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LEGAL UPDATES AND NEWS

Federal Reserve Issues Interim Final Rule on Dividend Waivers by Federally Chartered MHCs and Is Expected to Allow Grandfathered MHCs to Waive Dividends Pending Receipt of Comments on the Interim Final Rule

Introduction and Recent Board Action

The Federal Reserve Board (the "Federal Reserve" or the "Board") has issued an interim final rule (the "Interim Rule"), pursuant to Section 625(a) of the Dodd-Frank Act, regarding dividend waivers by mutual holding companies ("MHCs") chartered under the Home Owners' Loan Act (the "HOLA"). The Interim Rule, codified at 12 C.F.R. § 239.63(d), sets forth the procedures that MHCs chartered under the HOLA (which we refer to as "Federal MHCs") must follow in requesting the Board's approval of dividend waiver requests. The Interim Rule does not apply to MHCs of state savings banks that are chartered under state law. However, as discussed below, we anticipate that the Federal Reserve will also apply the dividend waiver standards for "Non-Grandfathered MHCs" (defined below) to state chartered MHCs that request dividend waivers. Comments are due on the Interim Rule by October 27, 2011, and we encourage all MHCs, whether or not chartered under HOLA, to submit comments to the Federal Reserve.

The Interim Rule is disappointing for several reasons. First, the Interim Rule requires a majority of the eligible votes of members to approve a waiver (the same standard applicable to a significant corporate event such as a mutual to stock conversion). As a practical matter, this would prohibit dividend waivers by all Federal MHCs notwithstanding the clear language of Section 625(a) of Dodd-Frank which provides that the Federal Reserve *may not object* to dividend waivers by Grandfathered MHCs if two conditions are met – (1) the waiver is not detrimental to the safe and sound operation of the savings association subsidiary, and (2) the board of directors of the MHC expressly determines that a waiver is *consistent* with the fiduciary duties of the board of directors of the MHC to its mutual members. (We believe both of these standards can easily be met.) Second, the Interim Rule requires Non-Grandfathered MHCs to satisfy additional onerous conditions before a waiver may be approved by the Federal Reserve, including either having a majority of the MHC's *entire* board of directors (exclusive of those directors who own stock in the subsidiary) approve the waiver or having all officers, directors and their associates, as well as tax-qualified and non-tax-qualified stock plans waive their receipt of dividends. Third, the Interim Rule leaves no doubt that the Federal Reserve has made little effort to understand the MHC structure and its benefits to community banks, and the rule's presumption that MHC dividend waivers create a conflict of interest for MHC boards does not bode well for MHCs that will need to interface with the Federal Reserve on transactional and other matters in the future.

Luse Gorman already has had several discussions with Federal Reserve staff regarding the negative impact of the Interim Rule and the Board's questionable statutory authority to require Grandfathered MHCs to obtain a member vote before the Board will approve their dividend waivers. Last week, we were advised in connection with a dividend waiver request we submitted to the Board on behalf of a Grandfathered MHC, that the Board would not object to dividend waiver requests by Grandfathered MHCs and would waive the member vote requirement of the Interim Rule pending the completion of the comment period on October 27th and the implementation of a final rule. We believe that the Board staff has acknowledged the legal and substantive issues associated with the member vote requirement for Grandfathered MHCs under the Interim Rule. However, the real challenge for all MHCs will be convincing the Federal Reserve that the dividend waiver standards applicable to Grandfathered MHCs should apply to all MHC dividend waiver requests.

Brief Summary of Interim Rule

The Interim Rule provides that all Federal MHCs must provide notice to the Board at least 30 days prior to the dividend payment date if the MHC intends to waive dividends. If the MHC before December 1, 2009 – was organized under Section 10(o) of the HOLA, issued minority stock, and waived dividends (a "Grandfathered MHC"), then the Board may not object to the MHC's waiving dividends if it satisfies three conditions. Specifically, it must submit a resolution and accompanying materials to the Federal Reserve to the effect that the dividend waiver would not be detrimental to the safe and sound operation of its subsidiary association and that the board of directors has determined that the waiver is consistent with the fiduciary duties of the board of directors to the MHC members. However, the Interim Rule also adds a requirement, not found in Dodd-Frank, that the MHC must obtain the approval of a majority of the eligible votes of members before it can waive dividends.

All other Federal MHCs ("Non-Grandfathered MHCs") are subject to more onerous conditions before they may waive dividends. These include (i) having non-stockholder directors, consisting of a *majority of the entire board of directors*, approve the dividend waiver, or having officers, directors and stock benefit plans waive the receipt of dividends, (ii) requiring the Board's non-objection to the amount of the dividend, and (iii) taking into account the amount of waived dividends in determining an appropriate exchange ratio in the event of a conversion of the MHC to stock form.

The Interim Rule follows Dodd-Frank in providing that the Federal Reserve will not take waived dividends into account in determining an appropriate exchange ratio in the event of a second step conversion of a Grandfathered MHC to stock form. However, waived dividends will be considered by the Federal Reserve in second step conversions by Non-Grandfathered MHCs.

Summary and Analysis of Interim Rule

The Interim Rule provides that all Federal MHCs must provide the Board notice and receive the Board's non-objection prior to waiving dividends. The Interim Rule then distinguishes between Grandfathered MHCs and Non-Grandfathered MHCs with respect to what actions an MHC must take for the Board to act on the waiver request.

1. *General Restrictions on Dividend Waivers.* Section 239.63(d)(1) provides that an MHC may waive the receipt of dividends declared by a subsidiary if: (i) no insider (or associate of an insider) of the MHC owns any shares of stock of the class to which the waiver would apply; or (ii) the MHC gives written notice to the Board of its intent to waive dividends not later than 30 days prior to the dividend payment date and the Board does not object to the waiver.

2. *Notice Requirements for all Federal MHCs.* The notice to the Federal Reserve must contain a resolution adopted by the board of directors of the MHC, together with supporting materials, stating that proposed dividend waiver is consistent with the fiduciary duties of the board of directors to the members of the MHC. The resolution must include the following:

(i) A description of the conflict of interest that exists between the MHC directors' ownership of stock in the subsidiary declaring the dividend and any actions the MHC and the board of directors have taken to eliminate the conflict of interest, such as a waiver of the directors' right to receive dividends;

(ii) A finding by the MHC board that the waiver is consistent with their fiduciary duties despite any conflict of interest;

(iii) If the MHC has pledged stock of the subsidiary as collateral for a loan to the MHC or is subject to any other loan agreement, an affirmation that the MHC is able to meet the terms of the loan agreement; and

(iv) An affirmation that a majority of the members of the MHC *eligible to vote* have within 12 months prior to the dividend declaration date of the subsidiary, approved a waiver of dividends by the MHC, and that any proxy statement used in connection with obtaining the member vote contained a detailed description of the proposed dividend waiver and the reasons for the dividend waiver, disclosure of the MHC directors' ownership of stock in the subsidiary declaring dividends and actions the board has taken to eliminate any conflict, and that any proxy given by the mutual members on the dividend waiver vote is valid for no more than 12 months from the date given.

3. *Standards for Board Approval of Waivers by Grandfathered MHCs.* The Interim Rule provides that the Federal Reserve *may not object* to a dividend waiver by a Grandfathered MHC if: (i) the waiver would not be detrimental to the safe and sound operation of the subsidiary savings association; and (ii) the board of directors expressly determines that the waiver is consistent with the fiduciary duties of the board of directors to the mutual members of the MHC. As a general observation, we believe that *not* waiving dividends would be detrimental to the safe and sound operation of the subsidiary savings association.

4. *Standards of Board Approval of Waivers by Non-Grandfathered MHCs.* Non-Grand-fathered MHCs are subject to the following additional requirements for receiving Federal

Reserve non-objection to a dividend waiver: (i) the savings association subsidiary must operate in " a manner consistent with the safe and sound operation of a savings association"; (ii) the board of directors of the MHC must expressly determine that the waiver is consistent with their fiduciary duties "despite any conflict of interest"; (iii) either (A) a *majority of the entire board of directors of the MHC approves the waiver*, and any director with direct or indirect ownership or control of shares of the subsidiary declaring the dividend, or who otherwise benefits through an associate from the waiver, has abstained from the board vote, or (B) each officer or director (or their associates) of the MHC and any tax-qualified and non-tax-qualified employee stock benefit plan in which such officer or director participates that holds any shares of stock of the class to which the waiver would apply *waives the right to received any dividend declared by a subsidiary of the MHC*; (iv) the Board does not object to the amount of dividends declared by a subsidiary of the MHC (considering the reasonableness of the entire dividend distribution declared if the waiver is not approved); (v) the waived dividends are excluded from the capital accounts of the subsidiary holding company for purposes of calculating any future dividend payments; (vi) the MHC accounts for all waived dividends in a manner that permits the Board to consider waived dividends in evaluating the exchange ratio in the event of a full conversion of the MHC to stock form; and (vii) the MHC complies with such other conditions as the Board may require to prevent conflicts of interest or actions detrimental to the safe and sound operation of the savings association.

5. Impact of Waived Dividends on Second-Step Conversions. The Interim Rule provides that the Federal Reserve will consider waived dividends in determining an appropriate exchange ratio in the event of a conversion of *a Non-Grandfathered MHC* to stock form. The Interim Rule specifically provides, consistent with Section 625(a) of Dodd-Frank, that the Federal Reserve will not consider waived dividends in determining an appropriate exchange ratio in the event of a stock conversion by Grandfathered MHCs.

Observations Regarding Impact of the Rule and Board Strategies

By any measure, the Interim Rule is a setback for MHCs that had anticipated that the Federal Reserve Board would take a fresh look at MHC dividend waivers in view of the capital raising success of the MHC structure and the key role that dividend waivers play in the attractiveness of the MHC structure and the ability of MHCs to attract capital. The Interim Rule, as drafted by the Federal Reserve, effectively eliminates the ability of MHCs to waive dividends. The basis of the Federal Reserve's position is the idea that a conflict of interest is created when an MHC board with members that own stock in a subsidiary elect to waive the receipt of dividends from that subsidiary, which will indirectly benefit those board members through their ownership of stock. The Board's conflict of interest analysis is overly simplistic and we believe that even if there is a conflict of interest (which we do not concede) it can be addressed in a far more investor friendly manner than that set forth in the Interim Rule. Consider, for example, how the potential conflict of interest associated with a decision by a mutual board to convert to stock form was addressed through the creation of a liquidation account in the converted stock bank. Conflicts of interest often arise, and regulators and boards have dealt with these conflicts without harm to investors.

We anticipate that with the input of the MHC community during the notice and comment period that expires on October 27th, the Federal Reserve will formally reconsider the member vote requirement for Grandfathered MHCs since it is clearly a substantive change that contravenes the specific requirements of Section 625(a) of Dodd Frank. If this is the result, then Grandfathered MHCs should be able to waive dividends regularly and without a member vote or dilution of public stockholders in the event of a conversion of Grandfathered MHCs to stock form.

For Non-Grandfathered MHCs, two things must happen before they can reasonably expect to waive dividends. First, the Federal Reserve must eliminate the member vote requirement. We have always maintained that such a vote incorrectly assumes that members have rights that are comparable to those of public stockholders. In effect, the Interim Rule elevates the rights of members, whose status is essentially in the nature of creditors of a bank, over those of stockholders at a time when the financial institutions industry is having difficulty attracting capital. If members do not have substantive ownership rights like public stockholders, the Federal Reserve's conflict of interest argument largely disappears. Second, the Federal Reserve must allow subsidiaries of MHCs to pay reasonable dividends and MHCs to waive such dividends without dilution of minority stockholders. MHCs may be better off not waiving dividends than waiving dividends but diluting minority stockholders as required by the Interim Rule. A number of state chartered MHCs have successfully implemented strategies of either not paying or not waiving dividends, and Non-Grandfathered MHCs should consider these alternatives if the Federal Reserve does not change some of the burdensome requirements in any final rule that is adopted.

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