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MODERNIZING CORPORATE GOVERNANCE FOR MUTUALS -- PRESERVING MUTUALITY

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Since 1994 mutual savings institutions have operated in an increasingly favorable economic environment. As discussed in greater detail below, the right to self-determination of mutual institutions is no longer threatened by the intrusive activities of Congress, or mutual regulators and third-party acquirors. However, with the significant economic prosperity that mutuals have experienced they have become more attractive targets for special interest groups, depositors and plaintiff law firms. The good news in this is that mutuals are more capable of taking specific action to strengthen their corporate governance to ward off insurgent initiatives. On a national level, the policy position of the regulators and key banking regulatory committees should provide the needed support and security for these initiatives. Thus, mutual managers and Boards should not fail to use this opportunity to strengthen their corporate governance.

The Congress and State Legislature

In 1994 the mutual form of ownership underwent intensive scrutiny on Capitol Hill. The House and Senate Banking Committees held extensive hearings on the alleged evils of stock conversions, specifically insider advantages over depositors' "ownership interests." Some committee members actively discussed methods to distribute a portion of a converting institution's value to depositors; the FDIC, House members and the Shadow Financial Regulatory Committee suggested that this portion be as much as 70%. Some on Capitol Hill went so far as to suggest that the mutual form of ownership was outdated and, therefore, mutual institutions should be mandatorily converted to stock form.

On the state legislature level, there have been some initiatives less supportive of mutuality notably in New England. In Massachusetts, a Massachusetts Senate Committee considered a bill that incorporated a number of features specifically promoted by a group that has been active in attacking insurance industry demutualizations and was prominent in stalling the Cambridgeport conversion. The bill included such features as distribution of free stock to depositors, payment of legal fees of protestants and a mandatory set aside of a portion of the institution's capital in a charitable foundation. In Connecticut, the legislature passed a watered down version of a bill that originally would have transferred voting rights from corporators to depositors.

The Mutual Regulators

Largely in response to the flurry of Congressional activity in 1994, mutual regulators reassessed their oversight of mutual institutions. At the federal level, the Federal Deposit Insurance Corporation (the "FDIC") enacted a rule which effectively grants the FDIC "veto" power over all stock conversions but incorporated most of the OTS regulatory features governing conversions. Moreover, the FDIC rejected permitting mutual depositors to mandate their institution's form of ownership, and abandoned their efforts for legislative authority to implement a program that would distribute a major portion of the capital generated in conversions to depositors. Ultimately, the FDIC issued a letter affirming mutuality and the benefits to the banking system of its preservation.

The Office of Thrift Supervision (the "OTS") also scrutinized the mutual form of ownership with a particular focus on the distribution of insider benefits and the relative merits of the mutual holding company versus the full conversion.

This regulatory review resulted in two major revisions to the conversion regulations. The first in 1995 placed new limits on repurchases, use of ESOPs and postponed the time after a conversion when stock benefits could be granted to insiders. The second, a much more comprehensive revision, changed the fundamental basis upon which Boards should decide how to raise capital and how much. These regulations further revised the mutual holding company regulations reflecting the increased capital ratios that most mutuals enjoy today. The revisions added significant insider benefits to the mutual holding company regulations giving Boards added incentive to choose a partial issuance over a full conversion.

There were also proposals to merge the OTS into the Office of the Comptroller of the Currency ("OCC"). Proponents of such a merger argue that dual federal banking regulatory agencies is an obsolete system which is no longer beneficial in today's banking industry. Regardless of the merit of this argument, an OTS/OCC merger would likely result in mutual institutions being regulated by an agency that has no experience with mutual institutions or appreciation for their culture and historical commitment to the community. An OTS/OCC merger could also result in a uniform financial institutions charter which would not take into account the unique aspects of the mutual form of ownership. While such proposals are not dead, there is almost no current movement to merge the agencies, especially on Capitol Hill.

The Threat from Special-Interest Groups and Depositors

In 1994 national consumer groups, including the Consumer Federation of America criticized the mutual form of ownership. Their general message was that mutual managers were unjustly enriching themselves at depositors' and taxpayers' expense, thereby necessitating a change in the status quo. Such groups proposed granting a major share of a mutual's net worth to depositors and/or community projects. They also proposed the elimination of general proxies and the imposition of a new depositor/community democracy upon mutual governance.

In 1994 numerous depositors of mutual institutions organized their own community groups in order to protect their "ownership interest." Such groups monitored decisions of officers and directors of mutual institutions and, when disagreeing with such decisions, attempted to block them via proxy fights and/or petitioning courts and regulators. In North Carolina and Illinois alone, depositor-interest groups have successfully blocked or delayed activities initiated by Home Savings Bank, Graham Savings Bank, Scotland Savings Bank and Avondale Federal Bank for Savings.

Additionally, individual depositors filed multimillion-dollar lawsuits in New York, Ohio, North Carolina, Illinois and Wisconsin alleging improper activities on behalf of mutual officers and directors. In the conversion of one New York savings bank, Greenpoint Savings Bank, no less than six depositor suits were filed. In North Carolina and Wisconsin, depositors, in an attempt to block proposed merger-conversions, purchased newspaper advertisements and engaged in letter-writing campaigns condemning the transactions.

This period of insurgency was followed by almost a decade of relative inactivity. However, within the last few years there has been a resurgence in depositor activity, some of it spontaneous, some of it caused by individuals or groups which have followed a pattern of disruptive actions. These actions have taken place throughout the country, some taking place where mutuals are concentrated, others occurring in isolated locations such as California. The most controversial example in recent memory of a conversion involving a major institution encountering significant opposition was the conversion of New Haven Savings Bank. That case encountered significant political opposition with the Mayor of New Haven and local unions mounting a campaign to halt the conversion that involved public protests, litigation and intensive press coverage. It was finally resolved with New Haven Savings Bank completing its conversion after being required by the Connecticut Banking Commissioner to fund a charitable foundation controlled by the community with $25 million. This case was similar to an earlier conversion of Cambridgeport Savings Bank in Massachusetts which was opposed by local community groups seeking the formation of a community foundation and other concessions. However, the opposition in Cambridgeport was unsuccessful as compared to the success of the New Haven insurgents. Another example of insurgency was the recent mutual holding company reorganization of Clifton Savings in New Jersey. In that case, the insurgency was led by an individual whose reputation was made as an insurgent investor who conducted proxy fights with recently converted institutions often influencing their sale. He agitated for a position on the Clifton Board. When rebuffed, he resorted to litigation which was unsuccessful but eventually did frustrate Clifton's attempts to adopt its stock benefit plan. He then turned his attention to two other mutuals seeking to influence them to convert to the stock form. In one case he was able to have significant influence in causing a small mutual to issue stock in a mutual holding company reorganization. Most significant, is that recent insurgency has not been limited to institutions in the process of conversion but in several cases has involved mutuals with no stated intention to convert to stock form.

In the other case in New Jersey, involving a much larger institution, Spencer Savings Bank, the insurgent first sought Board representation personally criticizing the Board and management. He then sued the Board to reverse their refusal to give him Board representation and challenging their bylaws and governance procedures. Clearly a new pattern has emerged that involves mutuals with no stated intention to issue stocks publicly. In an unrelated but similar case far from New Jersey, San Rafael FS&LA, a depositor insurgent has undertaken a campaign to influence the conversion and sale of stock by the institution. San Rafael, like Spencer Savings, also sought to preserve its mutuality. All of these cases involve complex strategies to overcome the various corporate governance procedures that are designed to preserve the prerogative of a mutual Board of Directors to determine its own corporate form. They often cloak attempts to overcome incumbent defenses by resorting to challenges based on concepts embodied in the Sarbanes-Oxley reforms.

Safeguarding an Institution's Mutuality

Supportive regulatory policies by both the OTS and the FDIC and a Congress that has indicated little concern with issues peculiar to mutuals is a cause for a strong sense of political security. Unprecedented economic prosperity has also restored the financial confidence of the mutual thrift industry. Of course, this economic prosperity is also shared with the thrift industry as a whole. Equity securities in thrifts and banks have performed at record levels and attracted significant investor interest. As a consequence, the demand for common stock issued by converted thrifts is also at a high point. This reversal of fortune from the crisis years, however, has given rise to a new challenge for mutuals -- investors who are unwilling to accept an institution's commitment to its mutuality. Mutual Boards and managers must be prepared to meet these new challenges.

It is valid to consider alternative corporate structures, such as the private mutual holding company form of ownership. Such structures can preserve mutuality in that their formation involves the preservation of the essential elements of the mutual institution. It begs the question, however, to offer standard conversion or conversion by mutual holding company formation, with a minority stock issuance as solutions to Boards of Directors seeking to preserve their mutual form. For mutual managers wishing to preserve their institution's autonomy and mutual corporate structure, affirmative action means modernization. Mutual managers must implement programs to modernize those areas of their institution which are generally most susceptible to intrusive activities. These are the areas of corporate governance, depositor relations, business planning, employee tenure and compensation and corporate form. The implementation of such programs are particularly advisable during the period of a heightened sense of corporate accountability.

- <u>Corporate Governance</u>. In the area of corporate governance, mutual managers must modernize their institution's organizational documents, such as its mutual charter and bylaws. Commonly, these documents do not contain the most current protection permissible under applicable federal and state law. A number of new bylaw provisions have been preapproved by OTS which should be considered for adoption. At the state level, various legal precedents support revision and added protection for incumbent boards. Mutual managers must also review their institution's corporate polities and procedures (e.g., meeting minutes and committee structures). Such policies and procedures are consistently reviewed by regulators and invariably subpoenaed in litigation involving depositors and third-party acquirors. Mutual managers should also develop a contingency voting plan in preparation for the possible prohibition of general proxies.

- Business Planning. In this area, mutual managers must develop a sound business plan which fully justifies their institution's present balance sheet structure. Well-capitalized institutions without short- and long-term plans for their capital are exposing themselves to the public and private entities claiming a right to such capital. Additionally, mutual managers may consider developing a plan which will pay special dividends to depositors should their capital levels be higher than those necessary for future operations.

- Depositor Relations. In the area of depositor relations, mutual managers must review their institution's proxy-solicitation procedures, particularly for compliance with federal and state law and with a view towards possible hostile acquisition attempts. They must also review their form of proxy, depositor voting procedures, and any other procedures relating to annual and special meetings of depositors (e.g., communications among depositors). Additionally, mutual managers must educate themselves on how to confront insurgent depositor activity in an aggressive and decisive, but political and legal manner.

- Employee Tenure and Compensation. In this area, mutual managers must analyze their institution's present compensation structure and related compensation plans and/or agreements with a view toward regulator and depositor scrutiny. Compensation agreements can also be a valuable tool in combating hostile acquisition attempts.

- Corporate Form. Mutual managers must analyze their institution's corporate form and the ability of such form to preserve their institution's mutuality. It is quite possible that alternative corporate forms will better protect their institution's mutuality from intrusive activity. This analysis involves a wide array of different strategies. It includes a comparison of the relative security of the federal and state charters but more interestingly, with the private mutual holding company, can produce a wide range of permutations of different regulatory choices. For example a private mutual holding company with a mid tier could be subject to three different bank regulatory agencies calling upon the advantages of each.

In the end, the message for mutual managers is simple: Be prepared. Although the present mutual environment is in many ways more favorable than any time in the past, it is not so favorable that mutual managers should ignore the increasing attempts by insurgents to impose their objectives on incumbent boards. By acting affirmatively and instituting programs in the areas outlined above, mutual managers can limit their institution's exposure to intrusive activities. Correspondingly, they can preserve their mutuality and right to self-determination while prospering further.