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Why the Fed needs to amend its interim final rule on MHC dividend waivers

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Source: Luse Gorman Pomerenk & Schick PC

Since Bridgeport, Conn.-based People's United Financial Inc. formed the first mutual holding company (MHC) in 1988, more than 150 mutual institutions have opted for the MHC structure, and in the process have raised approximately $22.4 billion of new equity capital (including second-stage conversions and secondary offerings). So why has the Federal Reserve Board (FRB) adopted an interim final rule (IFR) that would significantly impair the ability of mutual institutions to use the MHC structure to raise capital at a time when investors have very limited appetite for financial institution stocks? Moreover, why is the FRB targeting MHCs when there is no evidence that mutual members have been adversely affected by MHC dividend waivers?

According to the FRB, the IFR is necessary because a key component of the MHC structure — the ability of MHCs to waive the receipt of dividends — involves an inherent conflict of interest that is unfair to mutual members. To this end, the IFR will effectively prevent all federally chartered MHCs from waiving dividends under the guise of fiduciary responsibility. This would be highly problematic for MHCs, which must be able to both waive dividends and have their subsidiaries pay reasonable dividends without dilution to minority stockholders, in order to attract investors and capital. The FRB should make three changes to the rule that would more effectively address its conflict of interest concerns in a way that is consistent with the relative rights and interests of members and stockholders.

The interim final rule

In a nutshell, the IFR requires all federally chartered MHCs to annually obtain the approval of a majority of the eligible votes of members before they may waive the receipt of dividends. Federally chartered MHCs that were formed prior to Dec. 1, 2009 and waived dividends before that date (so-called "grandfathered MHCs"), are spared a host of additional restrictions that are punitive and effectively impose an insurmountable barrier to waiving dividends.

The boards of directors, management and stock plans of non-grandfathered MHCs must also waive their right to receive dividends as a condition to the MHC waiving dividends. Alternatively, a majority of the entire board membership must approve the waiver, with any director who owns stock that is the subject of the dividend waiver abstaining from the board vote.

As if these restrictions weren't enough, even if a non-grandfathered MHC's board and members approve a dividend waiver, the IFR seeks to insure that no such waivers will ever occur by requiring that waived dividends be factored into any exchange ratio in the event an MHC converts to stock form. This is another way of saying that waiving dividends will cause dilution to minority stockholders in the event of a conversion transaction.

Shortcomings of the IFR

The IFR is flawed on several levels. The Dodd-Frank Act is very specific in its directive to the FRB regarding dividend waivers by grandfathered MHCs. Section 625(a) tracks verbatim the former OTS regulations, and nowhere in Dodd-Frank is there any mention of a member vote to approve MHC dividend waivers. We believe that the FRB has exceeded its statutory authority in requiring such a vote.

Obtaining a member vote to waive dividends would also be a daunting challenge and a waste of corporate assets for most MHCs. The IFR requires that MHCs provide members a proxy statement describing the reasons for the proposed dividend waiver, and a majority of the eligible votes of members must approve the waiver. Some federal MHCs also do not have member voting, so the IFR would be creating new voting rights that are not contained in the charters or bylaws of these entities.

Getting members to vote would require an aggressive and expensive proxy solicitation effort. It would also involve significant legal, mailing and related expenses, all of which would reduce the capital resources of the organization that are available to members and stockholders alike.

It is puzzling why the FRB has singled out MHCs with respect to potential conflicts. It is also unclear why the FRB is requiring a member vote for something (declaring or waiving dividends) that is historically the prerogative of a board of directors.

The FRB's conflict of interest theory is misguided

All of the proscriptions contained in the IFR, as well as the IFR itself, are based on the FRB's concern that there is an "inherent conflict of interest" associated with MHC dividend waivers. Oddly, the IFR does not describe the conflict of interest or why this particular conflict warrants a rule that many believe would irreparably damage the MHC structure. The IFR rejects the practical and successful approach to dividend waivers contained in former OTS rules, notwithstanding the OTS's years of experience with MHCs.

The FRB's conflict theory, as described in its 1997 decision in the dividend waiver request of Greater Delaware Valley Holdings, MHC, has two essential elements. First, directors or trustees of an MHC who also own stock in their subsidiary bank or mid-tier holding company

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(collectively, a "subsidiary") that is declaring the dividends, personally benefit from the dividend waiver. This personal benefit results from "a transfer of value" from the MHC to minority stockholders because in addition to receiving their regular portion of the dividends declared, minority stockholders receive a pro rata interest in the waived dividends that become part of the retained earnings of the subsidiary. Second, the decision by a board to waive dividends is not reviewable by the mutual members.

An MHC dividend waiver does not transfer value from mutual members to minority stockholders

The FRB's value transfer argument assumes that (i) value that appropriately belongs to the MHC is being transferred to minority stockholders when an MHC waives dividends, and (ii) the transfer of value may be to "the detriment" of mutual members. Value can only be transferred from an MHC to minority stockholders if an MHC has the same ownership rights in a subsidiary's common stock as all other minority stockholders. While on the surface this would appear to be the case – both groups own the same class of common stock, on closer examination the common stock of a subsidiary held by minority stockholders represents a very different ownership interest than the common stock held by an MHC.

The shares of subsidiary common stock held by an MHC are not transferable, do not have the same voting rights, are not traded on an exchange and are not distributed to members when an MHC converts to stock form. Members have no economic stake or risk in the market performance of subsidiary common shares.

By contrast, the shares of the subsidiary held by the minority stockholders are transferable, subject to risk and typically trade on the NASDAQ. Moreover, the public shares are purchased for fair value and add to the overall capital of the MHC's subsidiary.

For example, in a full conversion of ABC Savings Bank, all of the shares of common stock have been sold and all shares are entitled as a matter of law and equity to receive the same dividend. But assuming the bank forms an MHC and sells 40% of its common stock, the new stockholders will have contributed additional capital to the new stock holding company for their 40% interest, while the MHC will have contributed no additional capital for its 60% interest.

Consider what would happen if ABC Savings Bank's MHC were to liquidate immediately after the minority stock offering. The mutual members, who indirectly "own" 60% of ABC Savings Bank through the MHC, would receive a windfall benefit equal to 60% of the capital contributed by minority stockholders.

The other concern of the FRB is that members may be harmed by MHC dividend waivers. While the interests of minority stockholders are definite and easily quantified by the cash investment that each stockholder makes in an MHC's subsidiary, the United States Supreme Court has concluded twice that the rights of members of a mutual institution are extremely limited and essentially of no value. See Society for Savings v. Bowers, 349 U.S. 143 (1955).

Members have the right to share in any remaining surplus of an MHC in the event of its liquidation or dissolution, but have no right to share in the earnings of an MHC. In the event of the failure of a bank, the depositors are protected by FDIC deposit insurance and typically suffer no loss. Conversely, in a bank failure, the minority shareholders will be first to incur a loss.

The FRB nevertheless assumes that members are disadvantaged when an MHC waives dividends, thereby foregoing an opportunity to increase its capital and, indirectly, the liquidation interests of members. It is unclear, however, whether accepting dividends actually benefits members. Moreover, if, as discussed below, waived dividends are added to a savings bank's liquidation account, then the liquidation interest of members actually increases as a result of waiving, rather than accepting, dividends.

Waiving dividends is consistent with the fiduciary duties of an MHC board to its members

An easy solution to the dividend waiver dilemma would have been for the banking regulators to allow MHCs to issue two classes of common stock, with substantially the same rights except with respect to the payment of dividends. This did not happen, so the logical step for MHC boards was to waive the receipt of dividends unless they had a need for those dividends.

The IFR and the former OTS regulations governing dividend waivers require an MHC board to determine that the dividend waiver "is consistent with the board of directors' fiduciary duties." Most MHC boards have concluded readily that a dividend waiver is consistent with their fiduciary duties for several reasons.

First, most MHCs are shell corporations with no operations and limited use for cash. This requires an MHC board to consider alternative uses for the cash that are in the best interests of the MHC organization as a whole.

Second, receiving a dividend will typically result in federal and state income tax on the dividends received by the MHC that can exceed 10% of the dividends paid. Paying taxes will reduce the overall capital resources available to the MHC group and particularly the subsidiary savings bank, and makes no sense from a safety and soundness perspective if the MHC has no use for the dividends. This, by itself, should be sufficient for most MHC boards to conclude that waiving dividends is consistent with, if not in furtherance of, their fiduciary duties.

Third, the cash dividends waived by an MHC can be retained by its subsidiary and contributed to the savings bank to support lending and overall growth. This growth will enhance the capital resources of the subsidiary, which will be in the best interests of members and all stockholders, including the MHC.

Lastly, MHC boards have concluded that since the public stockholders have invested risk capital in exchange for their shares, the MHC may not be entitled as a matter of equity to the same dividends as public stockholders. Additionally, since members have no right to participate in the receipt of dividends and will not benefit one way or the other from a dividend, a dividend waiver is in the best interests of the MHC and its subsidiaries.

The decision to pay or waive dividends is appropriately within the purview of a board of directors

The FRB should defer to the board of directors of an MHC in the exercise of its fiduciary duties, and respect the protections afforded such directors under the business judgment rule. As a matter of general corporate law and practice, boards of directors, not stockholders, determine whether to pay or waive dividends, and overlapping boards with an ownership stake in their subsidiary is no reason to deviate from this standard.

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The courts have recognized that directors sitting on boards of affiliated corporations owe a fiduciary duty to each corporation. In Delaware, the applicable standard requires that "individuals who act in a dual capacity as directors of two corporations, one of whom is the parent and the other the subsidiary, owe the same duty of good management to both corporations, and . . . this duty is to be exercised in light of what is best for both companies." See Weinberger v. UOP, Inc., 457 A.2d 701, 710-711 (Del. 1983).

The FRB's 1997 decision in the dividend waiver request of Greater Delaware Holdings MHC sheds light on its conflict of interest concerns. In that decision, the FRB also expressed the concern that trustees of an MHC are not elected by members and therefore cannot be removed by members. Most federal MHCs do authorize member voting and members elect directors. If members are dissatisfied with the actions of one or more directors, they can choose not to elect such persons. While members, like stockholders of a public corporation, rarely remove directors, this fact should not detract from the point that the decision to pay or waive dividends is appropriately a decision for a board of directors and not members or stockholders.

Changes to the IFR that will allow dividend waivers while protecting the interests of members

The IFR goes well beyond what is reasonable or necessary to protect mutual members when an MHC elects to waive dividends. The FRB should make the following three changes to the rule:

- Require all waived dividends to be added to a liquidation account of the subsidiary savings bank in the event its MHC converts to stock form. The waived dividends would be tracked and would not be available for distribution to minority stockholders.
- Allow all MHCs, including non-grandfathered MHCs and state-chartered MHCs, to waive dividends without dilution to minority stockholders in the event an MHC converts to stock form. The amount of dividends declared by an MHC's subsidiary would be subject to the review and approval of the FRB to ensure that minority stockholders do not receive dividends in excess of their share of the subsidiary's earnings.
- Require that proxy materials mailed to members/depositors to vote on an MHC reorganization clearly disclose the MHC's intent to waive dividends and how such waivers may affect members.

As a condition to approving MHC applications, the FRB previously has required applicants to commit that if any dividend waiver is granted, the amount of waived dividends would be a restriction on the retained earnings of the subsidiary savings bank, would not be available for distribution to minority stockholders, and would be added to the subsidiary savings bank's liquidation account in the event of the conversion of its MHC to stock form. This, by itself, should resolve the FRB's conflict concerns.

The restriction on retained earnings and the liquidation account would prevent minority stockholders, including board members who are also minority stockholders, from benefiting from the MHC's decision to waive dividends. Accordingly, since value has not been transferred from the members to minority stockholders, there should be no dilution of minority stockholders in the event of a conversion of an MHC to stock form. *i*

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