.

A. The Federal Savings and Loan Insurance Corporation (FSLIC)

In 1934, the Congress established the FSLIC to insure the accounts of Federal savings and loan associations and eligible-state chartered associations. In order to become an insured institution, the association must apply to the FSLIC for insured status and agree among other things that it "will provide adequate reserves satisfactory to the Corporation to be established in accordance with regulations made by the Corporation before paying dividends to its insured members; but such regulations shall require the building up of reserves to 5 per centum of all insured accounts within a reasonable period, not exceeding twenty years, and shall prohibit the payment of dividends from such reserves or the payment of any dividend if any losses are chargeable to such reserves." 10/

It has been argued that the presence of the FSLIC alters the traditional relationship of the saver/member in a mutual institution. Because of the FSLIC, the saver runs less risk of loss of his savings. The Morristown court noted that one of the reasons that accountholders were entitled to the surplus is because the surplus was built up to protect the accountholder from loss. Thus, the argument has been made that the surplus found in current mutual associations now exists to protect the accountholder only indirectly, and is primarily held for the protection of the FSLIC. Accordingly, it is argued that it should be distributed upon conversion either directly to the FSLIC or to the FSLIC to manage a public trust for the promotion of housing. The counter argument is that the surplus still serves its original function, that of protecting accountholders against loss. The FSLIC simply serves as an additional reserve fund which is small in comparison to the total reserves of insured institutions. Moreover, if an association gets into financial difficulty, its own reserves, rather than those of the FSLIC, are the first line of defense. Further, the basic protection to accountholders provided by the FSLIC is not through its reserves but rather through its examining and supervisory role.

It is true that one of the traditional indicia of ownership is that the owner shares in both the profits and losses. However, this risk has at most been substantially reduced by the existence of the FSLIC. Further, to reason analogously, a person does not have less of an ownership interest in any property, such as his house, because he insures it against loss. The Congress did not establish the FSLIC to alter ownership interests but to strengthen and preserve them. Finally, the accountholder insures himself against loss, at least up to $20,000, by paying a premium for this service indirectly through the association. It is a strange argument that, in order to attain insurance of his account, the accountholder must not only pay the normal premium but must also lose his ownership interest in the association.

B. Rate Control

In 1966, Congress amended section 5B of the Federal Home Loan Bank Act, to require that the Bank Board, after consulting with the Board of Governors of the Federal Reserve System and the Board of Directors of the Federal Deposit Insurance Corporation "prescribe rules governing the payment and advertisement of interest or dividends on deposits, shares, or withdrawable accounts, including limitations on the rates of interest or dividends on deposits, shares or withdrawable accounts that may be paid" by savings and loan associations. 11/ The Board has exercised its responsibility under this provision and has established by regulation a schedule of rates or ceilings for the various types of accounts offered by savings and loan associations. 12/

Under the rate control legislation, all accountholders in savings and loan associations receive a rate of interest on their deposits up to the fixed maxima in the Board's regulations. The Springfield case disallowed distribution of any of the surplus to government deposits, inter alia, because of the fixed rate of return on those deposits. Thus, it is argued that another traditional indicia of ownership, sharing in the profits of the association, has been altered by recent legislation. Mutual associations are no longer permitted to distribute all earnings among accountholders after expenses and allocations to reserves; they can pay only up to the interest rate maxima on all accounts. Any excess earnings are held by the association and increase the surplus. In this sense, the benefits available to members in mutual associations after 1966 are dissimilar to the benefits available to them prior to that date.

Further, it is argued that to the extent that rate control has served to increase the surplus of mutual associations since 1966, the distribution of the value of a converting mutual in the future could result in an inequity to former depositors who, since 1966, have not shared in any of the profits other than the interest payments up to the maxima. Under the Board's proposed conversion regulations only accountholders on the distribution record date would have a right to any such excess surplus.

There are various counter arguments to the foregoing lines of reasoning. First, the authority for differential rate control ceilings was not enacted in 1966 to increase the surplus of mutual associations and in fact has not generally operated to do so. Rather, it was enacted to prevent severe deterioration in the financial condition of thrift institutions generally and to provide support for the housing market. As a general proposition, rate control has not caused significant accumulations of surplus in the savings and loan industry which would disproportionately benefit current depositors in mutual associations. Rather, it has prevented thrift institutions as a group from being subject to destructive competition in tight money periods due to their limited asset and liability powers.

Second, even prior to 1966 depositors in mutual associations did not have a contractual right to all the net profit of the association in the form of interest or dividends. At most, they had the right to such interest or dividends as the board of directors might declare. Rate control operates essentially as a limitation on the discretion of the board of directors and does not operate to alter ownership status. Again to reason analogously, the holder of a share of stock in an industrial corporation does not have less of an ownership interest because the government has imposed ceilings on profits and dividends.

Third, the rate control legislation is a temporary measure and may be phased out in the future. Accordingly, undue emphasis cannot be placed on this factor in considering the equities of distribution.

C. Deposit Associations

In 1969, the Board amended the Federal regulations to provide for use of the term "savings deposits" as opposed to the old terminology of share accounts. Section 545.1-2 of the Federal Regulations permits Federal associations to become "deposit associations". The only legal difference between a deposit association and a share association is the status allowed to the accountholder in a deposit association of being treated as a creditor along with all other creditors upon dissolution of the association. Again this alters the traditional ownership arrangement in that savings accountholders are treated as both members and creditors. They get paid first along with all other creditors and they have a right to share in the surplus if there is any after their claims and all others have been satisfied. However, it is clear from the Federal regulations that the accountholder's status as a member of the institution is to remain unchanged especially as regards liquidation or dissolution. 13/ Hence, the change in terminology does not effect in any way the distribution problem and is only mentioned here in the interest of covering all points.

V. Indicia of Ownership

Although the recent legislation has affected the traditional relationship between a member of a mutual association and the association, the basic question remains whether these changes amount to a change in the nature of the ownership of an association. In Sections A, B, and C of Part IV, I have suggested reasons, keyed to each piece of legislation, why the nature of the ownership has not changed. This Part presents a more general analysis of the matter.

All societies, associations or corporations have members who exercise certain control over the business. The attributes of control represent the ownership interest of the members when dealing with an association which owns property and is organized for the purpose of conducting a business.

Since it is clear that the stockholders of a modern stock corporation are the owners of the corporation, this Part will analyze the similarities between the rights of members in a mutual association and stockholders' rights in a stock corporation.14/

The rights of members in a mutual association are: the right to vote, the right to amend the by-laws, the right to request special meetings, the right to communicate with other members, the right to inspect the corporate books and records, the right to nominate and elect directors, the right to run for director, the right to remove directors and the right to participate in the assets remaining after liquidation.15/

Section 4 of Federal Charters N and K (rev) gives each member of a Federally chartered mutual association the right to cast one vote for each $100 or fraction thereof of the withdrawable value of his account.[16/] Each borrowing member is also entitled to one vote in addition to any votes he may possess as a savings accountholder. The right to amend the by-laws is a necessary power over the internal workings of the association.[17/] The right to request special meetings[18/] and the right to communicate with other members are similar to the rights enjoyed by stockholders in a stock association.

The right to nominate and elect directors is similar to stockholders' rights.[19/] The right to run for director is subject to statutory requirements but is otherwise no less restricted than a stockholders' rights. The right to remove a director for cause is common to both stockholders and members of a mutual association. The right to participate in any assets remaining after liquidation is a right enjoyed by both stockholders and members of a mutual association.[20/]

In summation, all of the rights enjoyed by stockholders in a stock corporation are present in a mutual association's membership.[21/] Thus, under modern concepts of control of property, a member of a mutual association may exercise as much control as a stockholder in a stock corporation who is a clearly recognized owner of the corporation in which he holds stock.

VI. Charter Requirements and Prior Board Regulations and Procedure

A. Section 10 Charter N and K (rev.)

In addition to the above described evidence of ownership, there is a specific Federal charter provision which has a bearing on the distribution of the ownership interest in a Federal savings and loan association.

Section 10 of Charters N and K (rev.) under which virtually all Federal associations are chartered provides:

> All holders of savings accounts of the association shall be entitled to equal distribution of assets, pro rata to the value of their savings accounts, in the event of voluntary or involuntary liquidation, dissolution or winding up of the association.

There are two problems with relying on this section as dispositive of the rights of accountholders to share in the distribution of the ownership interest in a converting association. First, the section states that "all holders of savings accounts of the association" shall be entitled to equal distribution of assets. The language is extremely general. Does it mean all holders of savings accounts on the date the institution votes to convert itself? Does it mean all holders of savings accounts on the effective date of conversion, which can be some time after the vote on conversion? The Board's proposed regulations provide that only accountholders of record on December 31 of the year preceding the vote on conversion or earlier should be entitled to share in the distribution. As mentioned earlier, the regulation is designed to control shifts of funds in expectation of a conversion distribution. As such the regulation meets the statutory requirement that the Board supervise conversions on an equitable basis. However, the charter language does not specify such a formula. In addition, the regulations require a time-weighted distribution allocating a larger percentage of the distribution to accounts held for longer periods of time. A time-weighted distribution is also not specified in section 10.

The other problem is the fact that the charter provision speaks in terms of voluntary and involuntary liquidation and dissolution, without specifically referring to conversions. It is clear that a conversion is not an involuntary liquidation except perhaps in a supervisory case. However, is a conversion a voluntary liquidation or a dissolution?

The act of conversion is an exchange of one legal form for another involving a recapitalization or reorganization. The holders of savings accounts in the original mutual association will be the holders of savings accounts in the new stock association and will be the owners of most of the stock in the new association. In fact it is a requirement of the Internal Revenue Service that a certain continuity of ownership exist if the conversion is to be tax free. 22/ Thus the new association will have much the same ownership as the old mutual association. In addition, the new association will be housed in the same buildings, will have the same directors and officers, will be engaged in the same business, will have the same lending area -- in short the only changes will be in its legal form and perhaps in its name and chartering authority.

Liquidation usually involves the total elimination of the association, in that all of the assets are sold, all debts are paid and any surplus is distributed to the remaining stockholders because there will no longer be a legal entity to hold them. Since after a conversion the assets and liabilities of the association will continue in the same manner as prior to conversion, a conversion is not a true liquidation.

Fletcher, in his work on Corporations, draws a distinction between a reorganization and a dissolution stating that a reorganization is not generally considered a dissolution.23/ On the other hand, Section 10 was drafted nearly 20 years ago when mutual to stock conversions were very rare. At that time there were only three states which alowed stock associations. Thus, the failure to specifically list conversions in Section 10 does not demonstrate that the draftsmen intended to exclude this event from the operation of the distribution requirements. In addition, as is developed in Section B below, the Board in the past has treated conversions as dissolutions. Both a conversion and a dissolution involve a surrender of the institution's charter and some reorganizations involve dissolutions. Hence, the use of the term "dissolution" in Section 10 provides evidence that conversions involving Federal mutuals should be accomplished by way of pro rata distribution to the accountholders.

B. Prior Board Regulations and Procedures Concerning Conversions.

The legislation authorizing the conversion of Federal mutual associations to State chartered stock associations was passed in 1948. There was no discussion of the problem of distribution of ownership when a mutual converted to a stock association because, as noted above, there were only three States permitting stock associations at that time.

In the States that did permit stock associations, there were a number of associations which converted in the early 50's with the Board's approval. These associations, located in Texas, Colorado and California, converted, in some cases, by going into voluntary dissolution and transferring all the association's assets and liabilities to a newly formed state chartered stock association. Although there was a dissolution under the federal regulations, there was no distribution of surplus to the accountholders. Instead, the accountholders in federal mutuals were issued investment certificates in paid up amounts equal to the participation value of the share account in the federal and were given priority in subscribing for the stock to be issued in proportion to the withdrawable value of the shares of such members on the date the new by-laws and transition was approved by the members or some earlier date.

The association's reserves were typically transferred en masse to the new association to be kept as a reserve against losses. The early plans approved by the Board contained the requirement that the reserve funds would not be used for the payment of dividends to the stockholders of the new association. However, in the event of dissolution of the stock association, the stockholders would be entitled to what remained of the reserves after all expenses had been paid.

In the federal mutual cases, the Board required that the reserves be frozen for 10 to 15 years with the provision that they be distributed pro rata to the original mutual shareholders at the time of conversion in the event that the stock association was dissolved during that period. The original mutual shareholders were issued certificates evidencing their contingent interest in the reserve fund. This requirement became standard for all conversions as state supervisors insisted that protection be afforded mutual shareholders in state chartered mutuals similar to the federal requirements.

In 1955 the Board proposed regulations pertaining to the conversion process. The regulations required that accountholders receive, at cost, their pro rata share of the stock issued by the stock association. In 1957, the Board revised and republished its conversion regulations. The regulations required that the entire amount of the permanent stock to be issued be distributed, without payment, on a pro rata basis to all existing accountholders. Any shareholder who chose not to receive stock had to be paid in cash for his share.

In 1961, the Board adopted in final form the regulations proposed in December of 1955 and revised in February of 1957. These regulations, §546.5 of the Federal Regulations and §563.22-1 of the Insurance Regulations, are still in effect. The regulations provide that every accountholder of record shall be entitled to receive "the full equivalent in cash of the value of such shareholder's interest in the excess of the net worth of the mutual association over the withdrawal value of all accounts in such association". One conversion in Texas was processed under these regulations in 1963.

Regardless of the merits of these earlier regulations and procedures under State and Federal laws, it is clear that all of them attempted to distribute the value of the association to current accountholders, rather than to other groups of accountholders or to public authorities.

VII. Conclusions

The original conduct of mutual associations, the common law, charter and bylaw provisions, and Federal and State law and regulations have established, and continue to provide evidence of, an entitlement in the accountholders to share in a pro rata distribution of the ownership interest in a mutual association upon liquidation, dissolution and conversion. It should be clear from this memorandum that these sources have not described this entitlement fully and specifically in the case of conversions. Nevertheless, the entitlement is described with sufficient clarity, and the counter-arguments are sufficiently unpersuasive, that in my judgment the Board must adopt a set of conversion regulations which are based on it.

The argument has been raised that a law or regulation requiring the distribution of all or some of the value of the mutual association to the State, the FSLIC, a public trust fund or to any entity or person other than the most current feasible depositors would violate the Fifth Amendment's prohibition of taking property without just compensation. Thus, such a law or regulation could not be constitutionally enacted by the Congress or adopted by the Board.

In my view, this argument is valid, but within certain limits. If the Board adopts conversion regulations based on recognition of the aforementioned ownership, and if after sufficient practical experience it is reasonably determined that shifts of funds and other invidious side effects are not adequately controllable under conversion regulations based on such recognition, then I believe both the Board and the Congress could constitutionally modify or condition this interest. In other words, if it is proven that the ownership interest of current accountholders cannot as a practical matter be fully recognized consistent with the general welfare, then the interest may be modified or conditioned.

However, the practical test mentioned in the previous paragraph has not occurred. It is not sufficient in my judgment to base any modification of the ownership interest on a prediction that recognition of this interest will have results inconsistent with the general welfare. This is an interest that has existed and been fostered for over a century and a half in the country; it is a property interest, a type of interest for which the constitution is particularly solicitous; it is an enormous property interest, amounting to over a billion dollars; and it is held by millions of Americans. The case for modifying such an interest should, and in my view must, be based on hard, actual evidence, not on predictions. Moreover, I believe that any modification must be the minimum modification necessary to control the side effects which lead to the modification. Hence, I believe the Board and the Congress must proceed at least for the present on the basis that the accountholders alone own the mutual association, and are along entitled to a pro rata distribution of the value of a mutual association upon conversion to the stock form.

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Footnotes

1/ 12 U.S.C. § 1464 (i)

2/ 12 U.S.C. § 1724 et seq.

3/ § 593 Internal Revenue Code of 1954, as amended.

4/ The Bank Board and the Federal Savings and Loan Insurance Corporation (FSLIC) and state supervisory authorities control, in the chartering and insuring of savings and loan associations, the location of associations so that there are enough to serve each community and not an overcrowding in other areas.

5/ The capitalization requirements of a Federal association are found in 12 C.F.R. § 543.3.

6/ The trust fund approach was presented by the Institute for Public Interest Representation, Georgetown University Law Center at the public hearings on Conversion Regulations held on March 12 and 13, 1973. See transcript pages 217-238. A similar suggestion was made by the Council of Savings and Loan Stock Companies as follows:

"We propose under the plan that a mutual savings and loan association which is converting shall issue a debenture in an amount equivalent to the dollar amount of the net worth of the association. The debenture would be issued to a public corporation, the purpose of which would be to assist in providing housing for the elderly poor, or other poor. The debenture would have a term of 30 years and have an annual sinking fund which would provide the funds for public housing. The funds received by the public corporation would be distributed within the localities or states in which the association issuing the debenture was located. In this fashion the earnings of the association obtained in the community will be returned to the community." See transcript pages 185-217.

7/ The Friend Report, Summary of Conclusions and Recommendations, p. 37. The Friend study was commissioned by the Board in 1969 to perform a comprehensive analysis of the Home Loan Bank System.

8/ J. Sundheim, Law of Building and Loan Associations (3rd. Ed. 1933); Bodfish, History of Building and Loan in the United States (1931); H. Bellman, The Building Society Movement, (1927); Brigham and Pettit, Effects of Structure on Performance in the Savings and Loan Industry in Vol. 3, Study of the Savings and Loan Industry (1969).

9/ 12 C.F.R. § 544.1.

10/ 12 U.S.C. § 1726(b).

11/ 12 U.S.C. § 1425B.

12/ 12 C.F.R. § 526.

13/ Section 545.1-2(c) reads:

In the event of voluntary of involuntary liquidation, dissolution or winding up of the association . . . such savings deposits shall have the same right to share in the remaining assets of the association that they would have if they were such savings accounts.

14/ See generally Kreidler, Who Owns the Mutuals? Proposals for Reform of Membership Rights in Mutual Insurance and Banking Companies, 41 U. Cin. L. Rev. 275 (1972).

15/ Russell, Prather, Members and Their Right to Control, Legal Bulletin, January 1958. The citations in the rest of this section pertain to federally chartered mutual associations. There are similar provisions in state charters of mutual associations.

16/ 12 C.F.R. § 544.1

17/ 12 C.F.R. § 544.5.

18/ Section 11 of Charter N provides that no amendment, addition, alternation, change or repeal of the charter shall be made unless . . . [such] is submitted to and approved by the members at a legal meeting.

19/ 12 C.F.R. § 544.5.

20/ Section 10 of Charters N and K (rev.),12 C.F.R. § 544.1.

21/ However, there is distinction between a member of a mutual association and a stockholder in a stock corporation in that in a mutual savings and loan association the member's account may be redeemed by the association. Section 7 of federal charters N and K (rev.). Thus a member of a mutual association does not have complete control over his ownership interest as does a stockholder.

22/ See § 368(a)(1)(f) of the Internal Revenue Code concerning non-taxable reorganizations.

23/ 15 Fletcher, Cyclopedia of Corporations, ch 62.