Office of Thrift Supervision

Department of the Treasury

Business Transactions Division

Memorandum:

Mutual Savings Associations and Conversion to Stock Form

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May 1997

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I. SUMMARY

Recent efforts to reform the thrift and banking laws in order to enable depository institutions to compete most effectively with other financial service providers and within the boundaries of safety and soundness have included some limited discussion of the future of mutual savings associations. This paper attempts to illuminate this aspect of the banking reform debate by explaining the historical origins of the mutual associations and the policy judgments that are reflected in current government regulation of mutuals.

The activities and operations of a federal mutual savings association do not in principle differ from those of a federal stock association. Both are able to make residential real estate loans and a variety of other loans and investments, subject to the qualified thrift lender test and certain limitations set forth in section 5(c) of the Home Owners' Loan Act. What does distinguish a mutual from a stock thrift are its rules of governance, and what drives that distinction is the absence of specific, individual equityholders. A mutual has equity, of course, in the form of surplus generated by its earnings. This equity belongs to the depositors as a group, but is not divisible among them except in the event of dissolution.

For this reason, a mutual does not have the same disclosure and reporting obligations as a stock institution and is subject to a different kind of governance from a stock corporation. The indivisibility of a mutual's surplus means that a mutual's depositors do not have the same power (or expectations) as stockholders. (The presence of federal deposit insurance, of course, also removes a substantial portion of the risk that depositors otherwise might bear.) In place of the control otherwise exercised by stockholders, the government by regulation empowers depositors to assume a part of the oversight role and imposes tighter controls itself on a mutual's management.

This memorandum begins with a brief overview of the historical development of mutual savings institutions and the legal rights and roles that depositors have in such institutions. The memorandum also examines the historical development of the OTS mutual to stock conversion regulations and reviews the regulatory treatment of institutions in the period following conversions, particularly focusing on what protections are available to recently converted institutions against the threat of hostile takeovers. The memorandum concludes with a discussion of the relatively recent rise of mutual holding companies.

II. HISTORICAL DEVELOPMENT OF MUTUALS

Mutual savings associations can trace their origins back well over 150 years, and they developed under state law for nearly a century before the federal mutual charter was created in 1933. The federal charter has remained relatively unchanged since that time.

A. Evolution of State Mutual Associations

Although the concept of mutuality has come to be viewed in opposition to stock ownership, the earliest mutual institutions were organized principally as stock organizations. The first mutual building and loan association in the United States was the Oxford Provident Building Association of Philadelphia County, established in 1831. Modeled after the building societies of England, Oxford was capitalized through the subscription for shares by members of the local community. In at least six respects, the structure and operation of Oxford distinguished it (and other early building associations) from what we now understand to be the mechanisms by which stock corporations are run.

First, Oxford was organized according to what we might call a concept of complete mutuality. The success of the institution depended solely on the creditworthiness of the investors. The groups of investors and borrowers were identical. In order to be a borrower one had to have subscribed for shares, and every subscriber had to take out a loan during the ten-year life of the institution. The order in which subscribers could take out loans was determined by an auction process; the subscriber willing to pay the highest premium would have one of the first loans. Thus a subscriber would be involved in four different transfers of funds: regular payments of principal and interest on the loan; monthly installment payments on the subscription; the receipt of a semi-annual dividend; and the right to receive the par value of the stock when the institution terminated.

Second, shares were not prepaid. In the case of Oxford, each subscriber was required to pay an initiation fee of $5 for each share, plus monthly payments of $3. (A subscriber was limited to a maximum of three shares.) The par value of each share was $500, meaning that at the end of the ten-year period, each subscriber would receive $500, for which he had paid $365 in nominal dollars over a ten-year period, in addition to the interest on his loan. The fact of monthly subscription payments is a corollary of the complete mutuality of the institution. Since the community of borrowers was limited to the subscribers, the institution had at any one time only a limited need for funds. Had subscriptions been prepaid, then an institution would have found itself with more funds than it could put to use under its charter.

Third, the institution's only sources of funds were the subscription payments that all subscribers made, plus whatever payments

of principal and interest were made by the borrowers at any one time. As with installment payments, this fact follows from a completely mutual association. No deposits or other forms of credit were accepted by the institution. Since shares were not prepaid, the system of monthly installment payments ensured a steady flow of funds. A subscriber who failed to stay current in subscription payments would forfeit his interest.

Fourth, as a result of the one-time issuance of shares and the installment payment system, the shares in Oxford and the other early mutual institutions were extremely illiquid. The shares did not trade on any exchange or other forum open to the public, and even if they had, the installment payment system would have made pricing very difficult. All subscriptions had to be taken when the institution first organized; the institutions did not make later offerings. The only liquidity existed in the fact that a person seeking credit after a mutual had been organized could negotiate with a subscriber to take over the installment payments and the borrowing right.

Fifth, the life of the institution was fixed, terminating, in Oxford's case, after ten years. The fixed term nature of Oxford and other early mutuals also flowed from the fact of complete mutuality -- at some point all investors would have received all the credit they desired, and thus there was no further economic need for that particular institution. This feature caused Oxford and similar institutions to become known as "terminating plans."

Sixth, Oxford and similar institutions had no formal calculation of capital. All funds paid to the institution constituted capital, since the distribution of all of those funds to subscribers on the date of termination depended on the success of the institution. Capital could vary widely,

growing as borrowers repaid their loans and diminishing as an institution paid out dividends or made additional loans to subscribers.

The century-long history of mutual building and loan associations, from the establishment of Oxford Provident in 1831 to the creation of the federal mutual charter in 1933, is perhaps best understood as the disappearance of these six distinguishing features in response to market forces. What remained, however, was a concept of mutuality in the ownership of the institution. All subscribers (later, either shareholders or depositors) owned the net worth of the association, but no individual could liquidate or sell that interest alone.

The first of the distinguishing Oxford features to disappear was the limited lifespan of the building and loan and the corresponding one-time nature of such an institution – and with this change came a departure from the complete mutuality embodied in Oxford Provident and other institutions. By the 1850s, Oxford and many other associations throughout the country were issuing several series of shares at stated intervals. As with the termination plan, each series had a fixed maturity date, and all subscriptions had to be made at the outset of a particular series, but missing the subscription to one series did not now mean that a borrower was foreclosed from later subscribing with the institution. In one sense, this development, known as the serial plan, meant that subscribers to any one series constituted their own smaller institution within the larger association. The significance of the serial plan, however, was that no longer were all subscribers completely dependent on all borrowers.

The next widespread development occurred in the late 1870s, with the disappearance of any interval between subscriptions for shares.[1] Under what is known as the "permanent plan" a person could at any time subscribe for the shares of a building and loan association. The books on each subscription, its maturity date, and installment payment obligations were kept separately.

A variation of this structure was the "Dayton plan," which emerged in the 1880s and eventually became the model for the federal mutual charter. The Dayton plan departed in several respects from the restrictions in the first Oxford Provident organization. A Dayton plan institution was able to obtain funds more broadly than other building and loan associations because it permitted subscribers to prepay their shares and to make payments on their subscriptions at any time and in any amount. Further, a Dayton plan institution accepted deposits that, unlike subscriptions, did not carry with them a borrowing obligation. In addition, to the extent a subscription served a purpose as an investment vehicle, the Dayton plan strengthened that feature by allowing withdrawals without substantial penalties. Dayton Plan members were no longer committed to systematic payments on shares, but instead were free to subscribe for shares upon which payments of dues could be made at any time and in any amount. Members were also generally permitted to withdraw, after reasonable notice, the full amount of their deposits and any dividends due as of the withdrawal date. It was during this period that mutual institutions began to establish reserves for losses. Under this system, a portion of the

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[1] Building and loan associations in South Carolina appear to have operated as permanent plans since the 1840s, but the concept did not spread elsewhere until 30 years later. *See* H. Morton Bodfish, *History of Building and Loan in the United States* 93-97 (1931).

earnings would be set aside until the reserves would reach a specified percentage of assets, typically 5%, with the balance being paid as dividends on the shares.

By the turn of the century, the fundamental principle of the modern mutual was in place: that the net worth of the association belonged to the depositors or shareholders as a whole, but they were unable individually to exercise the rights of equityholders. This principle was borne out in several late nineteenth century decisions governing the rights of depositors in the event of dissolution.

In 1877, the Supreme Court recognized the ownership rights of mutual members in the surplus of a mutual institution in *Huntington* v. *Savings Bank*:[2]

> [T]he 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.[3]

A Rhode Island court came to a similar conclusion in a case[4] decided thirteen years after the *Huntington* decision. The Rhode Island 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 the time of distribution to) the depositors and not to the bank. The court stated that:

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[2] 96 U.S. 388 (1877).

[3] *Id*. at 389.

[4] *Mechanics' Savings Bank* v. *Granger*, 20 A. 202 (1890).

> the 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. 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 in 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.[5]

This recognition that a depositor could not withdraw a portion of the mutual savings bank's reserve was mirrored in other cases, whose holdings reaffirm that the assets earned by a mutual (in more modern terms, its net worth) belong to depositors as a group. The issue in those cases was whether depositors who had withdrawn their accounts before dissolution still had a right to share in the institution's surplus. The courts concluded that they did not, in part relying, as the *Huntington* court had, on the protective purpose that the surplus or reserve served for all depositors. For example, the court in *Morristown Institution for Savings* v. *Roberts*,[6] explained:

> 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

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[5] 20. A. at 203.

[6] 8 A. 315 (1887).

> 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...
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> [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....[7]

Another New Jersey court later followed this reasoning, although it pointed out what now would be characterized as a free-rider problem: the possibility that speculators would make deposits shortly before dissolution, thus allowing them to share the surplus on the same basis as the other depositors whose longer term accounts actually helped build the surplus.[8] The court said:

> 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 ... 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 of the depositors for the beginning of the bank. It is well known that many of those have already withdrawn and thereby, as it has been well

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[7] *Id.* at 317.

[8] 54 A. 543 (1903).

> 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.... 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.[9]

An Ohio court expressed similar concerns in *In re Cleveland Savings Society* in 1961, [10] but adhered to the depositors-only rule that had been enunciated in *Morristown*. In so doing, it rejected a proposal to factor the length of time funds had been on deposit in determining a depositor's share of the surplus.[11] Four years later, another Ohio court approved a distribution plan based upon the principles set forth in the *Cleveland Savings Society* case.[12] In this case, *Springfield Savings*, however, the court also upheld a provision in the distribution plan that provided for an earlier cut-off date applicable only to depositors who had inside knowledge of the possibility of dissolution. The court found that the deposits were made for the sole purpose of speculating upon the possibility of

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[9] *Id*. at 435.

[10] 192 N.E. 2d 518 (1961).

[11] *Id*.

[12] *In re Springfield Savings Society*, 230 N.E.2d 139 (Ohio 1965).

participating in the surplus and were not made in the ordinary course of business.[13]

The concern about late depositors unfairly sharing in the surplus has not been significantly realized because few mutuals now dissolve, but there is a related concern about late depositors participating in a mutual-to-stock conversion offering. The OTS regulations attempt to deal with this issue by requiring converting institutions to establish a cut-off date for participation and by permitting converting institutions to establish a local depositor preference.[14]

B. The Federal Mutual Charter

Although there were slight refinements to the mutual structure in the first three decades of the twentieth century, the next major development was the enactment of the Home Owners' Loan Act in 1933 ("HOLA").[15] With the adoption of HOLA, Congress authorized the newly created Federal Home Loan Bank Board ("FHLBB") to charter federal mutual savings and loan associations to expand the best practices of mutual savings associations to areas not adequately served by state-chartered institutions. Since almost all savings institutions were mutual institutions at that time, Congress chose to follow that historical tradition and authorized only mutual savings association charters.

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[13] *Id*. at 150. *See also Federal Home Loan Bank Board* v. *Elliott*, 386 F.2d 42 (9th Cir. 1967) (upholding FHLBB decision to disallow certain depositors from participate in receiving any benefits from a merger of a mutual into a stock because the deposits were made on the basis of insider knowledge).

[14] *See* 12 C.F.R. § 563b.3(d)(12) (local depositor preference), .3(e) (eligibility record date).

[15] Act of June 13, 1933, ch. 64, § 1, 48. Stat. 128.

In drafting the charter, the FHLBB followed the mutuality principle embodied in the Dayton plan. The new federal charter was clear that a mutual member had the right to share in the assets of the savings association upon dissolution or liquidation. Specifically, section 8 of the federal mutual charter provided that "holders of accounts of the association shall be entitled to equal distribution of assets, pro rata to the value of their accounts, in the event of voluntary or involuntary liquidation, dissolution, or winding up of the association."

The original federal regulations, including the form of the federal charter, Charter E, had many other features of the Dayton Plan.[16] The initial capitalization of these institutions typically consisted of pledged accounts established by the organizers. A federal mutual would fund itself through share accounts, which could be opened or closed at any time, as in the Dayton plan. Today we would recognize the share accounts essentially as deposit accounts (although not necessarily immediately payable on demand) that were insured by the Federal Savings and Loan Insurance Corporation.

In 1936, the FHLBB changed the form of the charter to eliminate some of the confusing terminology derived from the state models. The new federal charter, Charter K, provided for only two types of savings accounts and provided for greater operating flexibility. Federal mutual associations currently may raise capital in the form of savings deposits or other accounts for fixed, minimum or indefinite periods of time as authorized by its charter or OTS regulations and may issue passbooks, time certificates of deposits, negotiable order of withdrawal accounts and

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[16] L. Kendall, *The Savings and Loan Business: Its Purposes, Functions and Economic Justification* 23 (1962).

other accounts as authorized. Unlike the early charters, only holders of savings accounts, but not borrowers, are voting members of the mutual association under the current charter.

C. Rights of Accountholders Under the Mutual Charter

The federal mutual charter grants certain rights to mutual members, which gives them some control over the affairs of the institution. The ability to exercise control over a mutual savings institution by its members, however, is not coextensive with the rights of stockholders of ordinary corporations, although there are similarities. The members of a federal mutual savings institution have the right to vote, the right to amend the bylaws, the right to nominate and elect directors, the right to remove directors for cause, the right to request special meetings, the right to communicate with other members, the right to inspect the corporate books and records, and the right to share pro rata in the assets of the association following liquidation.[17]

In enacting HOLA, however, Congress has generally left to the OTS (or its predecessor, the FHLBB) the authority to determine when a mutual institution's members have voting rights. Except for provisions relating to the conversion of a federal mutual to stock form,[18] there is no statutory requirement that federal mutual institutions' members have voting rights. Although the charter of a federal mutual savings institution does grant such rights, it does not specify that all significant corporate

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[17] Members of state mutual savings banks do not necessarily have the same range of rights as members of federal mutuals.

[18] 12 U.S.C. § 1464(i)(3). Such depositor votes may not be required in conversions under certain state laws governing conversions of state savings banks.

transactions be approved by a vote of its members. In the case of a merger with another savings institution, for example, approval of a mutual institution's members is not required unless the OTS specifically requires a vote in connection with its review of the merger transaction.[19] Dissolution of a federal mutual does require a vote of the members.[20]

Despite these rights of the members, these institutions are for all practical purposes controlled by the management of the institution.[21] This is so at least in part because depositors do not have the same incentives as stockholders. Deposit insurance provides protection against loss, a protection stockholders do not have. As for capital gains, depositors do not have individual claims to the accumulation of net worth in a stock institution the way that stockholders do.

An important custom that perpetuates management control is the use of perpetual proxies that accountholders typically grant to management at the time they open a savings account. The OTS regulations permit a mutual institution's management to solicit proxies that are of unlimited

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[19] 12 C.F.R. § 546.2(e) (1995).

[20] 12 C.F.R. § 546.4.

[21] As one critic of the mutual structure noted:

> The growth of the typical association, the separation of savings membership from borrower membership and the emergence of a new group of professional managers altered the original conception of a mutually "owned" and mutually "managed" association. Mutuality has no more meaning for savers and borrowers than has the theological concept of "justification by works" for contemporary church members. Mutuality is now a euphemism designed to serve as the first line of defense for an entrenched management group....

A. Nichols, *Management and Control in the Mutual Savings and Loan Association* 75 (1972).

duration.[22] These are commonly referred to as "running proxies." Proxies that are for a period of more than eleven months or are solicited at the institution's expense go to the board of directors or a committee appointed by the board of directors.[23] The use of these proxies, coupled with the management's control over meetings of a mutual savings institution, attenuates the influence that depositors may have.

Other features of the mutual corporate governance structure that influence management's ability to control the affairs of a mutual association include the large number of voting members, the limitation on voting rights in the charter, stringent limitations on communication among members, and the absence of any requirement for a minimum number of members to establish a quorum. The federal mutual charter, for example, limits the number of votes that any member may have to 1,000.[24]

D. Accountholder Rights Under Tax Law

The U.S. Supreme Court has recognized the limited power of the accountholders of a mutual in two tax law cases. In *Society for Savings* v. *Bowers*,[25] the Court was faced with the issue of whether a depositor received taxable income as the result of the accumulation of surplus in a

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[22] *See* 12 C.F.R. Part 569 (1995).

[23] 12 C.F.R. § 569.3 (1996). This provision was added to prevent the practice of individual management members exercising control of a mutual savings association or in some instances, transferring control of a mutual association to third parties for cash payments. *See, e.g., Beverly Hills Federal Savings and Loan Association* v. *Federal Home Loan Bank Board*, 371 F. Supp. 306 (C.D. Cal. 1973).

[24] 12 C.F.R § 544.1 (1996). Section 6 of the model federal mutual charter states: "each holder of an account shall be entitled to cast one vote for each $100 ...of the withdrawal value of the member's account;" and "[n]o member, however, shall cast more than 1,000 votes."

[25] 349 U.S. 143 (1955).

mutual savings institution. The Court held that the savings association's accumulated surplus, for purposes of federal taxation, was taxable as property of the savings association and not of the depositors. In reaching its decision, the Court stated:

> [One] might not have expected the legislature to tax the ownership interests of the depositors of these banks on the same basis as stockholders are taxed. 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. If he continues, his only chance of getting anything more would be in the unlikely event of a solvent liquidation, a possibility that hardly rises to the level of an expectancy. It stretches the imagination very far to attribute any real value to such a remote contingency, and when coupled with the fact that it represents nothing which the depositors can readily transfer, any theoretical value reduces almost to the vanishing point.[26]

Thus, the Court recognized that the only taxable interest belonging to any individual depositor in a mutual thrift was the deposit account and interest paid on it. The right to receive a share of the surplus in the event of liquidation is only a contingent one, and until a distribution is made, no taxable event has occurred.

A corollary of the non-taxability of a depositor's contingent interest would be that the conversion of a tangible economic interest into a contingent interest would be a taxable event, and that is in effect what the

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[26] *Id.* at 149-50.

Supreme Court held in *Paulsen* v. *Commissioner*.[27] Specifically, the Court concluded that depositors' interests in surplus of an ongoing mutual are too insubstantial to satisfy the continuity of ownership interest test for purposes of the reorganization provisions of the Internal Revenue Code.[28] When a state-chartered stock savings institution merged into a federally chartered mutual savings association, the plaintiff's exchange of stock in the state stock association for certificates of deposit and savings accounts, representing "share interests" in the federal mutual thrift, was not a tax-free exchange of equity securities, but rather a taxable gain on the sale of securities.

E. Depositor Rights to Distribution in a Conversion

Although the relevant case law generally stands for the proposition that mutual accountholders have a right to receive their pro rata share of the association's surplus upon dissolution or liquidation, a more difficult question faced by the courts was whether a mutual to stock conversion constitutes a dissolution or liquidation such that accountholders

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[27] 469 U.S. 131 (1985).

[28] 26 U.S.C. §§ 354(a)(1), 368(a)(1)(A). In its analysis, the Supreme Court stated that the debt characteristics of the association's deposit accounts (*i.e.*, the savings accounts and certificates of deposit were not subordinated to creditors' claims, the deposits were not considered permanent contributions to capital, the depositors had the right to withdraw the face amounts of their deposits in cash, and in practice the savings association paid a fixed, established rate on its accounts) greatly outweighed the equity characteristics (*i.e.*, the deposits accounts were the only ownership interests in the association, the shareholders had the right to vote, and the account holders were entitled to a pro rata distribution of the savings association's assets in the event of a solvent dissolution or liquidation). Thus, the Court found that the mere maintenance of a deposit in a mutual savings association should not be considered as the equivalent of owning an equity interest in a stock corporation. Instead, the Supreme Court's position, at least in the context of tax issues, is that a depositor's relationship to a mutual savings institution is essentially that of a creditor.

would be entitled to receive a distribution of the converting association's accumulated surplus when the thrift converts.

In 1973, the New Hampshire Supreme Court was one of the first courts to address this issue. In *In re City Savings Bank of Berlin and Berlin City National Bank*,[29] the court held dissenting depositors in a mutual-to-stock merger conversion were not entitled under the due process clause of the Fourteenth Amendment to a right of appraisal or a cash payment option for their share of the bank's surplus. The court concluded that to hold otherwise would provide depositors with a "windfall" which is "something they neither earned or bargained for", also noting in this regard that "[h]aving no voice in the management of the affairs of the bank, a depositor today in a mutual savings bank is an ‘owner’ of the bank and its surplus more in theory than in reality; in most respects his ‘ownership’ is only a technical fiction."[30] The court also made the observation, by quoting with approval the banking commissioner's conclusion that "[i]f the owner-depositor is given and exercises the option of taking of cash and depleting the surplus it would, as a practical matter, render the plan ineffective."[31]

In the first case to challenge the then newly-adopted conversion regulations of the FHLBB, *York* v. *Federal Home Loan Bank Board*,[32]

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[29] 309 A. 2d 31 (1973).

[30] *Id*. at 32, *citing* Kreider, *Who Owns the Mutuals? Proposals for Reform of Membership Rights in Mutual Insurance and Banking Companies*, 41 U. Cin. L. Rev. 275, 276 (1972).

[31] *Id*. at 33.

[32] 624 F.2d 495 (1980).

depositors in a federal mutual savings association challenged the authority of the FHLBB to approve their institution's plan to convert to stock form under the FHLBB's conversion regulations. The plaintiff argued that the proposed conversion would deprive the depositors of their property rights in the association while providing windfalls to those purchasing conversion stock. The court rejected these arguments and found that:

> [a]lthough the depositors are the legal "owners" of a mutual savings and loan association, their interest is essentially that of creditors of the association and only secondarily as equity owners. Depositors' rights are circumscribed by statute and regulation. They are not allowed to realize or share in profits of the association, but are entitled only to an established rate of interest. [At the time of this decision, federal savings institutions were uniformly limited by Regulation Q on the amount of interest they could pay on deposits.] The depositors do not share in the risk of loss since their deposits are federally insured and their only opportunity to realize a gain of any kind would be in the event the savings and loan association dissolved or liquidated.... In fact federal regulations prohibit savings and loans from dissolving without [FHLBB] approval, and no solvent association has ever secured approval for dissolution. Thus, it is apparent that depositors will not be deprived of property rights by conversion to a federal stock organization. Depositors' only actual rights, their rights as creditors, will remain unchanged by the conversion.[33]

The view that mutual accountholders are not entitled to any form of compensation upon the conversion of a mutual savings institution was also upheld in *Goldberg* v. *Philadelphia Savings Fund Society*,[34] where the court opined that:

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[33] *Id*. at 499-500. *See also Lovell* v. *One Bancorp*, 818 F. Supp. (D.Me. 1993), *aff'd*, No. 93-1553, 1994 U.S. App. LEXIS 178, (1st Cir. Jan. 7, 1994).

[34] 9 Phila. 459 (Pa. Ct. Com. Pl. 1983).

> Plaintiffs will simply suffer no legally cognizable deprivation as a result of the proposed conversion. The fundamental rights of the depositors as creditors of this institution ... will, in reality, be unchanged by the approved plan of conversion. Any effort to equate the proposed conversion to a liquidation (in which case a different result might obtain) is, therefore, unrealistic.[35]

The *Goldberg* court also commented on the negative practical effects of an opposite result, noting that "to compel ... some form payment or compensation to the depositors for their alleged 'ownership' interest in the surplus accumulated would ... frustrate and thwart the legislative intent [of recapitalizing the industry] in permitting such a conversion in the first place."[36]

The New Hampshire Supreme Court, however, reached a different conclusion in *Appeal of Concerned Corporators of the Portsmouth Savings Bank*.[37] In that case, the plaintiffs objected to their savings bank engaging in a merger conversion transaction instead of a standard conversion. The court found that the trustees of the bank, in approving the plan of merger conversion, had violated their fiduciary duties to the depositors of the savings bank arising from the provisions of the savings bank's charter even though the plan of conversion provided for a liquidation account. However, the court's decision was based primarily upon the fact that the depositors' rights in this transaction were specifically

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[35] *Id*. at 463.

[36] *Id*.

[37] 525 A.2d 671 (N.H. 1987).

provided for in the savings bank's charter,[38] a special charter granted by the state legislature in 1823. Since charters of most savings institutions, including those of federal mutual institutions, do not have the unique provisions of the New Hampshire savings bank's charter, the *Portsmouth* decision is of limited precedential value.

III. MUTUAL-TO-STOCK CONVERSIONS

With the adoption of HOLA, Congress authorized the newly created FHLBB to charter federal mutual savings and loan associations. Since almost all savings institutions were mutual institutions in 1933, Congress authorized federal savings association charters only in the mutual form. The only “conversion” provision in the original HOLA addressed the conversion of a state-chartered thrift institution into a federal mutual association. In 1948, Section 5(i) of HOLA was added to permit federal associations to convert to a state charter.[39] This amendment included authority to convert to a state stock charter but required that a stock conversion be on an equitable basis and subject to approval by the FHLBB and the Federal Savings and Loan Insurance Corporation ("FSLIC").[40]

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[38] The specific provision of the charter that the court relied upon provided that "the net income and profits of all deposits of money received by said corporation <u>shall</u> be paid out and distributed in just proportions... [to the depositors]" (emphasis added).

[39] Act of July 3, 1948, ch. 825, § 1, 62 Stat. 1239. *See generally Hearings on H.R. 2798, H.R. 2799, and H.R. 2800 Before the Comm. on Banking and Currency*, 80th Cong., 1st Sess. (1947)

[40] As of 1948, only three states authorized stock charters.

Congress did not first authorize a federal stock charter (or a conversion to that charter) until 1974.[41]

A. Moratoriums

The FHLBB imposed a moratorium on mutual-to-stock conversions in 1955 because the rules governing such transactions varied from state to state and, in a number of cases, appeared to favor management at the expense of the depositors.[42] The FHLBB issued proposed regulations in 1955 and 1957 and a final regulation[43] governing federal mutual-to-stock conversions in 1961. A similar regulation governing state-chartered associations was adopted in 1962.

These regulations were based on the "free distribution" model and provided that every accountholder of record 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. Beginning in December 1963, however, the FHLBB imposed a second moratorium on conversions amid concerns that, on the one hand, mutual associations were interpreting the "free distribution" method differently and that, on the other hand, this method created an incentive for speculators to open deposit accounts at multiple institutions in the hope of cashing in on a free-distribution conversion. The FHLBB

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[41] See Pub. L. No. 93-495, § 105(d), 88 Stat. 1500, 1504 (1974).

[42] The FHLBB did this by issuing a letter to all of the Federal Home Loan Bank Presidents. See Minutes of meeting of the FHLBB (June 23, 1955). This moratorium was applicable to both federal and state chartered associations. This was the first instance that the FHLBB attempted to regulate mutual-to-stock conversions of state-chartered associations.

[43] 12 C.F.R. § 546.5 (1962).

stated that "[a] study of the [conversion] issue is needed if the relevant policy questions are to be properly evaluated, justifiable and reasonable criteria are to be uniformly applied, and appropriate procedures are to be consistently followed."[44]

During the following decade, the FHLBB commissioned three major studies of the conversion process. As a result of these studies, it became clear that there were serious weaknesses in the prior conversions that needed to be addressed before additional conversions were permitted. As stated in one report,[45] these concerns included the fact that (i) depositors were not given adequate information about the conversion plan, (ii) a control group of the mutual institution (usually management and its affiliates) initiated the conversion and was able to appropriate a large part of the value of the converting association for the group, and (iii) conversion plans often were initiated by marginally profitable institutions and thus converted savings institutions had a relatively high rate of failure.

In 1971, the FHLBB accepted a test case to further study the conversion process. A conversion application was approved, and the federal association involved converted to a state-chartered stock institution. In September 1972, the FHLBB announced that it intended to terminate the moratorium upon the adoption of final conversion regulations. Proposed regulations were issued in January 1973.[46] These regulations provided for a pro rata free distribution of the conversion stock or a cash equivalent to

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44 Minutes of meeting of the FHLBB (Dec. 5, 1963).

45 See Herman, Conflict of Interest in the Savings and Loan Industry, in II Irwin Friend, *Study of the Savings and Loan Industry* 798-801 (1969).

46 38 F.R. 1334 (1973).

the mutual accountholders. The FHLBB held public hearings on these regulations while Congress was also holding hearings on the need for legislation in this area. In August 1973, Congress, acting out of concern that additional time was needed to address potential abuses in mutual to stock conversions, imposed a statutory moratorium on conversions until June 30, 1974.[47]

There were a number of objections to the free distribution method. First, it was criticized for being unfair and arbitrary because long-time depositors who withdrew funds on the day before the record or eligibility date of the conversion date got nothing. By contrast, depositors who deposited money on that day would receive the same benefits as non-withdrawing, long-time depositors. Moreover, there was evidence that these types of depositors, sometimes referred to as "free riders", were often acting on the basis of tips from insiders.

Another criticism was that these types of conversions would likely result in significant shifts of funds by depositors to those associations that were seen as likely to convert. In addition, there was substantial concern expressed by the directors and management of existing mutuals that they would be forced to convert because of the substantial profits that could be made by the depositors. It was also alleged that the process could be manipulated by management and their affiliates and that most of the profits would accrue to these insiders. It was also apparent that conversions with free distribution of stock would not result in additional capital being raised by the industry and that there would be no benefit to the housing finance market. Finally, there were technical concerns that this

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[47] Act of Aug. 16, 1973, Pub. L. No. 93-100, § 4, 87 Stat. 343.

method of conversion might result in a taxable event to the converting association.

B. Basis for Current Regulations

As a result of the FHLBB and Congressional hearings, the FHLBB proposed a new set of conversion regulations in November of 1973.[48] The new regulations, in response to the criticism of the free distribution plan embodied in the earlier proposal, provided for the sale of stock of the converting institution at a price equal to its pro forma market value as determined by an independent appraisal.

In adopting final regulations in 1974,[49] the FHLBB made a number of specific findings and, in summary, found that any method of conversion that provided for a "windfall" distribution to the accountholders would create strong incentives for unacceptable shifts of funds among savings associations and other financial institutions and would tend to force mutual associations to convert irrespective of whether such institutions or the communities they serve would be benefited by such conversion. As a result, the FHLBB found that no method of conversion could be considered equitable unless such "windfall" distribution is virtually eliminated. In the FHLBB's view, the only viable method of avoiding the "windfall" distribution was to provide for a sale of stock based on a market value appraisal.

The 1974 regulations, as subsequently amended during the next five years, implemented a number of requirements that have remained a

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[48] 38 F.R. 34060 (1973).

[49] 39 F.R. 9142 (1974).

core part of the current conversion process. The regulations required that: (i) the stock be sold at its appraised fair market value, not given away; (ii) the depositors' rights to share in the net worth of a mutual institution in the event of a liquidation or dissolution be preserved by the establishment of a liquidation account; (iii) depositors be given nontransferable subscription rights to subscribe for the stock on a priority basis; (iv) depositors be given adequate information about the conversion and ongoing information about the institution's operations for a minimum period of three years after the conversion; (v) depositors approve the plan of conversion by a majority of the votes eligible to be cast and revocable proxies must be solicited by the converting institution; (vi) limits be established on the number of shares that can be acquired by any person or group and that adequate restrictions be in place to prevent any person or group, including insiders, from acquiring control of the converting institution; (vii) dividends and other distributions with respect to the stock be limited and subject to regulatory oversight; and (viii) conversions occur as a tax-free reorganization

The 1974 regulations were still subject to criticism by members of Congress and others. Many continued to believe that management and other insiders would be able to manipulate the process and garner "windfall" profits for themselves. As Senator Proxmire noted, the 1974 regulations did not set any explicit limits on the amount of stock that management could buy and there were continuing concerns that the appraisal process would be manipulated to set an artificially low price for the conversion stock. In addition, there were concerns that arose about the vulnerability of converting institutions to hostile takeover attempts. The

conversion regulations were amended in 1976 and 1979 to address these concerns.[50]

In 1979, the FHLBB sought to encourage further participation by accountholders and limit management purchases. As was noted by the FHLBB when it adopted the amendments, management of converting associations had purchased on average 34% of the total stock sold, although this percentage was considerably higher in some cases. To address this issue, and to encourage a broad base of participation in the conversion, the FHLBB adopted a number of amendments. First, management purchases were limited to 25% in the aggregate[51] and management was no longer permitted to sell unsubscribed shares by utilizing a private placement. In addition, management was restricted from selling any shares purchased in the conversion for a period of three years. The amendments also made changes to the subscription procedures to increase the amount of shares that account holders could purchase in the subscription offering. Finally, the amendments provided for an overall purchase limitation of 5% for any person in the conversion.

C. Federal Deposit Insurance Corporation Concerns

In 1994 the Federal Deposit Insurance Corporation ("FDIC") adopted regulations to govern mutual-to-stock conversions of state chartered nonmember savings bank in a manner substantially consistent with the OTS' regulations. As part of the process, however, the FDIC issued a request for comments on the conversion process and identified

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[50] The 1976 amendments are discussed in Section IV *infra.*

[51] This was later increased up to 35% for smaller converting institutions.

certain problems that the FDIC perceived were inherent in the OTS conversion program.

The FDIC stated that the appraisal process was fundamentally flawed and that conversions inevitably resulted in significant gains in the first few days of trading in a converting institution's stock.[52] In the view of the FDIC, this resulted in significant value being transferred to insiders and other sophisticated investors at the expense of the nonparticipating depositors.[53] The release also stated the FDIC believes that "it may be difficult for a healthy mutual to develop a sound business plan while raising enough new capital to receive a valid appraisal."[54] The FDIC also expressed concerns that the conversion appraisal process would cause institutions to raise more capital than a converting institution needs.

OTS shared these concerns about the appraisal process as it saw median first-day price increases on conversions at 25-30%, when those for initial public offerings of non-depository companies were on the order of 15%. As a result of the significant increases in the latter part of 1992 and 1993, the OTS staff met with the firms that perform the large majority of appraisals and advised them of the OTS' concerns about appraisal prices. In addition, the OTS issued revised appraisal guidelines. As a result of these actions, initial price increases in conversion stocks have declined in 1995 and 1996. Over the last six months, the median first day price increase has been under 15%. In many instances, the price increase has

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[52] 59 F.R. 30357, 30358-59 (June 13, 1994).

[53] The release notes that the average first day increase or "pop" was 26% during 1992 and 1993. *Id.* at 30358.

[54] *Id.* at 30359.

been less than 5% and in a couple of cases, the conversion stock has declined below its initial offering price. Although it is arguable that price increases of 10-15% result in a windfall to the purchasers, this is more attributable to the typical pricing strategy that occurs for all initial public offerings.

The FDIC's second concern, that the conversion process causes institutions to raise too much capital, is more controversial. Conversions are subject to the disclosure requirements of the securities laws, and an important and material fact that is disclosed is the range of shares to be issued in the offering. Investors thus know how much capital the association is likely to raise in the offering and, by choosing to participate, these investors presumably have determined that they are not investing in an inefficient enterprise. The "too much capital" argument has meant, instead, that the earnings of the institution, allocated to its new capital, produces an earnings-per-share ratio that compares unfavorably to that of other companies. OTS does not regard this as a fundamental safety and soundness problem but has attempted to address the issue to some extent by requiring a three-year business plan.

The FDIC also raised a question about whether it is appropriate to cause institutions to raise a large amount of capital that is not used efficiently by the institution. While it is possible for this to occur, it is the marketplace that ultimately determines whether a particular offering has value and investors make investments based on perceived returns. There does not appear to be any evidence that recently converted institutions with high levels of capital pose any greater supervisory risk than other institutions. A mutual institution has the option to reorganize as a mutual

holding company, which permits an institution to raise and deploy capital in incremental steps.[55]

IV. POST-CONVERSION REGULATION

From the earliest days of the conversion program, it has been recognized that recently converted savings institutions are particularly vulnerable to takeover attempts because of the amount of time it takes to effectively deploy the capital raised in the conversion. It also take some time for the institution's management to adjust to being a stock institution and the new pressures that come from being accountable to shareholders and the marketplace. In addition, as the FHLBB gained more experience with the conversion program, it became clear that mutual managers would be reluctant to convert to stock form unless there was some assurance that they would be protected from hostile takeover attempts for a period of time following the conversion.

A. Anti-takeover Provisions

The 1974 Regulations reflected the FHLBB's concerns about takeover attempts. Section 563b.3(i) stated that the "[FHLBB] finds that the new capital to be received by converted insured institutions will cause such institutions ... to be specially vulnerable to attempts by other companies to acquire control of such insured institutions." The 1974 Regulations prohibited acquisitions of a converted institution by a company

[55] In the mutual holding company structure, the savings association becomes a stock company, but more than 50% of its stock is owned by a holding company that in turn is owned by the accountholders of the former mutual. A minority of the stock of the thrift may be issued to other investors. Mutual holding company reorganizations are covered by 12 C.F.R. part 575.

engaged in an unrelated business for a period of three years and permitted a converting institution to adopt a similar prohibition as part of its charter.

The conversion regulations were amended in 1976 (adopted as temporary and made final in 1977)[56] as a result of perceived abuses in some of the initial conversions. The FHLBB stated that the regulations were being adopted to clarify the existing regulations, protect the integrity of the conversion process, and lessen the vulnerability of newly converted associations to hostile takeover attempts. In one instance, individuals who were not accountholders were purchasing subscription rights or entering into agreements with subscribers to immediately acquire their stock following conversion. In the other case, a group announced a tender offer during the subscription offering, which resulted in a massive oversubscription by the accountholders.

As a result of these and other abuses, the conversion regulations were amended to prohibit any offers to acquire subscription rights or the underlying conversion stock during the pendency of the conversion and to limit to 10 percent the amount of stock that any person could acquire without prior approval for a period of three years following the conversion.[57] This prohibition was applicable to both individuals, companies and persons acting in concert.[58] The FHLBB indicated that in

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[56] 41 F.R. 50414 (1976); 42 F.R. 14085 (1977).

[57] *See* 12 C.F.R. § 563b.3(i).

[58] *See* 12 C.F.R. § 563b.3(i)(3). In 1986, the FHLBB added a provision that a person is deemed to have acquired beneficial ownership of more than ten percent of a class of equity securities whenever that person acquires any combination of stock or proxies, whether revocable or irrevocable, that would create a determination under 12 C.F.R. Part 574 that the person had conclusive or rebuttable control. This provision was designed to ensure that all attempts to exercise a controlling influence during the three years following

adopting these amendments it wanted to lessen the vulnerability of newly converted institutions to unfair attempts to take advantage of the results of the conversion.[59] This anti-takeover protection also provides converting institutions an appropriate amount of time to deploy conversion proceeds into more long-term assets and encourages management to focus on the day to day operations of the newly converted stock institution rather than being distracted by potential hostile takeover threats.

In addition to limits on acquisitions in excess of ten percent of the stock, a converting association is permitted to adopt as part of its plan of conversion certain anti-takeover charter provisions.[60] The significance of this provision is that it does not require the approval of the shareholders, unlike other anti-takeover provisions which may be adopted subsequent to the conversion.[61]

These charter provisions, which are set forth at Section 552.4(b)(8), provide that a converting savings association may prohibit, for a period of up to five years, (i) an offer to acquire or acquisition of more than ten percent of any class of equity security of the converted savings association, (ii) cumulative voting for the election of directors, and (iii) the ability of stockholders to call special meetings of the savings association relating to a change of control of the association or to charter amendments.

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conversion, including the use of a proxy contest, would be subject to prior regulatory oversight. *See* 51 Fed. Reg. 40149 (1986).

59 42 F.R. 14085 (1977).

60 12 C.F.R. § 563b.3(i)(6) (1996).

61 If the savings association is state-chartered, the institution must submit an opinion of independent counsel that such charter provisions are permissible under state law.

The provision limiting acquisition of more than ten percent of a class of stock also permits the converted savings association not to count any shares acquired in violation of the charter provision as shares entitled to vote and not to permit any such shares to be voted in connection with any stockholders meeting.

Under the OTS charter and bylaw amendment regulations,[62] a recently converted association may also adopt, with shareholder approval if required, additional anti-takeover charter and bylaw amendments. The OTS has generally taken a liberal approach to these types of amendments and only has required that the association furnish an opinion of independent counsel that a corporation chartered in the state in which the savings association has its principal office would be permitted to adopt such a charter provision.[63]

B. Acquisitions of Stock in Excess of Ten Percent

This rule on acquisitions of stock in excess of ten percent during the first three years after a conversion provides seven different factors that the OTS may rely upon to deny an application to make such an acquisition.[64] First, OTS will turn down an acquisition of stock that would frustrate the purposes of the conversion. A fundamental concern expressed in the conversion regulations is the prevention of manipulation of the conversion process by insiders or other third parties to acquire

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[62] 12 C.F.R. §§ 552.4(c), .5 (1996).

[63] The OTS, however, retains its ability to determine whether a proposed charter provision is inconsistent with the statutes and regulations that a savings association is subject to.

[64] 12 C.F.R. § 563b.3(i)(5) (1996).

inappropriate benefits or windfalls. This factor also ensures that an institution adheres to all post-conversion requirements, including the maintenance of the liquidation account, dividend and stock repurchase limitations and insider restrictions.

Second, the stock acquisition must not be "manipulative or deceptive." In other words, adequate disclosure concerning the proposed transaction must have been made to stockholders of the converted association. Generally, the OTS would look to the compliance with the disclosure and anti-fraud requirements as embodied in the Securities Exchange Act of 1934 in assessing whether a proposed acquisition would be manipulative or deceptive.

Third, the acquisition must not subvert the fairness of the conversion. In adopting the anti-takeover rule in 1976, the FHLBB stated that it would consider the following issues in determining whether an acquisition would subvert the fairness of the conversion: (i) the basis upon which the conversion securities will be purchased, including the method of valuation of any cash or exchange offer; (ii) the effect of the offer on the value of any stock not tendered insofar as the liquidity of the trading market will be reduced; (iii) the effect of any windfall profits to be derived by any party from the offer; and (iv) the potential that the offer will result in expropriation of the proceeds of the conversion.

Fourth, the acquisition must not result in injury to the savings association. OTS will consider the impact of the proposed acquisition upon the future financial and managerial prospects of the converted association and whether there would be any potential harm to the association. Among other things, the OTS will examine whether there would be any debt incurred in financing the purchase of the stock which

could result in unreasonable dividend pressures and whether any new management members meet appropriate standards of competence and integrity.

Fifth, the acquisition must not be inconsistent with economical home financing. Although this is of less concern today than in the past, this factor reflected the FHLBB's concerns that companies engaged in unrelated business activities would attempt to acquire control of recently converted savings associations and utilize the capital of such institutions for purposes unrelated to housing finance.

Sixth, the acquisition must comply with all legal requirements in addition to the requirements and policies of the conversion regulations. This includes obtaining all required regulatory approvals from other federal and state regulatory agencies.

Seventh, the acquisition must not interfere with the prudent deployment of conversion proceeds. FHLBB added this principle in 1986,[65] to clarify its authority to reject a proposed acquisition if it determined that the acquisition would disrupt the "institution's effort to adjust to its reorganization to stock form and prudently deploy its conversion proceeds.[66]

Section 563b.3(i)(3) provides that whenever any person acquires more than ten percent of any class of equity securities of a recently converted savings association without prior OTS approval, the securities in excess of ten percent "shall not be counted as shares entitled to vote and shall not be voted by any person or counted as voting shares in connection

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[65] 51 F.R. 40127 (1986).

[66] *Id*. at 40131-32.

with any matter submitted to the shareholders for a vote." The OTS also has opined that a savings institution on its own initiative may enforce the regulatory prohibition on voting shares held in violation of Section 563b.3(i).[67] The opinion provided that "under appropriate circumstances..., an institution could rely upon [section] 563b.3(i)(3) to disregard shares in excess of ten percent for purposes of voting and establishment of a quorum if the institution concluded that the beneficial ownership of such shares was acquired in violation of [section] 563b.3(i)(3).[68]

The OTS may require as a remedy for a violation that the person holding such securities immediately divest any securities in excess of the ten percent threshold. The OTS also may seek civil money penalties for any violation of the anti-takeover rule. Finally, the OTS has taken the position that any violation of Section 563b.3(i) may constitute a basis for denial of any other applications, such as a holding company application, filed in connection with a proposed acquisition.

V. MUTUAL HOLDING COMPANIES

A relatively recent development in the organizational possibilities for savings associations is the mutual holding company. In 1987, Congress authorized mutual savings associations and savings banks to reorganize themselves in a holding company structure, in which the holding company was owned by the mutual members.[69] The purpose of

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[67] FHLBB Op. G.C. (Oct. 23, 1984)

[68] *Id.*

[69] *See* Competitive Equality Banking Act, Pub. L. No. 100-86, § 107(a), 101 Stat. 577 (1987) (now codified in 12 U.S.C. § 1467a(o)).

this new structure was "[t]o afford all FSLIC or FDIC-insured mutual thrifts the opportunity to obtain new powers while remaining mutual institutions."[70] These powers included those of a multiple savings and loan holding company (except insurance activities) and of a bank holding company,[71] although not (by implication) the full range of powers available to a unitary savings and loan holding company.

The mutual holding company form has been modestly popular. OTS regulates between 30 and 40 such institutions. The number varies because some mutual holding companies leave the category through a conversion to full stock status, while new ones are created as mutual savings associations decide to undertake such a reorganization. For all savings associations, whether state- or federal-chartered, that wish to reorganize in the mutual holding company form, OTS is the chartering authority for the holding company.[72] This is also true for mutual state savings banks that wish their holding company to be treated as a savings and loan holding company and therefore make the appropriate election under section 10(*l*) of the Home Owners' Loan Act.[73] In the absence of a section 10(*l*) election, the mutual holding company of a state savings bank is a bank holding company regulated by the Federal Reserve;[74] the

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70 S. Rep. No. 100-19, 100th Cong., 1st Sess. 42 (1987).

71 *See id.*

72 *See* 12 C.F.R. § 575.3(b); 58 Fed. Reg. 44106-07 (Aug. 19, 1993).

73 *See* 12 U.S.C. § 1467a(*l*).

74 *See* 12 U.S.C. § 1842(g).

chartering authority for the holding company is the company's state of incorporation.

As a practical matter, the attraction of the mutual holding company structure has been less the expanded powers it offers (since the full range of unitary thrift holding company powers could be obtained through the formation of a holding company in a mutual-to-stock conversion) than the opportunity it provides to raise capital in an amount less than that required in a full mutual-to-stock conversion, while retaining the mutual ownership base. A standard mutual-to-stock conversion involves the sale of the entire ownership interest of a thrift, and, in part for that reason, OTS requires that the offering raise capital in an amount equal to the appraised value of the institution. A mutual holding company reorganization, by contrast, permits an institution to raise incremental amounts of capital, provided that the mutual holding company retains a majority interest in the subsidiary thrift.[75]

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[75] A mutual savings association may reorganize into a mutual holding company in three ways. First, under section 10(o)(1) of the Home Owners' Loan Act, a mutual savings association may conduct the reorganization by (a) chartering an interim stock savings association, the stock of which is to be wholly-owned (except as otherwise provided in section 10(o)) by the mutual savings association; (b) transferring the substantial part of the mutual's assets and liabilities, including all insured liabilities, to the interim stock association; and (c) amending the mutual's charter to read in the form of a federal mutual holding company charter. *See* 12 U.S.C. § 1467a(o)(1). Second, the preamble to the final rule describes a method in which a mutual savings association forms a subsidiary stock savings association, which charters its own subsidiary stock savings association. The mutual then merges with the second-tier subsidiary (with the stock institution surviving), and the former first tier stock association amends its charter to read in the form of a mutual holding company charter. *See* 61 Fed. Reg. 58144 (Nov. 13, 1996). Third, OTS has permitted a mutual to reorganize by (a) organizing a Federal interim stock savings association as a subsidiary; (b) having the interim organize a second Federal interim as a subsidiary of the first interim; (c) the mutual exchanging its charter for a stock savings association charter and the first interim exchanging its charter for a mutual holding company charter; and (d) the second interim merging into the former mutual, with the stock of the former mutual being transferred to the new mutual holding company and the cancellation of the former mutual's ownership interest in the mutual holding company. The third

OTS' recent regulatory actions regarding mutual holding companies have focused on two financial aspects of the mutual holding company structure, rather than on the activities available to them. First, OTS is concerned about the opportunity that the structure presents to benefit minority stockholders at the expense of the mutual holding company members. This has emerged where the subsidiary thrift pays a dividend, but the mutual holding company decides to waive its dividend payment. Unregulated, a waived dividend either would permit the thrift to pay an additional dividend to the minority investors or effectively would enable the minority shareholders to obtain a disproportionate amount of the stock in a second-step conversion to full stock status. To address this possibility, OTS has notified institutions that, for those mutual holding companies formed after February 1, 1995, OTS will require that in any second-step conversion of such a company the amount of stock issued to the former minority shareholders will be adjusted to reflect the effect of dividend waivers.

Second, OTS last year approved the concept of a multi-tier mutual holding company structure. Under this arrangement, the subsidiary thrift would organize a stock company that would own 100% of the thrift and in turn would be owned by the mutual holding company and any minority investors in the same proportions in which they had owned stock directly in the thrift. The industry's stated purpose in seeking to create a mid-tier holding company is to facilitate stock repurchases. Such repurchases at the thrift level would trigger adverse tax consequences because of a thrift's bad debt reserve; there is no similar tax effect if the

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alternative requires OTS to waive compliance with certain technical requirements in 12 C.F.R. § 575.6(a), (b).

repurchase is conducted by the holding company. OTS issued an advance notice of proposed rulemaking on this matter in November 1996;[76] it expects to publish shortly a proposed rule. In the meantime, OTS has approved (as of May 1, 1997) five applications to form mid-tier holding companies.

VI. CONCLUSION

The mutual form of organization remains an important part of the savings and loan industry. A mutual's system of governance differs from that of a stock institution, but that system, including the government regulations currently in place, has produced hundreds of successful and prudently managed associations. A mutual, moreover, is not locked into its current form of organization; it can make the transition to the stock form under the rules now in place that are designed to ensure an orderly adjustment to the different pressures that come with stock ownership.

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[76] *See* 61 Fed. Reg. 58144 (Nov. 13, 1996).